Response of the British Property Federation to the Consultative Document: *Margin requirements for non-centrally-cleared derivatives*, issued in July 2012 by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions

1. The British Property Federation is the voice of property in the United Kingdom, representing businesses owning, managing and investing in property. This includes a broad range of businesses comprising listed and private corporate property groups, private equity real estate fund managers and financial institutions including pension funds, as well as those professions that support the industry, including law firms, surveyors, accountants and consultants. We aim to create the conditions in which the property industry can grow and thrive, for the benefit of our members and of the economy as a whole, by providing the knowledge and expertise needed by legislators and regulators in the UK and overseas in taking decisions that affect our industry. We welcome the opportunity to respond to this consultation.

2. Our core membership comprises companies and funds which develop, own and manage real estate on a commercial basis (referred to below for simplicity as "**property investors**"). Such organisations commonly use OTC derivatives in order to reduce market risks that affect their business. It is from the perspective of that type of user of OTC derivatives that we make these submissions. As a result, we wish to comment on only certain of the questions raised in the consultative document. We have sought to identify in the text below the numbered question to which a comment relates.

Background

3. The most common example of OTC derivatives use by property investors is for the purposes of interest rate hedging. Property investors are commonly financed using a combination of equity and debt. Debt finance is often (particularly in certain markets, including the UK) principally available on a floating rate basis, exposing the borrower to interest rate fluctuations capable of rendering its financing costs too high relative to its generally stable and predictable rental income. Interest rate swaps are a prudent and effective way of addressing that risk, allowing the property investor to achieve what amounts to a fixed rate loan which matches the profile of its income. It is usual for the borrower's obligations under the swap to be supported by the same security (namely, the real estate assets being financed) as the associated loan, ranking pari passu with or senior to that loan.

4. Currency hedges may also be used by property investors, for example where their rental income is in a different currency from their financing or other operating costs, or for repatriating profits from overseas operations or hedging their overseas assets. In certain circumstances property derivatives may also be used as a risk mitigation strategy in the real estate market.

5. As the consultative document makes clear (on page 1), the ongoing move to improve the regulation of OTC derivatives markets was designed "*to limit excessive and opaque risk-taking through OTC derivatives and to reduce the systemic risk posed by OTC derivatives transactions, markets and practices*".

6. We fully support those objectives, but they should have no more than a modest impact on the use of OTC derivatives by property investors (or indeed the use of OTC derivatives by most other non-financial businesses), which does not involve "*excessive and opaque risk-taking*" and does not meaningfully contribute to systemic risk. The use of OTC derivatives by property investors manages interest rate risk in a way that recognises the fundamentals of the real estate business and promotes stability in a market that is prone to volatility, by enabling property investors better to match the

characteristics (including the profile) of their debt financing with those of their income. Regulatory intervention should not discourage that.

7. We note that the implementation of the G20's regulatory proposals in Europe (and elsewhere) rightly recognises that central clearing is not generally appropriate for hedging activity conducted by non-financial businesses. As a result, two quite distinct categories of OTC derivatives will be non-centrally-cleared under the new regulatory environment:

(a) OTC derivatives which are ineligible for central clearing because they are not sufficiently standardised; and

(b) OTC derivatives entered into by a non-financial business to hedge commercial risks of its business, for which central clearing is inappropriate.

8. We believe those two categories of non-centrally-cleared derivatives must be treated differently in the context of the proposals for margin requirements set out in the consultative document. In our view, it is neither appropriate nor necessary to use margin requirements to promote central clearing in relation to hedging derivatives entered into by non-financial businesses. Such derivatives are not speculative in nature and serve to **reduce** risk: unlike with the first category identified above, it is not the case that there is "*generally higher risk associated*" with them (page 2 of the consultative document).

Key message

9. Real estate market participants use derivatives as commercial hedges to manage risks to which their businesses are exposed, most commonly as part of their borrowing arrangements. They typically provide collateral in the form of security over the underlying real estate which, while illiquid, is generally appropriate in the context in which it is used. Their use of derivatives does not contribute to systemic risk. Regulators should ensure that regulatory interventions designed to reduce systemic risk and enhance the transparency and stability of financial markets do not undermine the effective existing operation of this fundamentally benign activity.

Detailed submissions

Element 2: Scope of coverage – scope of applicability; Q4 and Q10.

10. We strongly agree that derivatives to which a non-systemically-important non-financial entity is a party should not be subject to margin requirements, for the reasons given on page 9 of the consultative document.

11. It is worth making one tangential observation at this point, prompted by the second reason given on page 9 of the consultative document, namely that "*such transactions are exempt from central clearing mandates under most national regimes*". We are concerned that the way European legislators have drawn the distinction between "financial counterparties" and "non-financial counterparties" under the European Market Infrastructure Regulation ("**EMIR**") incorrectly classifies some property investors – namely, real estate funds which fall within the broad scope of the Alternative Investment Managers Directive ("**AIFMD**"), regardless of size – as "financial counterparties".

12. Such property investors, even those that are so small that they are not subject to authorisation under the AIFMD, therefore seem likely to have their hedging derivatives forced into central clearing and to be subjected to margin requirements as a result. That is an inappropriate outcome which is inconsistent with the broader regulatory approach and runs completely counter to the logic of excluding non-systemically-important non-financial entities from margin requirements for non-centrally-cleared derivatives.

13. Furthermore, this approach could actually be counter-productive, in that it will discourage property investors who pose no systemic risk from prudent hedging of commercial risks by margin requirements. Exposure to margin calls would needlessly impose very substantial burdens on property investors, because these are businesses without ready access to liquidity due to the nature of their activities. Significant interest rate movements which, of themselves, should not affect the stability and profitability of a prudently hedged property investor could render it insolvent if they give rise to margin calls. Many would be forced to seek alternative funding solutions such as fixed rate debt from institutional lenders – if available. Others might opt to take more interest rate risk than they otherwise would have done.

14. We believe that the regulatory regime should promote the continued prudent and efficient use of derivatives for hedging purposes by property investors, whether they are classified as financial or non-financial. To that end, it would be sensible to allow bank counterparties reasonable flexibility as regards the type of collateral they may accept from property investors, how that collateral is valued, and the circumstances (including as regards the application of thresholds) in which more liquid forms of collateral might be appropriate.

Element 1: Scope of coverage – instruments subject to the requirements; Q2

15. We consider that, contrary to the proposed key principle for Element 1, foreign exchange swaps, options and forwards should not be subjected to margin requirements regardless of their term. While we recognise the prevalence of short-dated contracts in the foreign exchange markets and the reduced risks associated with them we would argue that both short and long-dated foreign exchange contracts allow property investors (and others) to match their hedges to the maturity of their underlying risk in an efficient and effective way.

16. If that view is rejected and some foreign exchange contracts are to be subject to margin requirements, we agree that those investments with a maturity of less than one year are particularly unlikely to be a source of systemic risk and should be exempted from margin requirements. In this regard, we are primarily concerned with the position of non-financial businesses in the real estate sector which need to hedge currency risk associated with (and ancillary to) their commercial activities, having regard to the point made above, that some such businesses seem likely to be classified as "financial" while others are correctly classified as "non-financial" under EMIR in the European context.

Element 2: Scope of coverage – instruments subject to the requirements; Q5,Q6, Q7, Q8,Q9 and Q10

17. More generally, we have some concerns about the extent to which margin requirements – especially for initial margin – imposed on derivative transactions between banks could result in increased costs being passed through to ordinary businesses. The effect could be disproportionate economic costs for whatever systemic risk mitigation benefits might be achieved. For that reason, we would oppose full, two-way margining without thresholds. We would urge the working group to consider reducing or eliminating initial margin requirements applicable to bank counterparties when such counterparties are hedging risk in connection with customer business.

18. While we do not have the expertise to comment on how thresholds might best be calibrated, we would support a risk-based approach that sought to minimise margin requirements to the extent compatible with the policy objective of mitigating systemic risk. That could be achieved both by using thresholds and by focusing margin requirements on swap dealers and key market participants. This is particularly important because entities (including real estate funds) may be classified as "financial" which are neither swap providers nor systemically significant and use derivatives for commercial hedging purposes. Such entities should be distinguished and protected from the potentially harmful impact that burdensome margin requirements would have on their risk management practices.

19. One potentially helpful risk-based approach might include looking at loss given default (having regard to a counterparty's assets as well as liabilities), rather than simply at the market value of the derivative – such an approach would be similar to that adopted by IFRS 13. In the real estate context, this would allow real estate security from which the derivative benefits to be taken into account in an appropriate way.

Implementation and timing of margin requirements; Q1

20. It would seem reasonable to align commencement of new rules relating to margin requirements for non-centrally-cleared derivatives with the implementation of the wider reform of OTC derivatives (i.e. the introduction of the EMIR regime in the European context).

Element 4: Eligible collateral for margin; Q20

21. In the context of centrally cleared derivatives, where the robustness and stability of central counterparties is of absolutely critical importance, we can see that the forms of collateral that might be deemed appropriate need to be carefully controlled, having regard to value and liquidity in stressed conditions or other non-normal market conditions (such as those resulting from extensive quantitative easing). We believe a more flexible approach is more appropriate in the context of non-centrally-cleared derivatives. A further advantage of allowing a broader range of types of eligible collateral would be to limit the distortive impact of artificially increasing demand for, for example, government debt (if few other types of asset are eligible as collateral).

22. Therefore, while we recognise that, <u>as a general matter</u>, real estate is not an appropriate form of collateral for derivative contracts, chiefly because of its illiquidity, that does not mean that real estate is an inappropriate form of collateral in all cases. Particularly in the context of interest rate hedging alongside a floating rate loan used to finance real estate, it makes perfect sense for security over the real estate to support both the loan and the hedge. The bank's aggregate exposure will generally mirror the exposure it would have had on a secured fixed rate loan – which would, of course, have required no (non-real estate) margin such as is contemplated by the consultative document. This is, indeed, an excellent example of where "*...rules may be less stringent if an entity also enjoys some other effective protection against a counterparty's default*" (page 9 of the consultative document).

23. Banks should generally take into account both their exposure under the loan and their exposure under the swap when determining pricing, the loan to value at which they are prepared to lend and the extent of overcollateralization required from the underlying real estate. Real estate collateral also makes sense from the point of view of the property investor borrower: these are most commonly organisations that would not have ready access to the sort of highly liquid assets that would generally be eligible collateral for margin, and the interest rate hedging forms an integral part of a secured financing arrangement. Given that this kind of hedging activity, far from contributing to

systemic risk, reduces risk and enhances market stability, it would be perverse to disrupt it by preventing market participants from continuing to use real estate as collateral.

Closing remarks

24. We do not have the expertise to provide meaningful comments in relation to other aspects of the consultative document. Subject as stated above, we are broadly supportive of its approach. Real estate investment entities, whether belonging to investment funds, private corporate property groups or listed corporate property groups including REITs, are fundamentally non-financial and enter into commercial hedges of their borrowings which benefit from security over the underlying real estate, which is appropriate security in that context. Our greatest concern is that such non-systemically-important, non-financial entities should not be subject to a requirement to provide liquid collateral on their hedging derivatives. The effect of such a move would be damaging for them and counter-productive in terms of managing risk and market stability.

25. If you have any questions on any of the above, please contact Peter Cosmetatos on +44 20 7802 0115 or by email at pcosmetatos@bpf.org.uk.