EPRA

EUROPEAN PUBLIC
REAL ESTATE ASSOCIATION

28 September 2012

Consultative Document

Margin requirements for non-centrally-cleared derivatives

Basel Committee on Banking Supervision
Board of the International Organization of Securities Commissions

EPRA comments submitted electronically to the Basel Committee on 28 September 2012.

Introduction

The European Public Real Estate Association (EPRA) is the voice of the European publicly traded property sector. EPRA represents stock exchange-listed property companies who own, manage, acquire, sell, develop, refurbish, and operate commercial property. Our membership also includes the investment institutions who invest in the sector and the firms and individuals who advise and service those businesses. The institutional investors within EPRA's membership include the largest pension funds in Europe with a long track record of investment into the property sector. Between them our 200 members represent over €250bn of commercial property.

Since its establishment in 1999, EPRA have been representing the European listed property sector in its discussions with those bodies that are responsible for the regulatory framework within which the sector operates, including the European Commission, ESMA, EIOPA, the International Accounting Standards Board, the OECD, and national governments and regulators.

Background

The most common example of OTC derivatives use by property companies is for the purposes of interest rate hedging. Property companies that develop, own and manage real estate, finance these activities using a combination of equity and debt. Debt finance is often principally available on a floating rate basis, exposing the borrower to the risk that fluctuations in interest rates might render its financing costs too high relative to its rental income. Interest rate swaps are a prudent and effective way of addressing that risk, allowing the property company to achieve what amounts to a fixed rate loan which matches the profile of its income. It is usual for a property company's obligations under the swap to be supported by the same security (namely, the real estate assets being financed) as the associated loan.

Currency hedges may also be used by property companies, for example where their rental income is in a different currency from their financing or other operating costs, or for repatriating profits from foreign operations or hedging their foreign assets.

General comments

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*".

We fully support those objectives and note that the implementation of the G20's regulatory proposals rightly recognises that central clearing is not generally appropriate for hedging activity conducted by non-financial businesses. Our strong view is 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.

Our expectation is therefore that the new regulation should have no more than a modest impact on the use of OTC derivatives by property companies (or indeed the use of OTC derivatives by most other non-financial businesses).

Two quite distinct categories of OTC derivatives will therefore 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 not appropriate.

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.

It is crucial to note that property companies 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 transparency and stability of financial markets do not undermine the effective existing operation of this fundamentally benign activity.

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EPRA Comments

Implementation and timing of margin requirements (Question 1)

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).

Scope of coverage – instruments subject to the requirements (Question 2)

EPRA considers that foreign exchange swaps 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 companies to match their hedges to the maturity of their underlying risk in an efficient and effective way.

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 margining requirements.

Scope of coverage – scope of applicability (Question 4)

EPRA strongly agrees 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.

In addition, we also believe that the regulatory regime should not discourage the continued prudent and efficient use of derivatives for hedging purposes by property investors, whether or not they are classified as “financial” or “non-financial”[1]. 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.

Scope of coverage – instruments subject to the requirements (Questions 5 to 10)

EPRA has some concerns about the extent to which margining 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.

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

[1] It is not yet clear how the many different types of property investors will be classified under the Alternative Investment Fund Managers Directive (AIFMD). Businesses within the scope of the AIFMD are deemed to be “financial counterparties” under EMIR.

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using thresholds and by focusing margining requirements on swap dealers and key market participants.

Eligible collateral for margin (Question 20)

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 government debt (if few other types of asset are eligible as collateral).

Therefore, while we recognise that, as a general matter, 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. This is in particular true in the context of interest rate hedging alongside a floating rate loan where real estate security supports both the loan and the hedge. In this case, the bank's aggregate exposure will generally mirror the exposure it would have had on a fixed rate loan – which would, of course, have required no 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).

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.

Conclusion

Subject as stated above, we are broadly supportive of the objectives outlined in the consultative document. Property companies, including REITs, are non-financial businesses that 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.

For questions, please contact:

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