INTEREST RATE HEDGING PRODUCTS

By Steven R. Davidson

Over the last five to ten years interest rate hedging products have become an increasingly common feature of real estate financing transactions. Many of these products are also referred to under the generic name “derivatives”. Derivative products have been the subject of much scrutiny during the past year due to several well publicized cases involving parties who lost substantial sums of money because of the use of derivatives. This article will explore the common types of derivative products used for interest rate hedging and why a borrower might choose to favor one product over another to hedge its interest rate risk in a loan transaction. Certain basic legal issues relating to the use of these products in connection with real estate financing transactions will also be explored. Despite the rash of negative publicity, derivatives still have an important place in financing transactions.

What is a Derivative?

There is no single definition of a derivative product. A derivative is sometimes referred to as an agreement or instrument whose value is linked to some underlying asset. That underlying asset can be one of any number of things, including a security, bond, currency, or commodity. The term “derivatives” covers a broad range of instruments including swaps, forward rate transactions, commodity options, bond options, foreign exchange transactions, cap, floor and collar transactions, and a wide variety of other instruments. While there are many standardized derivative instruments traded on major exchanges, the over-the-counter market offers a wide variety of products that can be customized for virtually any purpose.

Derivatives can be used to hedge risks ranging from the price of agricultural commodities to the exchange rate for foreign currencies. However, in financing transactions, the most
common risk being hedged against is the fluctuation in floating interest rates. For that reason, this article will focus on derivatives which are designed to hedge against such interest rate risk.

**Common Types of Interest Rate Hedging Products**

- **Interest Rate Swaps**
  An interest rate swap is a transaction in which one party pays an amount calculated by reference to a specified rate of interest and a hypothetical principal amount (sometimes called the “notional amount”) while the other party (sometimes called a “swap counterparty”) pays an amount calculated by reference to a different rate of interest based on the same notional amount. While the two interest rates chosen can be different floating rates, the most common type of interest rate swap involves one party making a payment based on a fixed rate of interest and the other party making a payment based on a floating rate of interest. When a borrower enters into an interest rate swap, it most frequently makes payments to the swap counterparty based on a fixed rate and receives payments from the swap counterparty based on a floating rate.

  An interest rate swap will often be obtained by a borrower when its loan is based on a floating rate of interest such as LIBOR (the London interbank offered rate) and the borrower does not want to take the risk associated with future increases in the floating rate. By carefully structuring the interest rate swap, the borrower can eliminate most of the risk of increasing interest rates. At the same time the borrower gives up the savings that otherwise would be achieved if floating interest rates declined. To better understand how the borrower effectively fixes its interest cost by using an interest rate swap, we need to review the mechanics of the interest rate swap in more detail.

  An interest rate swap is an exchange of interest payments -- there is no principal debt owed by either party to the swap (although frequently one party or an affiliate has
made a separate loan to the other party). For that reason, the agreement evidencing the interest rate swap is sometimes called an “Interest Rate Exchange Agreement.” In order to compute the interest payments exchanged, it is necessary for the parties to choose a notional amount. When the interest rate swap is entered into by a borrower to hedge the interest cost on a specific loan, the notional amount chosen is typically the principal amount of the loan. For loans having further disbursements, or scheduled amortization payments, a schedule of notional amounts that varies during the term of the interest rate swap can be used. If the borrower chooses to hedge only a portion of the interest rate risk, it can enter a swap based on a notional amount that is only a fraction of the principal amount of the loan.

The typical real estate borrower will pay an amount based on a fixed rate to the swap counterparty under the terms of the interest rate swap and in return will receive a payment from the swap counterparty based on a floating rate. After choosing the notional amount for the swap, the floating rate to be used must be selected. The floating rate chosen for the interest rate swap should be as close as possible to the applicable floating rate that the borrower pays to the lender under the loan. The payment dates and the dates on which the floating rate is reset under the terms of the interest rate swap agreement should also correspond to the dates that payments are due under the loan and the dates on which LIBOR interest periods expire under the loan. For example, assume the borrower has taken out a $10,000,000 loan with interest payments due on the 5th of each month based on an interest rate equal to one month LIBOR plus 200 basis points. If the borrower wants to use an interest rate swap to effectively convert that floating rate loan to a fixed rate loan, the borrower would choose an interest rate swap with a notional
amount of $10,000,000, payment dates on the 5th day of the month, and a floating rate index equal to one month LIBOR (the so-called “spread” payable in connection with the loan is usually not included in the terms of the interest rate swap agreement). The payments based on LIBOR that the borrower receives under the interest rate swap are passed through to the lender, and the borrower also pays to the lender the additional 200 basis point spread. The result is that the borrower’s interest cost under the loan does not vary even though LIBOR may vary substantially during the term of the loan. The borrower effectively pays a fixed rate equal to the fixed rate payable under the interest rate swap, plus the 200 basis point spread payable under the loan documents (this assumes no additional costs related to LIBOR are incurred by the lender and charged to the borrower under the note). However, the interest rate swap and loan remain separate transactions. The payment streams resulting from these two transactions resulting in the “effective” fixed rate cost to the borrower are illustrated in Table 1 on page ____.

Although the foregoing description implies that each swap party makes a payment to the other each month, typically the payments under the interest rate swap agreement are structured as net payments so that each month only one party is obligated to make a payment. Depending upon the current rate from time to time, the net amount due is paid by one party or the other. Over the life of a swap, payments can change directions many times. The swap is sometimes referred to as being “in the money” or “out of the money” for a party based on whether at that time the party is entitled to receive or obligated to pay the net payment.

The length of the term of the interest rate swap, like the notional amount, payment dates, and reference rate, is also important. If the borrower is trying to use the interest
rate swap to effectively fix its interest cost on a loan, it will usually choose a term for the
swap corresponding to the term of the loan. Although there is no money being borrowed
under the swap itself, the fixed rate quoted for the swap will vary based on the length of
the swap in a manner similar to treasury rates. With a normal yield curve the fixed rate
will get higher as the term gets longer.

Under an interest rate swap, both parties have continuing obligations to make
payments throughout the term. The ability of the parties to perform is therefore of critical
concern. Since many real estate borrowers are single purpose entities, the borrower’s
credit alone will not be sufficient to permit the borrower to enter into an interest rate
swap agreement. Unless the borrower’s obligations are guaranteed by a satisfactory
credit support provider, the obligations under the interest rate swap are often secured by
the real estate. (See discussion on page _____ for some special issues relating to using
real estate to secure obligations under an interest rate swap agreement).

Now that you understand the basics about how an interest rate swap works, you
may be asking yourself why the borrower in the above examples did not avoid the
complexities of an interest rate swap by simply obtaining a fixed rate loan in the first
place. There are a number of possible advantages to combining a floating rate loan and
an interest rate swap.

One of the principal reasons that interest rate swaps are used in combination with
floating rate loans is that many lenders providing these loans are not able to loan money
at a competitive fixed interest rate. Historically, insurance companies, pension funds and
other long term lenders have been providers of fixed rates. Banks, on the other hand,
have more commonly charged a floating rate of interest for their loans. When asked to
compete with the fixed rate proposals of long term lenders, banks often can not respond with competitive rates because of the way they fund their loans. Many banks have found that by offering an interest rate swap in combination with a floating rate loan they can successfully compete with the long term fixed rate lenders.

Interest rate swaps have not been only a tool to obtain a competitive fixed rate. They also provide greater flexibility in many cases when compared to fixed rate loans. A fixed rate loan typically will have a period during which prepayment is not permitted at all followed by a period during which there is a minimum prepayment premium associated with repaying the loan early, regardless of fluctuations in rates. A floating rate loan combined with a swap can be less restrictive. Typically a floating rate loan will have no prepayment prohibition and often will have no prepayment premiums. Although the breakage costs that Borrower would have to pay to terminate a swap early may be substantial if interest rates have declined, the borrower might actually receive a termination payment in connection with the swap rather than having to pay a prepayment premium if interest rates have gone up. Furthermore, since the swap is separate from the loan it does not necessarily have to be terminated when the loan is repaid. Accordingly, there is the possibility that the swap can be used to hedge the interest rate exposure on a different loan after the original loan has been paid.

In addition to the flexibility of allowing a swap to continue after the repayment of the loan, a borrower may also choose to enter into a swap after the loan has been made. For example, if floating rates are very low at the time the loan is closed, the borrower may decide to take the risk of some increase in the rate in order to take advantage of the low floating rates for as long as possible. While it is not unusual for lenders to require
that an interest rate swap be entered into to control its credit exposure, a lender will often give its borrower some flexibility to let the interest rate float as long as short term rates remain low.

- Interest Rate Caps.
  A second widely used interest rate hedging product is an interest rate cap. This product provides the borrower with protection against rising rates while still allowing the borrower to benefit if rates decline. Under an interest rate cap, the party supplying the cap agrees to make a payment to the borrower if a specified floating rate exceeds the applicable rate cap (sometimes called a “strike rate”). Let’s return to the example referred to above in which the borrower obtains a $10,000,000 loan at a floating interest rate of LIBOR plus 200 basis points. The borrower may purchase an interest rate cap based on LIBOR for a notional amount of $10,000,000 with a strike rate of 10%. This means that if LIBOR goes above 10% the borrower receives a payment from the cap provider equal to the difference between LIBOR and 10%, multiplied by the notional amount. The borrower has therefore effectively capped its interest cost at 10% plus the 200 basis point spread it is paying under the note regardless of how high LIBOR goes. Furthermore, the borrower still retains the benefit of declining rates with an interest rate cap. For example, if LIBOR falls to 5% the borrower pays only 5% (plus the 200 basis points spread).

  Typically an interest rate cap is purchased by the payment of an upfront fee. After that upfront fee is paid the borrower has no obligation to make payments in the future. This makes the interest rate cap a very attractive product to the cap provider because it takes no credit risk associated with the party purchasing the cap.
At first impression, the interest rate cap sounds like a good deal. The cap provider takes no credit risks associated with the borrower. The borrower protects itself against rising rates without giving up the benefit of declining rates. With these advantages, why doesn’t the borrower always obtain an interest rate cap? The answer to this question is the upfront fee that was referred to earlier. An interest rate swap can normally be obtained with no payment of an upfront fee. An interest rate cap usually has a substantial upfront fee (the lower the strike rate, the higher the fee). Therefore, borrowers are often willing to give up all or part of the benefit of declining rates in return for saving the upfront fee.

- Interest Rate Collars.

Although used less frequently than interest rate swaps or caps, an interest rate collar is a way for the borrower to reduce the upfront fee that would be payable with a cap and yet still retain some of the benefit of declining rates that the borrower would give up with an interest rate swap. An interest rate collar sets both a ceiling rate and a floor rate. If the specified floating rate index (again generally the rate payable by the borrower on its loan) exceeds the ceiling rate, the provider of the interest rate collar pays to the borrower an amount equal to the difference in such rates multiplied by the notional amount of the collar. If the specified floating rate is less than the floor rate, the borrower pays to the other party an amount equal to the difference between the floor rate and the specified floating rate multiplied by the notional amount of the collar. If the floating rate is between the floor rate and the ceiling rate then no payments are due from either party. Thus, the borrower still derives the same protection against rising rates from the interest rate collar that it would have if it entered into an interest rate swap or interest rate cap agreement. Furthermore, if rates decline, the borrower benefits from the declining rates
until the rates get as low as the floor rate. This is a benefit the borrower would have given up had it entered into an interest rate swap agreement. However, if rates go below the floor rate, the borrower no longer benefits from the declining rates as would have been the case had it purchased an interest rate cap. Not surprisingly, the fee payable in connection with an interest rate collar is less than the fee the borrower would pay to obtain an interest rate cap but more than the fee (if any) the borrower would pay to enter into an interest rate swap.

- **Other Products**

  Swaps, caps and collars are not the only interest rate hedging products available to borrowers. A “swaption” (an option to enter into a swap in the future) is just one example of the many additional products available in the marketplace. A discussion of such more exotic products is beyond the scope of this article.

**Legal Issues Associated with Interest Rate Hedging Products**

The use of interest rate hedging products can raise a number of regulatory, tax and other legal questions. This article will not attempt to comprehensively cover all of these issues. Instead, it will focus on some of the issues of greater interest when a real estate borrower obtains a floating rate loan and an interest rate hedging product.

- **Real Estate as Security for an Interest Rate Swap**

  A common form of security for a borrower’s obligations under an interest rate swap is a mortgage on the borrower’s project with a priority at least equal to that of the mortgage securing the underlying loan. However, an important technical point is that there is no principal indebtedness outstanding under a swap agreement. In some states, securing the indefinite contractual obligation (i.e., the borrower’s payment obligation under the swap) does not pose any problem, and the swap agreement simply can be
included in the list of obligations secured by the mortgage. The result in other states is less clear. In states where securing an indefinite contractual obligation is a problem, the documents are often drafted to recharacterize the amount due under the interest rate swap agreement as additional interest as long as the swap provider is the same entity as the lender. In many cases, however, the swap provider is an affiliate of the lender but a separate legal entity. With this structure, the lender often unconditionally agrees to advance to the affiliated swap provider any amounts due in connection with the interest rate swap agreement and these obligatory advances are then secured by the mortgage. Because of the obligatory nature of these advances, the priority of the lien usually relates back to the date of recording of the mortgage. Many major title insurers have been willing to issue special title endorsements insuring that the obligations under the swap agreement are secured with the same priority as the obligations under the loan documents based on the use of either of these two methods.

- Bankruptcy Issues
  Parties to a swap agreement should be concerned about several important rights that might be affected in a bankruptcy proceeding. The power to terminate a swap agreement following the bankruptcy of one of the parties without obtaining relief from the automatic stay is one of those rights. The ability of the parties to offset or net out termination values or payment amounts arising under multiple transactions between the same two parties is a second important right. Before 1990 there was great uncertainty as to the effect of a bankruptcy on the various rights of the solvent party to a swap agreement. Since 1990, Section 560 of the Bankruptcy Code makes it clear that both the right to terminate the agreement and the right to offset or net out termination values will be enforceable despite the existence of the bankruptcy proceeding.
Liability Issues

During the last 18 months there have been a number of well publicized instances of large losses related to derivative transactions. The losses were incurred by large corporations such as Proctor and Gamble and Gibson Greetings as well as by Orange County, California. With the vast publicity associated with some of these cases, it is not hard to understand why smaller entities such as those engaged in real estate financing transactions are also beginning to assert claims when the results of the derivative products that they purchased are not as expected. The claims made have included misrepresentation, breach of fiduciary duty, lack of suitability of the product sold, and violation of federal or state securities laws. Because this is an emerging area of the law, there is no clear guidance on many of the issues raised. As a partial response to some of the claims raised, many derivative dealers have incorporated into their standard documentation provisions comparable to those found in securities offering materials. These provisions include acknowledgments that the party entering into the transaction has consulted its own advisors and fully understands the nature and purpose of the product and is not relying on the provider of the product as an advisor in connection with the transaction.

Many interest rate swaps are provided by banks in connection with financing transactions. This creates the possibility of claims by borrowers that they were forced to enter into an interest rate swap with the bank or its affiliate as a condition to obtaining credit -- a possible violation of the Bank Tying Act (12 U.S.C. § 1972). Congress, when enacting the Bank Tying Act, intended to prohibit banks from extending their economic power with regard to the extension of credit into other markets where the banks may be able to force their customers to pay anti-competitive prices for products other than the
loan. It is not clear whether a loan and an interest rate swap obtained for the loan are two separate products such that they could be tied in violation of the Bank Tying Act. It can be argued that the swap is an integral part of the loan itself, and not a separate product. This is supported by the similarities between a fixed rate loan and a floating rate loan with a swap. However, there are no reported cases on this issue. It is certainly common to require as a condition of the loan that the borrower obtain an interest rate hedging product, so that it is less likely that the borrower will default on the loan should interest rates rise significantly. Because of the lack of clear authority under the Bank Tying Act, it is recommended that the bank keep careful documentation which shows that the borrower was not required to purchase the swap through the bank extending the credit but rather was free to obtain the swap from other providers in the market.

**Conclusion**

The derivative markets have grown dramatically. While the losses suffered by some and the resulting litigation may cause some to exercise some well-deserved caution, the markets can be expected to continue their expansion. The worst losses by parties using derivative products occurred when they were obtained for pure speculation and not for hedging purposes. Until someone develops a crystal ball that accurately forecasts movement in interest rates, these derivative products have a legitimate place to hedge interest rates in the real estate financing market.

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