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HEDGING IN REAL ESTATE FINANCE TRANSACTIONS – FROM CAPS TO SWAPS

For a number of years, borrowers in the real estate finance market have predominantly hedged their loans using interest rate caps with the premium being paid in full upon execution of the finance documents. The rising cost of this approach has led to borrowers seeking to use interest rate swaps instead of (or alongside) caps as their preferred hedging instrument. This note considers the issues raised and the structuring implications of this hedging strategy, for both borrowers and their lenders.

Key Practical Points for borrowers:

- Consider pricing impact on the debt of using a swap-based hedging strategy.
- Full ISDA documentation will be required – consider developing a template to be used going forward.
- Hedge counterparties to be involved earlier in the documentation process to comment on the intercreditor provisions.

RISING INTEREST RATE ENVIRONMENT

In a low interest rate environment, the upfront premium for a prepaid interest rate cap is relatively modest and makes for streamlined transaction structures. As there are no ongoing payments to the hedge counterparty (following payment of the upfront premium), few (if any) intercreditor arrangements are required between the borrower, the hedge counterparties and the lenders.

For more than a year, rising interest rates have caused the premiums for interest rate caps to increase significantly. As a result, we are seeing an increased use of interest rate swaps for a number of real estate finance structures. As the mark-to-market value of a swap can vary over time (both with regard to quantum and the party which is "in-the-money" or "out-of-the-money") and can create a credit exposure to the borrower, hedge counterparties providing swaps for real estate finance deals will often require greater protections, such as being a secured party and potentially having voting rights for any closed out mark to market exposure to the borrower. This has credit, legal and practical implications for both borrowers and lenders.

INTEREST RATE SWAP DOCUMENTATION

Interest rate caps are often documented under standardised "long form confirmations" which are not typically subject to lengthy review or negotiation, though, if a loan may be securitised, provisions dealing with downgrade (including collateral posting and replacement), will need to satisfy the rating agencies' criteria.

As hedge counterparties providing caps have fewer structural protections (because the premium for the cap is paid in full up front), the counterparty is often only identified after execution of the main documentation and entry into

the cap is a condition subsequent to the funding of the loan. This avoids the need for the lenders and the hedge counterparties to fund the loan and trade the cap at the same time and the hedge counterparties are not involved in the finance documentation negotiations.

Where an interest rate swap is used, the hedge counterparty has an ongoing credit exposure to the borrower so full ISDA documentation is necessary, which requires negotiation between the borrower and each hedge counterparty on a bilateral basis. These negotiations should occur in parallel to those for the loan documentation in order to give the hedge counterparty sufficient time to review both the terms of the swap, its rights to the cashflows under the loan agreement and its overall intercreditor and security position. Although it is possible for the swap to be entered into as a condition subsequent, to avoid renegotiation after closing, the parties will need to be confident that potential hedge counterparties will be comfortable with these intercreditor and security positions (as well as the overall hedging requirements in the loan agreement).

As a practical point, we are seeing some borrowers develop their own template forms of ISDA documentation to be used in their real estate financing transactions. The ISDA documentation will include a form of Schedule to the ISDA Master Agreement setting out the key credit terms between the parties, and may also include a template Credit Support Annex which governs collateral posting by the hedge counterparty, typically following a rating downgrade of the counterparty. Moving from an interest rate cap to an interest rate swap hedging strategy does not, in itself, change the borrower's credit risk on the hedge counterparty (it may even be less under a swap) but some borrowers are using the negotiation of full ISDA documentation as an opportunity to revisit their counterparty risk analysis and to include a collateral posting obligation on the counterparty in certain circumstances. This needs to be accompanied by corresponding changes to the finance documentation to create swap collateral accounts, the contents of which are not subject to the general application of proceeds waterfall.

INTERCREDITOR ARRANGEMENTS

If an interest rate swap is used, the hedge counterparty will be a party to the facility agreement which will regulate the position between it, the borrower and the lenders. The counterparty providing the swap will be a "Finance Party" and the hedging documents will be "Finance Documents" for certain purposes. If the documentation for the deal includes an intercreditor agreement (because there is mezzanine or junior debt in the structure), provisions dealing with the hedging could be included in that document instead.

If hedge counterparties are secured creditors, the lenders will need to take into account their rights and interests. The willingness of a lender to agree to this may depend on the type of entity they are (e.g. a bank versus a debt fund) and the knock-on effects on the lender's financing arrangements. Unless the lender is a bank and is also providing the swap, lenders may not agree to hedging by way of a swap (versus a cap) and the resulting effect on their rights. Therefore, borrowers must compare the benefits of hedging interest rate risks using a swap against any pricing implications on the debt and this should be discussed with the lenders early in the transaction timetable.

Key Commercial Intercreditor Points:

- Ranking of the hedge counterparty
- Termination rights of the hedge counterparty
- Voting rights of the hedge counterparty
- Financial covenants for hedge counterparty payments

KEY COMMERCIAL INTERCREDITOR POINTS

Ranking

In terms of ranking, periodic payments under a swap usually rank alongside interest payments on the loan, and termination payments under the swap rank alongside principal repayments on the loan. This can vary, particularly where the lenders are also the hedge counterparties. Pre-financial crisis, it was not uncommon to see other arrangements including the hedge counterparty ranking super senior to the lenders in lieu of any meaningful voting rights.

For deals that are to be securitised, it may be worth considering whether termination payments to the swap counterparty should be subordinated where the counterparty is the defaulting party, which is the normal position on securitisations. This may be easier to negotiate where the same bank is the lender and hedge counterparty.

Termination rights

Hedge counterparties will often require a set of termination rights that can be exercised independently of any lender consent. The range of termination rights required will be more extensive than for a cap and, as a minimum, will include failure to pay under the hedging and insolvency, but may also include:

(a) where the hedge counterparty is also a lender, a right to terminate if their lending desk no longer has a lending position (depending on the reason for this); and

(b) a right to partially terminate the swap if the amount of the hedging exceeds a commercially agreed percentage of the outstanding debt (usually somewhere around 100%).

The former is usually requested because a hedge counterparty's credit approvals depend on them also being a lender in the structure on an on-going basis. In commercial discussions, borrowers and lenders will need to weigh this requirement against the risk of becoming unhedged if a lender leaves the structure.

As regards the latter, a requirement to reduce the notional value of the hedge if it goes above a certain level may already be a requirement under the loan agreement (since, the greater the amount of the notional value, the greater the potential mark to market exposure to the hedge counterparty, which the lenders will want to limit). Both the lenders and the hedge counterparties have an interest in maintaining a fairly constant proportionate exposure between lenders and hedge counterparties over time.

Voting rights

Where a loan is hedged by way of a cap, the only parties with the right to vote under the facility agreement are the lenders, however the picture is more complex with a swap.

Due to the potential credit risk taken by hedge counterparties providing the swap, they may require voting rights on certain key decisions, such as acceleration. They will push for voting rights to the extent that the swap has terminated and a crystallised termination amount is payable to them, the intention being that they should be treated similarly to lenders with respect to voting rights to the extent of that crystallised amount.

Although a market-standard approach has yet to emerge with regard to voting rights, borrowers and lenders may wish to consider the level of control that hedge counterparties would be able to exercise in practice; the value of terminated swaps (unless they are particularly long-dated) may not be significant when measured against the size of the loan debt and, if voting rights for the hedge counterparty are contemplated, those may only be triggered in certain circumstances, for example, after acceleration.

Financial covenants

The parties should carefully factor potential payments (both periodic and termination payments) due from the borrower under a swap into the financial model for the structure.

For the purposes of interest cover or debt service type tests, often no significant changes are needed to the drafting of the covenants to account for the use of swaps. The LMA documentation already provides that the definition of finance costs includes amounts payable or receivable by the borrower under any hedging agreements during the relevant calculation period, thus capturing payments made to, and received from, the hedge counterparty.

However, debt yield and loan-to-value tests have been (and may continue to be) scrutinised in more detail. The nature of an interest rate swap means that the borrower can, at any point, be "in-the-money" or "out-of the-money", leading to lenders and hedge counterparties questioning whether the mark-to-market should be captured in the "net debt" side of the calculation.

This was predominantly not the case before the global financial crisis when swaps were commonplace. However, some lenders may recall enforcements where large swap liabilities were crystallised and, as a result, those lenders may be more cautious. In practice, the crystallisation of large swap liabilities was often associated with borrowers entering into long-dated swaps, which we have not yet seen re-emerge as a trend. Going forwards, the inclusion of the mark-to-market in the debt yield and loan-to-value covenants is likely to be deal specific, depending on factors like the lender's underwriting, the leverage and the length of the loan.

EXISTING FINANCINGS

Over the last few years, many loans have been entered into on the basis that the term of the loan can be extended by the borrower (possibly with two, or even three, one-year extensions). The conditions to that extension are typically minimal. For example, no default has occurred and is continuing, and additional hedging is entered into to cover the period from the date of the extension of the loan to the new termination date, and otherwise such hedging is in line with the original hedging requirements.

However, the vast majority of those loans do not contemplate that the hedging would be by way of a swap. Assuming no outstanding default, borrowers will either need to enter into a cap (at a cost likely to be higher than they had anticipated when the loan was originated) or hedge by way of swap (unlikely if the extension period is only one year) and renegotiate the intercreditor position to allow for secured hedge counterparties. If the latter route is taken, it is possible that some lenders may use the opportunity to impose other conditions to the extension of the loan in light of the changed market conditions.

In addition, where a swap is introduced into an existing financing, it is important to consider whether the existing security is sufficient to cover any liabilities which are (or may potentially be) owed to the hedge counterparty. This may be an important consideration in certain jurisdictions (for example Spain) where the secured liabilities covered by the mortgage are likely to be limited to a certain percentage of the original loan amount and, when calculated at origination, will not have taken into account any liabilities arising under an interest rate swap.

LOOKING TO THE FUTURE

The case for borrowers using swaps over caps in the current interest rate environment is clear. Whether lenders will agree to the hedge counterparty having voting rights where hedging is done by way of an interest rate swap is less so. The slowing of the real estate finance market over the last year means that a consistent market approach is yet to emerge. When contemplating a swap based hedging strategy, borrowers should keep in mind the intercreditor position they are asking their lenders to agree to, as well as the practical implementation points considered in this note.

CONTACTS

Claire Fawcett
Partner, London

T +44 207006 8737
E claire.fawcett@cliffordchance.com

Will Winterton
Partner, London

T +44 207006 4386
E will.winterton@cliffordchance.com

Anne Drakeford
Partner, London

T +44 207006 8568
E anne.drakeford@cliffordchance.com

Phil Sandu
Senior Associate, London

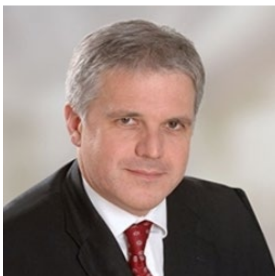
T +44 207006 2267
E phil.sandu@cliffordchance.com

Will Sutton
Partner, London

T +44 207006 3400
E william.sutton@cliffordchance.com

Barry O'Shea
Partner, London

T +44 207006 2017
E barry.oshea@cliffordchance.com



Andrew Carnegie
Partner, London

T +44 207006 4211
E andrew.carnegie@cliffordchance.com

Laura Smallcombe
Partner, London

T +44 207006 4546
E laura.smallcombe@cliffordchance.com

Emma Matebalavu
Global Head of Global Financial Markets, London

T +44 207006 4828
E emma.matebalavu@cliffordchance.com

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www.cliffordchance.com

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