



Hedging in UK Real Estate Finance Transactions - Part 1



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We previously we took an **initial look** at hedging in real estate financing transactions. In this article, we discuss the various hedging products that we commonly see in real estate financings.

Common forms of hedges

Interest rate derivatives

In the UK, interest rate hedging on real estate debt is relatively common and may be undertaken at (i) an asset level or (ii) a portfolio level. Hedging a floating-rate loan via an interest rate cap or swap is perhaps the most common way of managing interest rate risk.

An **interest rate cap** will set a maximum rate that the reference rate of the loan can reach before the Borrower is compensated. This means that the Borrower pays a floating rate (reference rate plus margin) up until a predetermined threshold level (the “strike”), but when the reference rate surpasses the strike, the Hedge Counterparty will pay out the difference between the actual reference rate and the strike. The Borrower can thus limit their interest rate risk at a predetermined maximum level, and their interest rate costs cannot then exceed the loan margin plus the strike rate of the cap. In return for taking interest rate risk above the strike, the Hedge Counterparty will charge an upfront premium. Given such an upfront payment, the Borrower will want to ensure that in the derivatives documentation:

- a number of standard triggers in the ISDA documentation are disappplied with respect to the Borrower (as it has fulfilled its payment obligation upfront), and
- there are sufficient triggers linked to the credit-worthiness of the Hedge Counterparty that is the cap provider.

An **interest rate floor** will set a pre-agreed strike rate that is below the current reference rate. Borrowers with such a product will get compensated by the Hedge

Counterparty should the reference rate fall to a level below the strike.

An **interest rate collar incorporates** both a cap and a floor, protecting against substantial volatility in both directions.

An **interest rate swap** (linked to a floating rate facility agreement) would permit the Borrower to pay a fixed rate to the Hedge Counterparty with the floating payments coming from the Hedge Counterparty, thus allowing the Borrower paying a floating IBOR rate under their facility agreement to protect against rising interest rates. (Conversely, if the base rate is lower than the fixed rate, the Borrower will owe the Hedge Counterparty the difference.) Unlike a cap, the market value of an interest rate swap may vary significantly, so in the event of early termination, or a partial unwind to avoid over-hedging under the facility agreement, the Borrower will have to pay the negative market value (and conversely, the Hedge Counterparty will have to pay the positive market value – for example, when the market value for the remaining term of the swap is higher than the fixed rate of the swap).

Currency hedging

Foreign exchange forward contracts (FX forwards) permit the Borrower with a cashflow or outflows in different currencies to buy (or sell) one currency by paying with (or selling) a different currency at a certain point in the future. The benefit for the Borrower is having a known value of the exchange rate that will apply to a future payment when managing its property portfolio.

A **cross-currency swap** works in a similar way to interest rate swaps. The Borrower will exchange one currency into another at the then-current market rate. At the maturity on the swap, the Borrower will be able to exchange back to the original currency at the same exchange rate, thus eliminating any foreign exchange risk on the relevant asset.

In next month's *REF News and Views*, we will continue with our discussion on hedging in real estate financing transactions by discussing the frequently negotiated tension points between the facility agreement and the Hedging Agreement.