



Banks need to rethink illogical hedging stance

A number of *EG Capital* articles have focused on how banks will deal with problem loans, with a variety of surveyors, property companies, accountants and financial services boutiques volunteering to help. The key always seems to be the active asset management these operations can offer; with the exception of the few willing to commit equity into the restructuring, the liability side of the balance sheet seems to be ignored.

When the Bank of England cut interest rates in response to the dire economic crisis, it is unlikely that it intended to exclude property investors from the lowest level of short and medium-term rates any of us have seen in our lifetimes. But with few exceptions, property companies had already hedged interest rate costs as a mandatory condition of CMBS issuance and many other bank loans.

Hedging usually came in the form of swaps or instruments that would create large mark-to-market losses if terminated. In quantifying the cost of terminating loans, banks now include this loss, even though it will be eradicated by the end of the loan period, if the hedging matches the underlying loan. Their rationale for doing so is that they have to put up reserves against this potential liability.

Including this 'loss' in the evaluation of any obligation, whether or not it is in default on loan-to-value or other covenants, has made most banks unwilling to look at any hedge restructuring where the borrower could reduce their funding costs.

Blending and extending hedging

When the market moved favourably, allowing borrowers to cut funding costs by extending swaps at a time of low interest rates, most banks were happy to 'blend and extend' swaps, as long as they were happy with the underlying asset value and income generation. While it would include a break clause coinciding with the end of the existing facility, it was usually taken as an enhancement of the credit, as it cut the refinancing risk if the loan were to expire at a time of high interest rates.

Now banks' neurosis over the temporary need to provide additional reserves against mark-to-market

losses has led them to adopt an illogical stance. They believe that blending and extending hedging means lending the mark-to-market loss over a longer period, which is unacceptable despite the fact that they are only required to post additional reserves if rates fall again.

Using the banks' logic, if interest rates were high, providing the borrower with a large mark-to-market profit, it would be fine if the borrower extended his hedge, however ruinous it might be to his business.

Banks need to change their thinking and allow borrowers to take advantage of market rates. Nobody expects rates to remain at today's levels for long; indeed, this realisation has led to a sharp steepening of the yield curve in the past couple of months. In refusing to extend hedging, banks are fully exposing borrowers to the potential for rates to be much higher when their loans, and hedging, expires in a couple of years time.

While loan-to-value problems have received all the attention, lower income levels as tenants default or negotiate lower rents mean that interest cover ratio covenants will come under pressure next. To accentuate that by not allowing borrowers to cut funding costs in line with lower income levels clearly risks producing more problem loans.

Many borrowers who would like to blend and extend their hedging would be more than willing to do so on the basis that a proportion, or perhaps all, of the additional net income was used to reduce the loan through more rapid loan amortisation. But in our experience, this has not persuaded banks to look logically at the resulting effect, rather than stare at temporary mark-to-market losses.

When rates rise again, banks will cease fretting about mark-to-market adverse hedge valuations and ponder on the great opportunity they have lost. Banks will probably be the biggest losers, as many more loans are likely to default as interest cover ratio covenants are triggered.

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