Rising Rates For Real Estate: Interest Rate Hedge Agreements Can Help

By: Malcolm K. Montgomery

The old proverb may be that “a rising tide raises all ships”, but in today’s rising tide of interest rates, real estate investors who fail to have an appropriate hedge program in place risk being overrun by the tide. The Federal Reserve has signaled its intention to continue the measured pace of short-term interest rate growth that has occurred over the past 15 months. During that period, the gap between the federal funds rate (the Fed’s benchmark short-term interest rate) and the Treasury’s 10-year note (a reference rate for many mortgage lenders) has narrowed to about one percent.1 Although many factors influence long-term rates, continuing increases in short-term rates make material increases in long-term rates more likely. Higher long-term rates in turn could expose certain segments of the real estate industry to considerable hardship.

Despite higher vacancy rates and reduced rent levels in some parts of the country, many landlords have remained profitable due largely to the low cost of borrowing. In addition, many real estate investment trusts have accumulated substantial debt loads as a result of years of acquisitions, rendering them particularly vulnerable to rising interest rates. Effectively managing interest rate risk will be of vital importance to many participants in the real estate industry in the months ahead. Indeed, Standard & Poor’s recently estimated that nearly one-third of the $30.6 billion in floating interest rate loans that it follows would mature in calendar year 2005.2 This represents the largest amount to mature in a single year over the next decade.3 The rates at which these financings will be refinanced, and the resulting impact, if any, on the performance of the real estate industry, have yet to be seen.

One of the principal ways in which real estate industry participants can mitigate interest rate risk is through the use of interest rate hedge agreements, which provide both borrowers and lenders with protection against escalating rates. The purpose of this article is to provide investors, lawyers, bankers and other real estate industry participants with an overview of interest rate hedge agreements and some of the negotiating points of which they should be aware. The article seeks to assist readers in ensuring not only that their hedge agreements successfully mitigate interest rate risk, but also that they are not inadvertently exposed to unforeseen risks in the process.
Basic Types Of Hedge Agreements

The three most common types of interest rate hedge agreements are caps, swaps and collars. Under an interest rate cap agreement, the borrower and hedge provider agree to a maximum interest rate. If the floating interest rate governing the underlying loan climbs above this maximum interest rate, the hedge provider pays the borrower the difference. In exchange for this service, the borrower pays the hedge provider a substantial one-time fee when the agreement is signed. The result is that the borrower is assured that it will not be required to pay interest at a rate higher than the maximum rate stipulated under the cap agreement. Thus, the borrower receives protection against any subsequent rise in interest rates without surrendering the benefits of any subsequent declines in rates.

Swap agreements convert a floating interest rate into a fixed rate. Under a swap agreement, the hedge provider offers a fixed interest rate to the borrower. If the floating interest rate on the underlying loan rises above this fixed interest rate, the hedge provider pays the borrower the difference. If, however, the floating interest rate falls below the fixed interest rate, the borrower pays the hedge provider the difference. When the payments between the parties under the hedge agreement are combined with the floating rate payable on the underlying loan, the net amount paid by the borrower will always equal the fixed interest rate stipulated in the swap agreement. Although there is generally no up-front fee associated with a swap, the borrower will be required to make payments to the hedge provider during periods when the floating interest rate is below the agreed upon fixed rate. The structure of an interest rate swap used to hedge a floating rate loan is illustrated in Exhibit 1.

A collar agreement sets both a maximum and minimum interest rate. If the floating interest rate governing the underlying loan remains between the minimum and maximum interest rates, the borrower neither makes nor receives any payments. If, however, the floating interest rate rises above the maximum interest rate, the hedge provider pays the borrower the difference. Conversely, if the floating interest rate dips below the minimum interest rate, the borrower pays the hedge provider the difference. The borrower is thereby exposed only to a confined range of interest rate fluctuations (i.e., fluctuations between the minimum and maximum rates), and is protected in the event rates rise above the prescribed maximum rate. In addition, while the borrower retains some of the potential upside associated with declining interest rates, the borrower surrenders the savings that would accrue if rates were to dip below the prescribed minimum rate. In exchange for this protection, the borrower pays the hedge provider an up-front fee, which is lower than would be required under a cap agreement.

International Swaps and Derivatives Association Master Agreement

The International Swaps and Derivatives Association (the “ISDA”) has created a master agreement (the “Master Agreement”) that is intended to function as a comprehensive document reflecting the collective experience of the derivatives industry. Although some hedge providers continue to use their own proprietary forms of hedge agreements, the ISDA Master Agreement has been widely accepted and has brought dual benefits of consistency and certainty to the industry.

The Master Agreement is made up of three components: the standard form Master Agreement, the schedule to the form (the “Schedule”) and the confirmation. The confirmation is a document or documents “confirming” the fundamental economic terms of the hedge agreement and is subject to the terms of the Master Agreement and the Schedule. In practice, the confirmation is often signed prior to preparation and negotiation of the form Master Agreement and Schedule. The standard form Master Agreement is not designed to vary from transaction to transaction. The Schedule is the instrument used by the parties to select among the various options provided for in the form Master Agreement and to otherwise tailor the Master Agreement.
to the specific transaction. The Schedule is the document into which the parties incorporate any negotiated points. The parties also may enter into a credit support annex under which a party that is “out of the money” may be obligated to post collateral to the party that is “in the money”. The credit support annex also is a standard form published by the ISDA.

Key Issues for Real-Estate-Related Hedge Transactions

Adoption of an interest rate hedge agreement can raise many issues. This article focuses on selected key topics.

Real Estate Security for Hedge Obligations

Many real estate borrowers are single purpose entities whose credit alone will often be insufficient to support the obligations under an interest rate swap or collar. In such circumstances, the same collateral securing an underlying mortgage loan is often used to collateralize the hedge obligations. This can give rise to unexpected issues.

Many lenders will not agree to share a mortgage with a hedge provider. Borrowers must therefore determine early in the process whether the hedge provider will require a mortgage as security, and if so, whether the lender on the underlying mortgage loan will agree either to share its mortgage or to pari passu priority with a mortgage securing the hedge. It may be possible to circumvent this problem by obtaining a hedge directly from the underlying mortgage lender, in which case either a single mortgage can be used or the two mortgages can be held by the same or affiliated entities. Alternatively, it may be possible for the borrower to identify a creditworthy guarantor of the hedge obligations in lieu of providing a mortgage. Borrowers with an interest in obtaining the best pricing for their hedge transactions (typically achieved through competitive bidding) should explore the structuring questions described above at the start of the financing transaction rather than deferring them to a stage at which the mortgage lender’s hedge provider affiliate may effectively be the only hedge provider from whom a required hedge product can be purchased.

Definite Obligation

Under the laws of some states, a mortgage must state a specific principal amount or definite obligation to be recorded and enforced. Under a swap agreement, however, the obligations of the borrower are by their nature indefinite. There is no principal obligation at issue and, depending on whether the agreement is “in the money” or “out of the money”, there may or may not be amounts payable by the borrower to the hedge provider under the agreement. If the hedge provider and the mortgage lender are the same entity, this problem can often be addressed by characterizing any swap payments as additional interest in the documents governing the loan and using a single mortgage to secure both the swap obligations and the obligations under the other loan documents. Alternatively, if the hedge provider is a separate but affiliated legal entity, the mortgage lender may agree in the loan documents to advance, as so-called “obligatory advances”, any payments due from the borrower to the hedge provider under the swap agreement. Such obligatory advances are then secured by the mortgage and, because of the obligatory nature of the advances, the priority of the lien securing them can in some states relate back to the date the mortgage is first recorded. If the hedge provider is a third party unaffiliated with the mortgage lender, neither of the above approaches to the indefinite mortgage problem may be available.

Mortgage Tax

In states that impose a mortgage recordation tax, two separate taxes will be imposed if the mortgage lender and hedge provider are granted separate mortgages. If the lender and hedge provider are the same entity, the second layer of mortgage tax can often be avoided by using a single mortgage and characterizing any payment obligations under the hedge agreement as additional interest under the loan documents. Such a
characterization will not be an available option if the hedge is secured with a separate mortgage.

**Title Insurance**

If the hedge provider seeks to secure its hedge with a mortgage, it is likely to also seek title insurance to insure the lien securing the hedge obligations. Borrowers find it easier to deflect such requests in transactions in which the hedge obligations are not secured by separate mortgages. Indeed, where a single mortgage is used, some title insurers are willing to issue special endorsements insuring that the obligations under the hedge agreement are secured with the same priority as the obligations under the mortgage loan documents. Assuming the hedge obligations have been characterized in the mortgage as additional interest, hedge providers can generally be convinced that purchasing additional title insurance in respect of those obligations is unnecessary (and arguably redundant) given that title insurance policies on their terms cover interest payment obligations without the payment of additional premiums to the title insurer. If a hedge provider ultimately does require separate title insurance for a swap or other hedge agreement, a debate will likely ensue as to the proper amount of title insurance to purchase. For a swap agreement, the “lore” among New York practitioners is to purchase title insurance in a face amount equal to ten percent of the notional amount of the swap.\(^\text{10}\) Given the high price of title insurance in many states, however, borrowers are well advised to structure their hedge arrangements to avoid the necessity of separate title insurance.

**Cross-Defaults**

A default by a borrower under a mortgage loan agreement with respect to which a hedge agreement is in place will typically trigger a cross-default under the related Master Agreement. Similarly, an event of default under the hedge agreement, particularly an event of default that results in an early termination of the hedge, is typically an event of default under the mortgage loan agreement. Hedge providers often propose a broad cross-default provision in the Schedule to the Master Agreement, which may reference defaults by affiliates (broadly defined) of the borrower in respect of separate financial obligations to the hedge provider (or its affiliates) above a certain threshold amount and defaults by affiliates under separate hedge agreements with the same provider. The parties can negotiate what parties should be included in the cross-default provisions as so-called “Specified Entities”, and what parties should be excluded.

Borrowers are cautioned to consider carefully the implications of broadly defining the category of Specified Entities that may trigger a cross-default under a hedge agreement. Consider, for example, a situation in which a particular borrower and its affiliates have numerous loans and associated interest rate swap agreements with a particular lender. If the cross-default provisions of the Master Agreements governing the swap transactions refer to affiliates of each borrower, the lender may be permitted to terminate all of the swap agreements (or, worse for the borrower, be permitted to choose which swaps to terminate and which to leave in place) upon a single event of default by a single affiliate under a single swap agreement. In turn, as noted above, the termination of each swap agreement by the hedge provider will likely trigger an event of default under the related mortgage loan documents. Borrowers should take special care to negotiate the cross-default provisions of the Master Agreement in order to avoid the potential for one under performing property to trigger an avalanche of cross-defaults on “out of the money” hedges.

**Treatment in Bankruptcy**

The US Bankruptcy Code was amended in 1990 to protect hedge providers from the potential catastrophic effects that could arise from the failure of a financial institution with significant exposure to derivatives. Provisions were added to the Bankruptcy Code exempting swap agreements from:
Operation of the automatic stay

The right of the bankruptcy trustee to assume or reject executory contracts

The prohibition on ipso facto clauses making bankruptcy an event of default

Limitations on set-off rights

The Bankruptcy Reform Act of 2005, effective as of October 17, 2005, further clarifies and expands these “safe harbor” provisions to cover a wider range of derivative products and eligible participants. The overall effect of the 1990 and 2005 amendments is to permit a party to a hedge agreement to terminate the agreement, offset and net out any payment obligations owed under the agreement (including the netting of termination values or payment amounts across multiple transactions between the same counterparties) and apply any margin collateral held in respect of those obligations notwithstanding the bankruptcy of the hedge counterparty – all without having to obtain permission from the court.11

The lesson here is that the bankruptcy-related provisions of the Master Agreement are likely to be enforced as written by a bankruptcy court. The filing of a bankruptcy petition will trigger an event of default under the Master Agreement that can be used by the hedge provider as a basis for terminating the hedge agreement and exercising its offset and netting rights. The terms of those rights may become particularly important, as they could have a significant impact on the financial value of the hedge transaction both in and outside of bankruptcy.

Offset Rights

Certain offset rights may have a significant negative effect on the value of a hedge agreement. For example, a relatively common offset clause is known as a “disguised walk-away” provision. Such a provision provides that a non-defaulting counterparty has no obligation to pay a derivatives settlement amount to a defaulting party unless all liabilities of any kind then owing by the defaulting party and its affiliates to the non-defaulting party and its affiliates have first been paid.12 While one can argue about the intrinsic fairness of this provision outside of a bankruptcy, consider the impact of the provision once a bankruptcy has been filed. If the hedge provider is an affiliate of the bankrupt borrower’s mortgage lender (as is often the case), the effect of the provision is to permit the hedge provider to argue that it has no payment obligations under the hedge agreement (even where the hedge is “in the money” for the borrower) unless the mortgage loan is paid in full, notwithstanding the existence of the bankruptcy case. Borrowers would be well served to eliminate onerous offset provisions from their agreements.

Conclusion

Interest rate hedge agreements are complex and should only be entered into only after receiving advice from qualified counsel. The topics discussed in this article are some of the more important issues of which real estate market participants should be aware when working with hedge agreements. Bearing these points in mind will help ensure that one is not taking on unforeseen risks when attempting to mitigate interest rate risk.

Exhibit 1

Fixed-for-Floating Interest Rate Swap

Notional Amount of Interest Rate Swap equals principal amount of Loan.
About The Author

Malcolm K. Montgomery is a partner in the Property Group of Shearman & Sterling LLP. He regularly represents real estate investment funds and other equity investors, as well as lenders to such investors, in transactions throughout the United States and abroad. Real estate finance transactions handled by Mr. Montgomery include multi-state secured credit facilities mezzanine financings, construction financings for single- and mixed-use projects, investment fund subscription financings, debt portfolio financings and hotel and resort financings. Mr. Montgomery received his B.A. from Princeton University in 1986 and his J.D. from New York University in 1989. He is a fellow of the American College of Mortgage Attorneys and a member of the Real Estate Financing Committee of the New York State Bar Association Real Property Section, the International Investment in Real Estate Committee of the American Bar Association and the Association of Foreign Investors in Real Estate.

The author would like to thank Karen Heymann, an associate with Shearman & Sterling LLP, and Shane Smyth, a former summer associate with Shearman & Sterling LLP, for their assistance in the preparation of this article.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

For more information on the topics covered in this issue, please contact:

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3. Id.
6. This issue does not arise in the context of interest rate caps, as the only payment made by the borrower to the hedge provider under a cap occurs upon signing the agreement. Thus, the creditworthiness of the borrower is irrelevant.
7. Providing real estate collateral to secure an interest rate hedge may be an alternative to entering into a credit support annex to the ISDA Master Agreement.
10. The “notional amount” is the principal figure used in the hedge agreement for the purposes of determining payments by one hedge party to the other. Depending on the type of underlying loan and the needs of the parties, the notional amount may be defined to equal (1) the aggregate principal loan balance of a term loan, (2) an increasing amount designed to equal at any given time the amount then outstanding under a construction loan or other multiple-advance facility; (3) an amount that amortizes as an outstanding loan balance amortizes; or (4) a portion of the principal balance of a loan where the borrower is hedging only a portion of its interest payment obligations.
12. See Davidson, supra note 9.