

July 11, 2011

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Secretary
Board of Governors of the Federal Reserve
System
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Gary K. Van Meter
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Executive Secretary
Attention: Comments
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Department of the Treasury
Office of the Comptroller of the Currency
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Attention: Comments/RIN 2590-AA45
Federal Housing Finance Agency
1700 G Street, NW, Fourth Floor
Washington, DC 20552

Re: “Margin and Capital Requirements for Covered Swap Entities” / File Numbers RIN 1557–AD43, RIN 7100 AD74, RIN 3064–AD79, RIN 3052–AC69, and RIN 2590–AA45

The undersigned trade associations respectfully submit this letter in response to the request for comments by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, “the Regulators”) regarding the joint notice of proposed rulemaking entitled “Margin and Capital Requirements for Covered Swap Entities,” (the “proposing release”).

Our trade associations represent real estate companies that own, operate, develop, finance and invest in commercial and multifamily properties throughout the United States. As representatives of the commercial and multifamily real estate industry, an economic sector that was and continues to be heavily impacted by the market downturn starting in 2008, we appreciate your work to promote transparency and stability in the financial markets through comprehensive financial regulatory reform.

Yet, we remain concerned about the potential impact that new derivatives regulations may have on the ability of owners, operators and developers of commercial and multifamily real estate to utilize low-cost, customized, over-the-counter derivatives to manage risk. In fact, because of the commercial and multifamily real estate industry’s significant reliance on property

to secure its hedging transactions, the limited extent to which such companies carry cash or liquid securities on their balance sheets, and the significant interest rate risks inherent in the industry, we believe the proposing release would disproportionately burden real estate companies.

As an initial matter, we believe that the proposing release runs counter to Congressional intent by proposing to impose margin requirements on end-users. The statutory language and legislative history of Title VII of the Dodd-Frank Act are clear that no regulatory margin requirements are to be imposed on any end-user that enters into a non-cleared derivative transaction. On this fundamental issue, we wish to associate ourselves with the comments made by the Coalition for Derivatives End-Users.

Beyond this significant issue, our primary motivation for submitting this comment letter is to register our concerns about two issues: 1) the requirement in the proposing release that all end-users must enter into credit support arrangements with their counterparties; and, 2) that the proposing release would place significant limitations on the types of assets that would be acceptable to meet the collateral requirements established by those credit support arrangements.

If the final rule maintains these provisions, it may become impractical or impossible for many commercial and multifamily real estate owners and operators to use swaps to manage risks related to the financing of their properties. This, in turn, could potentially prolong the lingering weakness in the commercial and multifamily real estate market. Moreover, because the industry is inherently asset intensive and because asset intensive industries generally depend to a notable degree on debt markets, managing interest rate risk is a significant priority for real estate companies. Absent the changes discussed in this letter, the proposing release could structurally undercut the industry by diminishing the ability for many real estate companies to efficiently manage the uncertain liquidity burdens associated with the operation and funding of property.

Derivatives Use by Commercial and Multifamily Real Estate Companies

Commercial and multifamily real estate companies generally finance their investments in real property with a combination of equity and debt. Whether their debt financing generally comes from variable rate loans or fixed rate loans, these companies ultimately prefer predictable, fixed-rate payments on their debt in order to reduce volatility of interest expense – which for many real estate companies can be their single largest expense – and to better match their financing costs with the cash flows from their properties. Interest rate derivatives are often used to manage this risk and to provide predictability.

Real estate companies frequently borrow at variable rates. Sometimes this is a function of market practice. For example, lenders will only provide variable rate financing for construction loans and revolving credit facilities. Similarly, bank lenders, in managing their own interest rate risks, are often unwilling to provide long-term fixed rate financing. Additionally, some real estate companies may prefer floating rate financing for transitional properties, properties that are not fully leased, or properties for which holding periods may be uncertain. For these and other similar transactions, it is very common for real estate companies to enter into two simultaneous agreements: a variable rate loan and a fixed rate swap that serves to hedge against interest rate

risk on the loan. While virtually economically identical to a fixed rate loan, these arrangements provide a number of benefits to the borrower, such as greater prepayment flexibility as compared to fixed-rate loans and reduced cost as a result of increased competition among a more diverse pool of potential lenders.

In other circumstances, long-term investors in real estate may finance their real property holdings with long-term fixed rate debt. Because a company is unable to “lock in” a loan rate more than 30-60 days prior to the loan closing, these property owners also utilize interest rate derivatives to gain certainty related to their future interest rate expenses. Real estate companies with larger portfolios of property often have numerous fixed rate loans, for which they routinely work to stagger the maturities in order to avoid having to re-price substantial portions of their debt in any given interest rate cycle. However, it is not always possible to adequately stagger these debt maturities. For example, a real estate company may purchase a portfolio of properties with existing financing, causing its debt maturities to be concentrated at a single point in the future. To mitigate this risk, real estate companies often rely on interest rate swaps to “lock in” future long-term fixed rates for the period in which this debt will mature and be rolled over.

Certainty about interest rates is vitally important for real estate companies. Income streams for real estate companies are typically fixed through contractual lease agreements. If a company’s borrowing costs are subjected to a floating rate, or if it must refinance a large portion of its debt in an unfavorable rate environment, and income streams are insufficient to cover this expense, the company’s profitable operation may be at risk. Therefore it is not a surprise that, in many cases, real estate companies are required by their lenders to utilize interest rate swaps to ensure that sharply changing interest rates will not jeopardize their ability to meet their payment obligations.¹

Securing Derivatives Transactions in the Commercial and Multifamily Property Sectors

Many real estate companies have been able to access derivatives on an unsecured basis. But, to the extent that they are required to provide collateral for swaps, real estate companies have been able to pledge their real property assets. In fact, it is often the case that the same property or properties – and the cash flows they generate – can secure both a loan and a swap used to hedge the interest rate risk on that loan. As briefly described above, such arrangements have served real estate companies and their lenders well. From the lender’s perspective, the credit risk profile of a variable rate loan hedged with an interest rate swap is nearly identical to the credit risk profile of a fixed rate loan. Additionally, the nature of the underlying loan provides a number of benefits to the borrower, including lower upfront cost, lower prepayment penalties, and a broader pool of potential lenders to include those that generally will only lend on a floating rate basis.

¹ In fact, the OCC, Federal Reserve System, FDIC, SEC, FHFA and HUD recognize the risk reduction value of these arrangements in their proposed rules on Credit Risk Retention. Specifically, among the standards that must be met by “qualifying CRE loans” is that the interest rate on the loan must be either: “(A) A fixed interest rate; or (B) An adjustable interest rate and the borrower, prior to or concurrently with origination of the CRE loan, obtained a derivative that effectively results in a fixed interest rate.” (Federal Register, Vol. 76, No. 83, Friday, April 29, 2011. Federal Reserve RIN 7100-AD70. §__.19(b)(7)(iii).)

For risk management and other business purposes, owners of commercial and multifamily real estate often establish property subsidiaries, such as limited liability companies (LLCs), to own and operate each individual property or a portfolio of properties. These property subsidiaries are generally the parties to any debt that finances the property and to any swap that may be utilized to manage the interest rate risk associated with the loan.

Allowing real estate companies to pledge property as collateral on an interest rate derivative is helpful because real estate companies often do not have ready access to liquid collateral, such as cash. By allowing a borrower to pledge the same property and cash flows as collateral for both a loan and a swap on that loan, these arrangements take on credit risk characteristics very similar to fixed-rate loans. More importantly, these arrangements have typically limited the need for real estate companies to set aside significant amounts of liquid assets to satisfy either current or potential future margin payments because the combined value of the property and the future cash flows from the property will generally exceed even a stressed valuation of the swap and loan.

Without the ability to pledge less liquid assets, these companies would have to set aside cash in order to ensure their ability to meet margin requirements. This would be especially difficult for property subsidiaries, which generally do not have highly liquid assets. Further, even if the property subsidiary is owned by a parent company that may have greater access to cash resources, the parent company may not be permitted to contribute additional cash to the property subsidiary due to the terms of credit agreements it is a party to in its own right.

Moreover, if real property is determined not to be eligible collateral for swaps, as is proposed in the proposing release, regulatory and market pressures would require real estate companies and their property subsidiaries to preemptively set aside cash sufficient to satisfy margin requirements resulting from potential “worst case scenario” rate movements. This would be necessary to ensure that stressed market conditions do not preclude a property subsidiary from meeting its future obligations. This would be an extremely unproductive use of resources for a property subsidiary that could force a company to avoid utilizing these important risk-reducing products or limit its ability to deploy cash to real estate development or management operations that create jobs and generate earnings for the company and its investors.

In summary, actions by regulators that would subject hedging activities like the ones described above to margin requirements – especially if these requirements do not sufficiently allow the pledging of non-cash collateral – could significantly increase costs and would create liquidity risk for commercial and multifamily real estate companies, without any meaningful reduction of risk within the financial system. This is especially troubling at a time when these industries continue to face significant challenges in the current economic environment.

Credit Support Arrangement Requirement Runs Counter to Current Practices

The proposing release would broadly require each end-user to enter into credit support arrangements with each of their swap counterparties.² Further, the proposing release would allow Swap Dealers and Major Swap Participants (“covered swap entities”) to set “appropriate”

² § __.5

exposure thresholds in these credit support arrangements, above which they must collect margin from the end-users they face.³

This requirement represents a significant change in current practice for many real estate company end-users. As described above, it is commonly the case that both the loan and the related swap are secured by the same real estate project and the borrower is not called upon to post additional collateral under a credit support arrangement.

We wish to associate ourselves with the comments made by the Coalition for Derivatives End-Users that urge regulators to adopt rules that do not require the use of credit support arrangements for every counterparty relationship and that urge regulators to clarify that they have no supervisory role over credit support arrangement thresholds mutually agreed to by a covered swap entity and an end-user.

In the event that the Regulators proceed with rules that require credit support arrangements, or in the event an end-user and a covered swap entity bilaterally decide to enter into a credit support arrangement and establish an exposure threshold, we appreciate that the Regulators have indicated that, under the proposed rules, less liquid collateral could be used to secure swaps that do not exceed the threshold. In these cases, we encourage the Regulators to account for the additional security provided to a covered swap entity by an end-user like a real estate company that pledges property as collateral for a swap when they determine whether a credit support arrangement threshold is “appropriate.”

Furthermore, we urge the Regulators to modify their proposed rules to provide that the pledge of physical assets, such as real property or future income streams from that property, would be eligible to cover all of an end-user’s collateral obligations if its swap(s) exceed the agreement’s thresholds. While we recognize these assets are less liquid, such an arrangement would create virtually the same credit risk that a lender has on a fixed rate loan given that the loan and swap are cross-collateralized to each other and the lender and swap provider are generally one and the same, commonly controlled, or are otherwise participants in the primary financing. Should the appraisal the lender performs as part of their ongoing monitoring of the loan indicate that the real estate collateral is not sufficient to support the aggregate liabilities under the loan and swap, the lender and swap provider would have the same remedies that exist under a fixed rate loan.

By Limiting Eligible Collateral Proposing Release Overlooks Both Congressional Intent and the Benefits of Combined Loan and Swap Arrangements

The proposing release would dramatically limit the types of assets that would be considered to be eligible collateral in the circumstances in which margin would be imposed on end-users. Despite clear statutory instruction within the Dodd-Frank Act that regulators “shall permit the use of noncash collateral” when such an allowance is consistent with preserving

³ § ___.2(m) and § ___.2(bb)

financial integrity and stability,⁴ the proposing release states that only limited types of highly-liquid, high-quality debt securities,⁵ would qualify as eligible collateral.

Not only would this run counter to the intention of Congress, it would represent a major change from current market practice, which allows end-users to secure their transactions with a much wider array of liquid securities as well as less liquid assets, such as real property or other physical assets, under the terms of their swap agreements. By limiting the types of eligible collateral in this way, the proposing release would significantly and negatively impact end-users like real estate companies whose balance sheets are typically comprised of less liquid assets such as property.

The proposing release also fails to recognize that arrangements in which counterparties face each other for both a loan and a swap used to hedge risks associated with that loan have inherent benefits that argue for their continued availability.

- First, the swaps in such bilateral arrangements are utilized exclusively to hedge against commercial risk⁶, rather than for speculation. By using swaps to mitigate risk in this way, both the borrower and the lender can gain comfort that rising interest rates will not preclude a loan from performing.
- Second, bilateral arrangements in which a loan and a swap are secured by the same property and its cash flows increase the lender's protection in the unfortunate event of default by the borrower. Through their underwriting processes, lenders will typically structure such transactions to ensure that the potential liabilities incurred by the borrower due to the loan and the swap will not exceed the value of the property. In fact, it is generally the case that the combined value of the property and the future cash flows from the property will significantly exceed even a stressed valuation of the swap, thus eliminating the need for the borrower to post additional margin.
- Third, these arrangements can also protect the lender. In sharply rising interest rate environment a swap actually reduces a borrower's net liabilities. If a borrower defaults, the lender can utilize the positive value of the swap to offset some of its loan losses.

It should be noted that Congress recognized the inherent benefits of such arrangements in the way they crafted the swap dealer definition. Specifically, the swap dealer definition exempts insured depository institutions that offer swaps in connection with the origination of a loan.⁷ By providing specific treatment for such arrangements, Congress acknowledged the important role swaps play in reducing risks inherent in commercial borrowing and lending. Further, this

⁴ Dodd-Frank Act Sec. 731

⁵ § ____.

⁶ As the term "commercial risk" is defined in joint proposed rulemakings from the CFTC and the SEC related to further definitions of key terms, as well as the end-user exemption from clearing requirements, in which the proposing regulators have stated it would encompass "a fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's assets or liabilities."

⁷ Dodd-Frank Act Sec. 716(b)(2)(B)

exemption evidences that such arrangements do not carry the risks the Act was intended to address.

The Regulators should revise their proposed rules to comport with Congressional intent and to provide that non-cash assets, such as real property will be considered eligible collateral for end-users in swap transactions.

Financing Facilities Would Be Inadequate to Meet Margin Requirements and May Violate Existing Loan Agreements

The proposing release suggests that a secured financing facility could be utilized by an end-user that is prevented from pledging non-cash collateral to its swap counterparty.⁸ Such an arrangement would raise practical problems for real estate companies, while making no meaningful contribution to the mitigation of systemic risk.

Real estate companies that might pledge real property as collateral for a swap may be limited by their loan agreements with regard to their ability to post liquid collateral or otherwise incur additional indebtedness. In fact, a requirement to enter into an arrangement that mandates the posting of liquid collateral may cause real estate companies to violate existing loan agreements.

Existing loan agreements often include two features that, in combination, are antithetical to the proposed requirements. First, existing real estate loan agreements often preclude borrowers from posting collateral. Second, existing loan agreements often require hedging transaction to be executed at points in the future. A borrower may thus, for example, enter into a five year floating rate loan that requires them to hedge the interest rate risk for successive 1-year periods. If the loan precludes the borrower from posting collateral and successive hedges are required to be executed after new rules become effective, the borrower will either be in technical default on its loans (for entering into hedges that require collateral) or will be in violation of the law (for entering into hedge arrangements that do not require liquid collateral).

For these reasons, regulators should, at a minimum, not require such provisions to take effect when a hedge is required in connection with a loan entered into prior to the effective date of these new rules.

It should also be noted that the use of secured financing facilities to meet margin obligations would not reduce risk within the financial system; rather it would simply shift the risk from the derivatives market to other segments of the commercial system. The exposure would remain, but instead of existing between derivatives counterparties, it would exist between lenders and borrowers, thus raising the question of the value of such a policy.

⁸ “[C]ounterparties that wish to rely on other non-cash assets to meet margin requirements could pledge those assets with a bank or group of banks in a separate arrangement, such as a secured financing facility, and could draw cash from that arrangement to meet margin requirements.” 76 Fed. Reg. 27578 (May 11, 2011)

Conclusion

The margin requirements contemplated by the proposing release would significantly and negatively impact real estate companies that utilize derivatives to manage their commercial risk. The negative impact of these proposals on real estate companies would be further magnified by the proposed limitations on the ability of end-users to pledge less-liquid assets, such as real property, as collateral for their derivatives transactions.

The undersigned organizations strongly urge the Regulators to revise their proposed rules to be consistent with Congressional intent to exempt end-users from margin requirements altogether. However, if the Regulators proceed to promulgate rules that would impose margin requirements on end-users, they should allow the continuation of the current market practice that allows real property to serve as collateral for swaps. If this issue is not addressed, the ability of real estate companies to use derivatives to manage risk could be significantly curtailed.

We appreciate the opportunity to comment on this important matter that will directly impact the ability of real estate companies to effectively and appropriately manage risk. We stand ready to meet or speak the Regulators or their staff if they wish to discuss our comments further. If you have any questions related to this submission, please contact Kirk Freeman, Senior Director, Government Relations, at the National Association of Real Estate Investment Trusts at (202) 739-9400 or kfreeman@nareit.com.

Sincerely,

American Resort Development Association
American Seniors Housing Association
Building Owners and Managers Association International
CCIM Institute
Commercial Real Estate (CRE) Finance Council
International Council of Shopping Centers
Institute of Real Estate Management
NAIOP, the Commercial Real Estate Development Association
National Apartment Association
National Association of Real Estate Investment Trusts
National Association of Realtors®
National Multi Housing Council
Realtors® Land Institute
Society of Industrial and Office Realtors®
The Real Estate Roundtable