

Proposals to Regulate Over-the-Counter (OTC) Derivatives Should Not Limit a REIT's Ability to Prudently Manage Risk

REITs Background

Congress created real estate investment trusts (REITs) in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate. REITs combine the capital of many investors to benefit from a diversified portfolio of income-producing real estate, such as apartments, storage facilities, hotels, shopping centers, offices, and warehouses. REITs are required to distribute at least 90% of their taxable income to their shareholders – and many distribute 100%. In exchange for doing so, federal law grants a deduction for the dividends they pay – the dividends paid deduction (DPD), which in 2008 totaled about \$17.8 billion for listed REITs.

REITs Use Derivatives Products to Manage Risk

REITs and derivatives end-users rely upon low-cost, customized over-the-counter derivative products – such as interest rate swaps, interest rate caps, forward starting swaps, and foreign exchange forward contracts – to mitigate risk and to manage the costs of their development and operational activities. For some REITs, interest payments on debt can be their single largest expense. These derivatives products allow companies to add predictability and consistency to their income and balance sheets by minimizing the volatility and reducing the risk that are inherent in variable interest rate debt instruments as well as foreign currency exchange rates.

The Need for Reform

In the wake of the recent financial crisis, the Administration and Congress should enact financial regulations that enhance transparency and accountability while restoring stability to capital markets. However, it is possible to enact this reform and minimize systemic risk while still maintaining access to reasonably priced and customized OTC derivative products for business end-users seeking to control cost and manage risk.

Any Reforms to the OTC Derivatives Market Must Reflect the Concerns of Business End-Users

Over the past several months, various proposals have been introduced to reform the over-the-counter derivatives market. In general, each proposal has recognized the need to address the potential systemic risk posed by the 85-90% of derivatives transactions that are conducted between two major market participants, while also acknowledging the concerns of business end-users who are seeking to manage business risk and who are parties to only approximately 10-15% of all derivative transactions.

However, business end-users, including REITs and other commercial real estate companies, still have concerns about any requirements that would (1) require the



derivatives they utilize to be standardized and executed on exchanges, (2) centrally cleared or cash margined, or (3) subjected to capital charges that are not based on actual risk. Such requirements would create a significant drain on working capital and could limit companies' ability to access these important risk management tools.

For example:

Exchange trading would end customization and increase volatility on income statements and balance sheets. A company that uses derivatives to hedge a specific risk, such as a variable interest rate on a specific loan with specific terms, could not access a standardized derivative contract on an exchange that would adequately offset the risk. This could lead the company to be required to post significant periodic, unrealized gains or losses to its income statement, resulting in greater earnings volatility that undermines the risk management value of these derivatives.

Cash collateral requirements under central clearing or bilateral margining requirements would tie up significant amounts of working capital. REITs and other end-users can currently access OTC derivatives without being subjected to regular margin calls. For example, REITs can secure interest rate swaps with illiquid collateral such as property. Alternatively, the counterparty may rely on the REIT's overall credit position, much like an unsecured loan.

If derivatives used by end-users are required to be centrally cleared – or otherwise subjected to cash margin requirements – businesses may have to post significant and uncertain amounts of working capital at a time when liquidity is necessary for the financial health of companies.

Capital requirements intended to contain systemic risk should be focused where they will be most effective: on major market participants. It is appropriate for regulators to use risk-based capital guidelines to establish capital requirements for financial institutions to protect against losses from their assets, including derivatives transactions. Like other proposed regulations of derivatives that are intended to promote safety and soundness of the wider financial markets, these increased standards are particularly important for the vast majority of transactions – those that occur between major market participants.

Additionally, reasonable capital requirements based on the actual risk of default are appropriate for customized derivatives used by end-users to manage risk. However, it is not appropriate to set arbitrarily higher capital requirements for non-cleared trades, as some have proposed, to discourage over-the-counter transactions by end-users.

