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EXPERT COMMENTARY: Marc Mogull on EMIR

The European Market Infrastructure Regulation (EMIR) is Brussels' attempt to regulate OTC derivatives trading activities by financial entities. We can fret about AIFMD but, if rational minds don't prevail, we may actually have to do something about EMIR. By Marc Mogull, founder of Benson Elliot Capital Management

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The European Market Infrastructure Regulation ("EMIR") is Brussels' attempt to regulate OTC derivatives trading activities by financial entities.

Derivatives mean a lot of things to a lot of people, but for us they mean the interest rate swaps that we utilise to hedge interest rate risk on our property borrowings (either for reasons of prudence or as required by lenders). The goal of Brussels regulators in regulating these kinds of financial activities in the wake of the financial crisis – increasing transparency and improving the safety and stability of capital markets – is not offensive. Their methods, however, if not modified, will be offensive for those of us in the property fund management business.

The EMIR proposals reference the recently adopted Alternative Investment Fund Managers Directive ("AIFMD") in their determination of who is a "financial entity" (and thus comes under the EMIR regime). All of us in the property fund management business will be caught up in AIFMD, though I certainly wouldn't characterise Benson Elliot or our peers as "financial entities". This matters, because EMIR will require our swap activities to be cleared through exchanges, rather than be handled (as they are now) over the counter.

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Beyond the cost, the most frightening aspect of this change will be a requirement to mark-to-market those positions regularly, and post collateral in connection with negative valuation movements. We've always accounted for these negative valuation movements, but there was no cash movement – the swap liability would unwind as the underlying loan reached maturity.

Derivatives activities in our sector relate entirely to legitimate financial exposures. They are hedges, not speculative investments, and they benefit from the same or in many cases higher ranking security than the actual mortgage loans they support. We aren't engaging in the creation or trading of naked positions and, as such, our swap activities pose no threat whatsoever to financial stability.

This is so manifestly obvious, and the proposed regulations, insofar as they relate to our sector, are so manifestly ill-conceived, that I assume someone will realise this and carve us out. They'd better, because for leveraged funds the cost could be enormous. Two years ago, the unrealised swap loss on a medium term loan could easily have reached 10-15 percent of the loan amount. Assuming 60-70 percent gearing, that would mean unrealised swap losses equivalent to 15-35 percent of invested equity. An obligation to post that kind of collateral could devastate returns on geared property funds, and certainly would not be in the interests of fund investors.

We can fret about AIFMD but, if rational minds don't prevail, we may actually have to do something about EMIR.