Blogs
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Asset Management ADVocate

Re-Proposed Rule 18f-4: Features of Loan Commitments that May Prevent “Leveraging Effects"

In a previous post, we compared loan commitments, which re-proposed Rule 18f-4 would treat as "unfunded commitment agreements," and "to be announced" ("TBA") mortgage-backed securities ("MBS") trades and put options, which Rule 18f-4 would treat as "derivative transactions," to identify features that may be unique to loan commitments. Our last post showed how one feature, greater uncertainty as to the term of eventual loans as compared to the average life of the mortgages that underlie TBAs (in each case resulting from prepayments of the loans and mortgages, respectively), could prevent loan commitments from fluctuating in value. If the value of the commitment does not fluctuate substantially, the commitment cannot "present an opportunity for the fund to realize gains or losses between the date of the fund's commitment and its subsequent investment" and thus will not have a leveraging effect on the fund. Gauging the probability of drawings and prepayments is not a practical approach to regulating commitments by investment companies, so we will continue analyzing the potential leveraging effects of the unique features of loan commitments we previously identified. Two features, the right to terminate the commitment and the expectation that the commitment would be drawn, were uniquely present in loan commitments. Two other features, the availability of offsetting transactions and posting margin to secure the commitment, were uniquely absent.

Termination of Commitment

Besides having the right to prepay loans, the borrower typically has the right to terminate a commitment without penalty. A commitment fee (which is equivalent to an option premium) is paid over the term of the commitment, unlike the upfront payment of an option premium. The possible early termination of the commitment and related fees makes it less likely that another lender would make an upfront payment for an assignment or participation in a loan commitment, making it less likely that a fund could realize gains on the commitment. Therefore, this feature should substantially reduce the potential leveraging effects of a loan commitment.

Commitment Commonly Exercised and Offsetting Transactions Not Available

These two features are related and should be considered together. Unless a commitment is intended as back-up liquidity for another source of funding, few borrowers will pay commitment fees for loans they never intend to take. Thus, in most loan commitments, both the lender and the borrower expect loans to be drawn, even if not up to the full commitment. In contrast:

> most TBA trades do not ultimately lead to a transfer of physical MBS. In many cases, the seller will either unwind or 'roll' an outstanding trade before maturity, rather than physically settle it."

This feature of TBAs permits trading by investors who never intend to take delivery of the MBS. Some (like mortgage originators) may invest in TBAs to hedge interest rate risk, others to speculate. Regardless of the motivation, this feature allows funds to realize gains and losses on TBAs before their settlement date (when the commitment to purchase the MBS comes due). Offsetting trades are also readily available for TBAs and options. Offsetting trades provide opportunities for gain or loss on the initial commitment. For example, a fund will gain if an offsetting TBA has a forward price higher than the initial TBA. A fund will lose if the premium it must pay for an offsetting option is higher than the premium the fund received. Although a participation in a loan commitment resembles an offsetting trade, we have not seen a participant make an upfront payment to acquire a participation in a commitment. Thus, the standard means of laying off a loan commitment, by assignment or participation, should not provide an opportunity for a fund to realize gains or losses on the commitment (rather than on outstanding loans).

No Margin Requirement

Margin should be needed only if at least one party expects the commitment (rather than the underlying asset) to have value. To implement a margin requirement, the parties must determine the value of the commitment and changes in that value over its term. This implies that the parties expect the value of the commitment to fluctuate, which can produce leveraging effects. Thus, a requirement to post margin for a commitment is a strong indicator that the commitment has potential leveraging effects. The absence of a margin requirement does not mean that a commitment is not expected to fluctuate in value, as evidenced by the fact that before the financial crisis many OTC derivatives traded without margin and margin will not be required for TBAs until March 2021. However, the **presence** of margin would be a sign that a commitment should be treated as a derivatives transaction rather than an unfunded commitment agreement.

Conclusion

In our final post in this series, we will try to bring all our earlier posts together into some concrete recommendations for defining "commitment agreements."

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