

Derivatives regulation

Analysis

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Funds will struggle to meet requirement to post cash as collateral for swaps, writes *Jane Roberts*

New derivatives code spells danger for property funds

Property funds are the investors most at risk from the effects of derivative regulations due to be implemented by the end of next year.

The concerns surround interest rate swaps, the derivatives property investors commonly use to hedge floating-rate borrowings. Under the European Market Infrastructure Regulations (EMIR), an EU-wide directive due to come into force by December 2012 (see panel), swap counterparties will have to post collateral to a clearing house, equal to the prevailing market-to-market value, plus an initial margin.

Crucially, as physical property will not qualify as collateral, cash will be required and outstanding contracts will be caught in the legislation in Europe, but not in the US.

At a breakfast meeting held in London by risk management consultant JC Rathbone Associates earlier this month, Bill Bartram, the firm's director, property risk, said: "The people most affected by these reforms will be property funds, which do not seem to have registered this as a threat."

Bartram said that the amount required to cover European property market outstanding contracts is likely to be more than £50bn. This would be "the Armageddon scenario", because property businesses do not usually hold large amounts of cash. As one member of the audience said, it can't be borrowed, either: "With bank liquidity only about £6bn annually in the UK, we would be lucky to find £10bn."

However, it is likely – although not yet certain – that many property investors will be safe. Exemptions to the definition of financial counterparties in the European Commission's draft Alternative Investment Fund Managers Directive (AIFMD) are



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supposed to be imported to EMIR, although this is not provided for in the current text of the EMIR directive. Property funds, however, are not included in the exemptions.

Chance of exemptions

If EMIR adopts the exemptions, quoted and large private property companies will come under the definition of the holding

companies exemption. Small property companies will also be exempt.

Nevertheless, Becky Worthington, financial director of Quintain, said the uncertainty surrounding this "commercially ludicrous" possibility is already a problem. She said one consequence is an increase in using caps instead of swaps.

"There are very few alternatives other than using a cap," Bartram says. "It would not be attractive to hold large deposits of cash, in readiness for margin calls, as this would dilute returns a lot. It is very easy to see a situation where existing funds are unwound early and demand for leveraged funds is reduced in the future."

Peter Cosmetatos, finance policy director at the British Property Federation, said the BPF's priority is "to secure a carve-out for directly invested real estate funds".

Property firms get swept up in hedge funds crackdown

The G20 Group of Nations' desire to reduce systemic risk in the financial world following Lehman Brothers' collapse encompasses derivatives. The aim is to move over-the-counter derivatives to clearing by a central counterparty.

In the EU, this is to be done through the EMIR directive, which will require all eligible derivative contracts (not yet defined, but believed to include interest rate swaps) to be transferred to a central clearing counterparty.

The directive's aim is to regulate financial companies that trade, rather than those that use derivatives to hedge, and non-financial

companies are exempt. However, EMIR's definition of financial companies has been imported from, among other places, the European Commission's draft Alternative Investment Fund Managers Directive.

This directive aims to monitor the activities of fund managers that are thought to create risk, particularly hedge funds, but property funds are also included in the directive.

Another draft of EMIR is due to be published soon, possibly on 24 January.

Real Estate Capital will publish a special issue on regulatory changes in March