



SIDLEY

Real Estate Bar
Association for
Massachusetts –
Derivatives 101

May 27, 2026

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Agenda

1. Products and Cash Flows:
 - a. Swaps
 - b. Caps
 - c. Collars
 - d. Breakage
2. Real Estate Finance Considerations
3. Derivatives Regulatory Considerations
4. Derivatives Documentation

1.

Products and Cash Flows

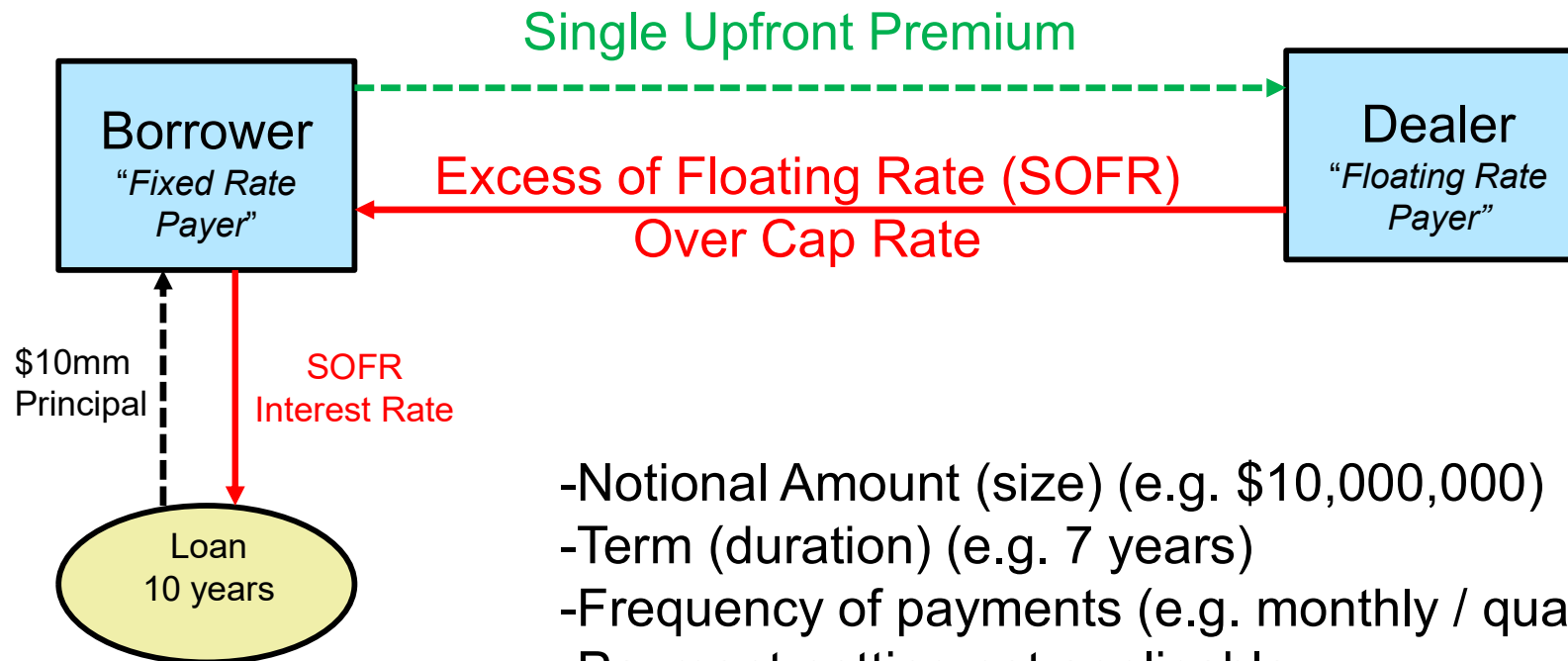
Types of Interest Rate Derivatives

- Swaps
- Caps / Floors (Options)
- Collars (combination of a cap & a floor)

Why do we use swaps, caps & collars?

- Interest rate swaps, caps and collars are commonly used to hedge floating rate debt
 - *Allows a borrower to synthetically fix (or cap) borrowing costs*
 - *Important for SPE/Limited recourse real estate borrowers who have limited cash flow/assets*
- In real estate finance, many credit facilities require the borrower to hedge interest rates
 - *Hedges provide lenders with credit and cash flow certainty related to the borrower's ability to cover rising interest rates*
 - *Caps may allow for higher LTV lending*

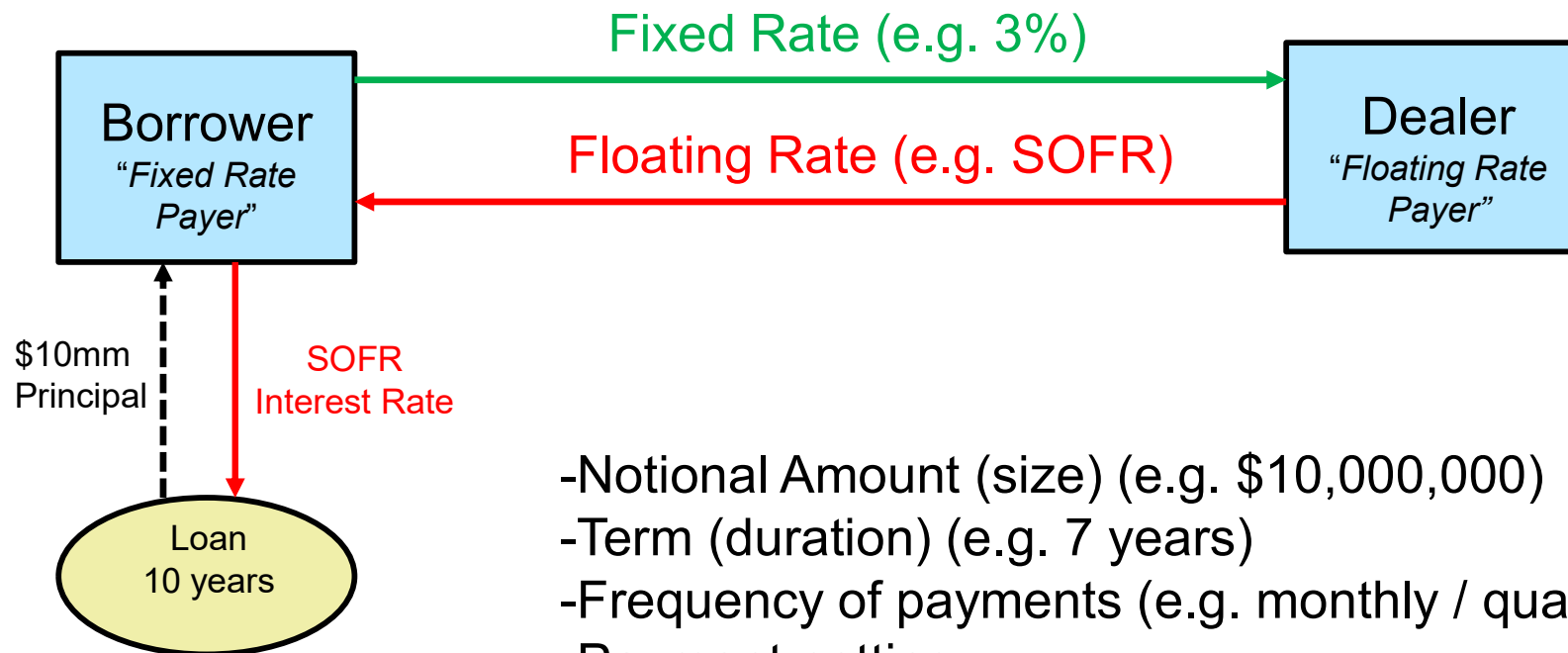
Interest Rate Cap



- Notional Amount (size) (e.g. \$10,000,000)
- Term (duration) (e.g. 7 years)
- Frequency of payments (e.g. monthly / quarterly)
- Payment netting not applicable

Allows Borrower to protect against SOFR increases above "Cap Rate" (e.g. 3%)

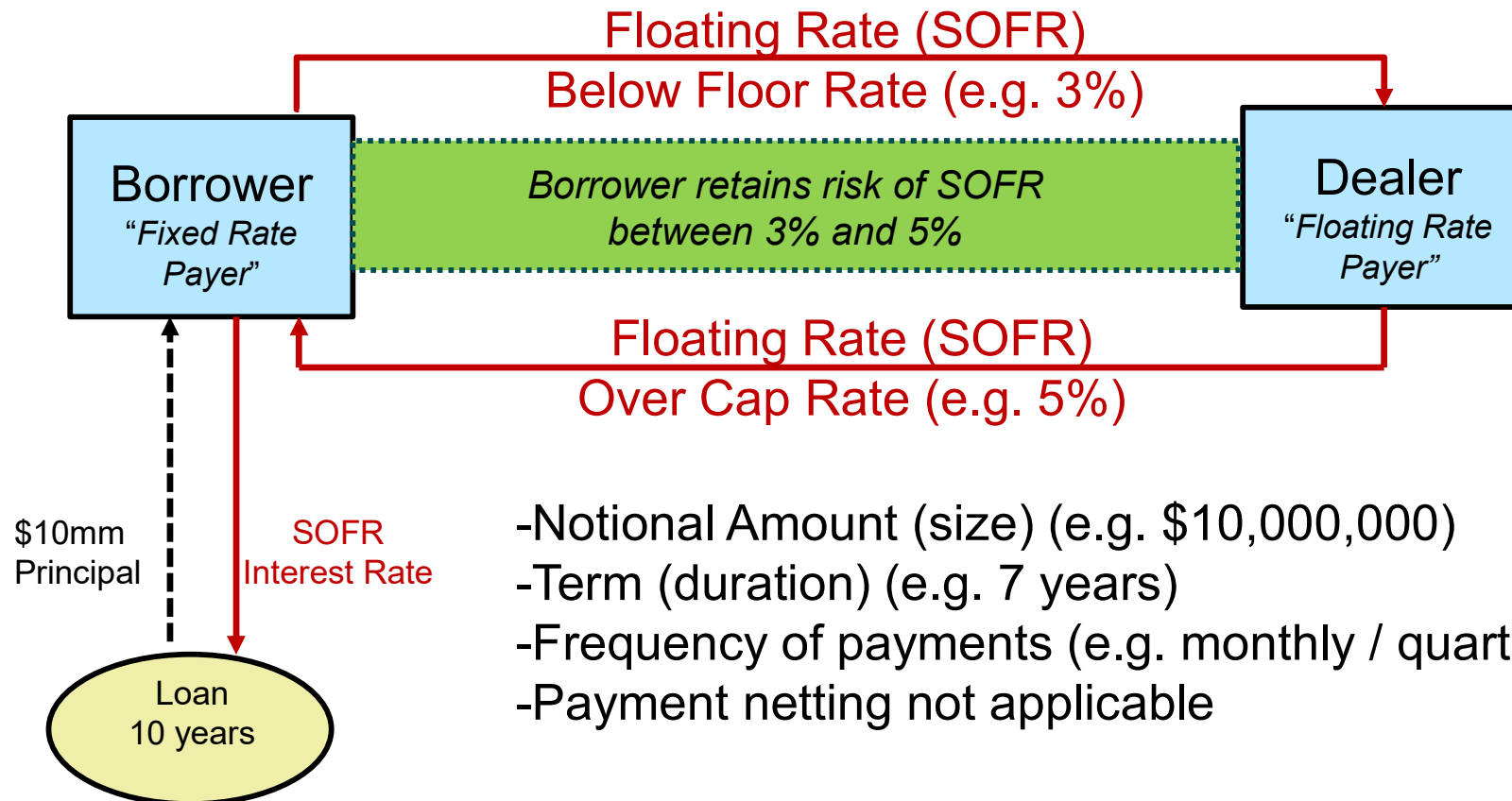
Interest Rate Swap



- Notional Amount (size) (e.g. \$10,000,000)
- Term (duration) (e.g. 7 years)
- Frequency of payments (e.g. monthly / quarterly)
- Payment netting

Allows Borrower to synthetically fix the rate of related floating rate debt at the Fixed Rate (e.g. 3%)

Interest Rate Collar



- Notional Amount (size) (e.g. \$10,000,000)
- Term (duration) (e.g. 7 years)
- Frequency of payments (e.g. monthly / quarterly)
- Payment netting not applicable

Allows Borrower to protect against SOFR increases above "Cap Rate" (e.g. 5%), but requires Borrower to pay Dealer if SOFR falls below "Floor Rate" (e.g. 3%) in lieu of an upfront premium payment.

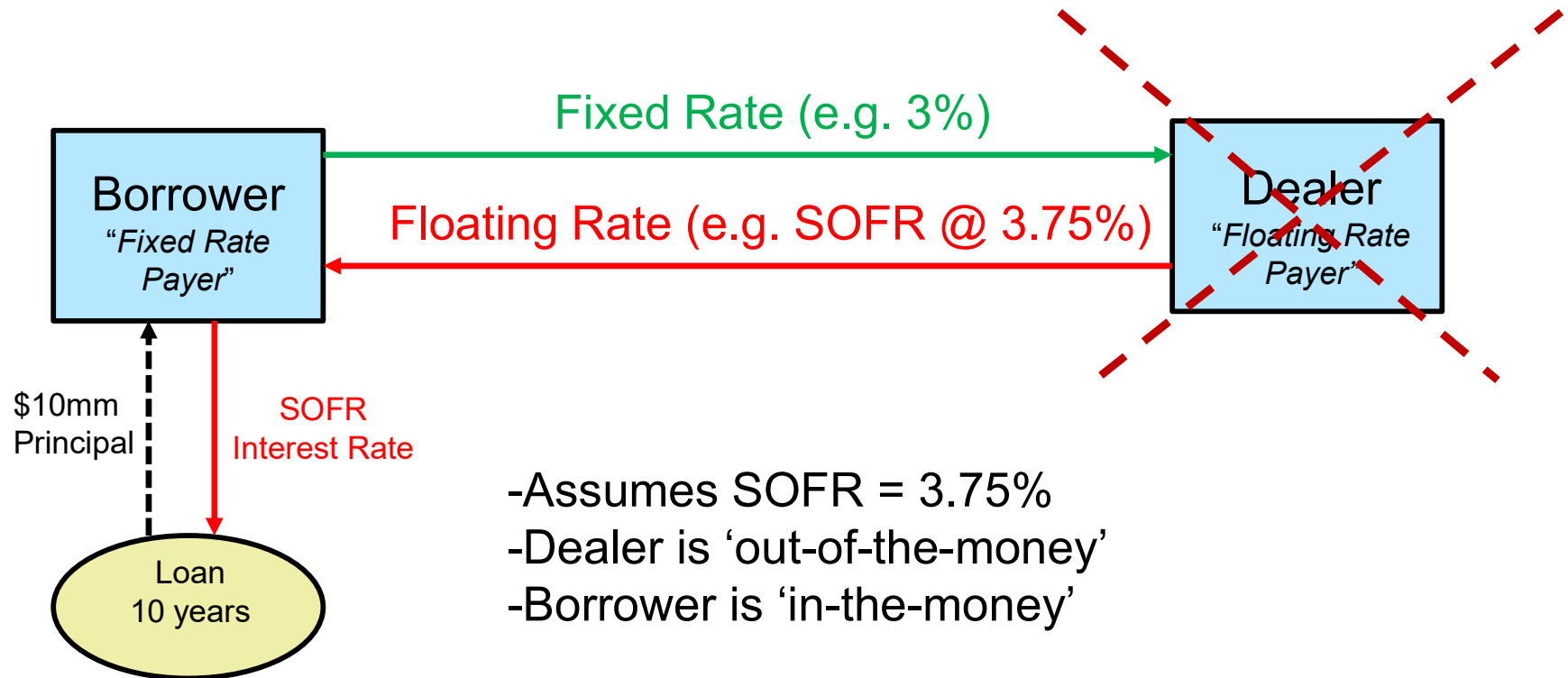
Derivatives Payments

- Upfront Payments
 - *Typical with Interest Rate Caps – the ‘buyer’ makes a single upfront ‘premium’ payment and then does not have any further payment obligations.*
- Scheduled Periodic Payments
 - *Typical with Swaps or Collars – each party is required to make periodic payments on their respective ‘payment dates’*
 - *If both parties owe an amount on the same payment date, then the amounts are ‘netted’ so that the party owing the larger amount pays the excess to the other party.*
- Breakage/Termination Payments
 - *Only payable if the transaction is prematurely terminated*
 - *Events of Default/Termination Events*

Derivatives Breakage/Termination Payments

- Value of a derivative is market-driven
 - *Value can be positive or negative at any time, depending on market conditions*
 - *Exception for prepaid caps, which are always in-the-money to the ‘buyer’*
- Derivative contracts are generally bi-lateral obligations because of market variability
 - *Either party can trigger an event of default or termination event*
 - *Exception for prepaid caps, where the triggers are usually turned **off** for the ‘buyer’*
- Upon an early termination or acceleration, breakage is paid by the *out-of-the-money* party to the *in-the-money* party

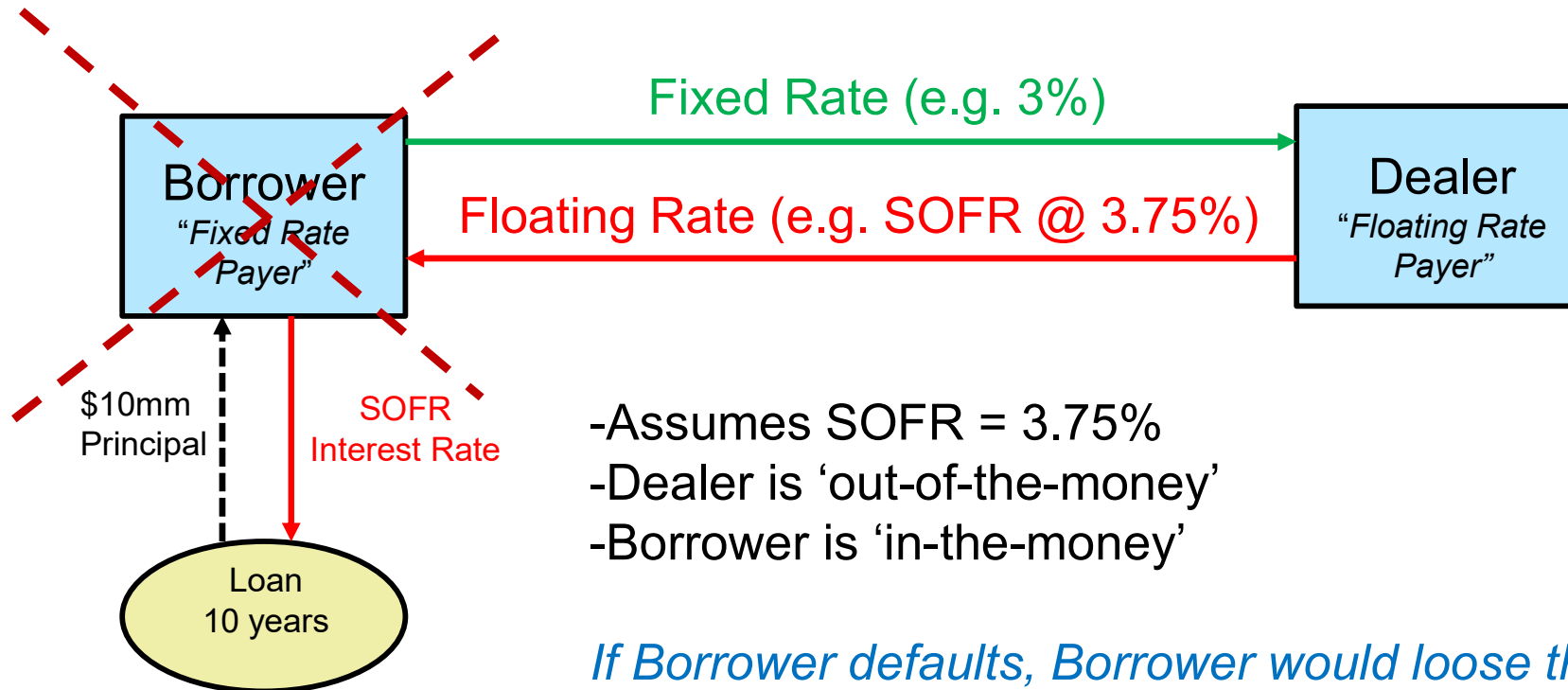
Interest Rate Swap Breakage



- Assumes SOFR = 3.75%
- Dealer is 'out-of-the-money'
- Borrower is 'in-the-money'

If Dealer defaults, Borrower loses the value of its position and Dealer gets a windfall, so Dealer would owe breakage to Borrower.

Interest Rate Swap Breakage



- Assumes SOFR = 3.75%
- Dealer is 'out-of-the-money'
- Borrower is 'in-the-money'

If Borrower defaults, Borrower would lose the value of its position and Dealer gets a windfall, so damages calculation would still require Dealer to pay breakage to Borrower, even though Dealer is not the Defaulting Party.

2.

Real Estate Finance Considerations

Derivatives & Finance Documentation

- **General Considerations for Caps/Swaps/Collars:**
 - ISDA obligations are bi-lateral
 - *Either Borrower or Swap Provider can trigger acceleration*
 - *Acceleration triggers are generally turned **off** for the buyer of a prepaid cap, so that the cap can't be terminated by the dealer if the buyer (borrower) becomes distressed*
 - ISDA Master Agreement distinguishes between “Events of Default” and “Termination Events”
 - *Defaulting Party/Non-Defaulting Party*
 - *Affected Party/Non-Affected Party*
 - *Bi-lateral nature of obligations & acceleration terminology need to be taken into consideration when drafting covenants and events of default in finance documentation*

Derivatives & Finance Documentation

- Collateral Assignments
 - *Caps, Swaps and Collars are typically collaterally assigned by the borrower (as pledgor) to the lender(s) (as secured party) in connection with real estate finance transactions*
 - *Section 7 of the ISDA Master Agreement prohibits transfers (including collateral assignment) without the prior consent of the counterparty*
 - *Interests in a cap/swap/collar are contractual rights and thus require the filing of a UCC Financing Statement in order to perfect*
 - *Typically, the pledgor, secured party and hedge provider (dealer) will enter into a “collateral assignment agreement”, pursuant to which the hedge counterparty will contractually agree to make payments to, and honor the direction of, the hedge provider in the event the borrower triggers a default under the finance documentation*

Derivatives & Finance Documentation

- **Interest Rate Cap Considerations:**
 - Dealer credit considerations:
 - *Typically, minimum rating requirements and downgrade triggers*
 - *If a downgrade trigger occurs, consider allowing the borrower to use any termination payment it receives to offset the cost of purchasing a replacement cap*
 - ISDA documentation considerations:
 - *Section 2(a)(iii) (Conditions Precedent)*
 - *Consider turning off so that payments can't be withheld*
 - *Section 5(a)(Events of Default) & (b)(Termination Events)*
 - *Consider turning off for Borrower so that Dealer can't accelerate for trigger events*
 - Cap terms:
 - *Tenor (duration) – alignment with maturity of financing*
 - *Floating Rate – alignment with loan interest rate and fallbacks*
 - *Accrual periods & Business Days – alignment with loan terms*

Derivatives & Finance Documentation

- **Interest Rate Swap & Collar Considerations:**
 - Source of payment for Borrower's obligations under swap or collar
 - *Coverage in waterfall*
 - *Typically, periodic payments are paid pari passu with interest and breakage payments are paid pari passu with principal*
 - Dealer will expect to be cross-collateralized and secured by collateral that supports the credit facility
 - *Security documentation/Mortgage needs to cover hedge obligations*
 - *Ability to amend/modify with (or without) consent of Dealer*
 - *Typically, Dealer just has 'drag along' rights*

3.

Derivatives

Regulatory Considerations

Derivatives Regulatory

- **Dodd-Frank Act - Key Derivatives Regulatory Requirements:**
 - Eligible Contract Participant (ECP)
 - *counterparty (Borrower) must qualify or derivative is illegal*
 - Financial Entity
 - Triggers mandatory clearing and exchange trading
 - broadly defined to include entities the activities of which are *'predominantly financial in nature'* as defined under the BHCA
 - includes Private Fund under Investment Advisers Act of 1940
 - '40 Act - 3(c)(1) and 3(c)(7)
 - Financial End-User
 - Triggers mandatory minimum margin
 - includes most Financial Entities + many regulated entities
 - '40 Act – 3(c)(1), 3(c)(7), 3(c)(5)(C) and Rule 3a-7

Derivatives Regulatory

- Reporting –
 - each swap must be reported to a ‘swap data repository’
 - *Generally, the hedge provider (dealer) will be required to undertake the reporting*
 - *exception for foreign banks*
 - each party must have a ‘legal entity identifier’ (LEI) for the swap to be reported
- Recordkeeping –
 - each party must maintain all documentation and records related to the swap for the term of the swap + 5 year

4.

Derivatives Documentation

Derivatives Documentation

- ISDA Master Agreements
 - 1992 Multicurrency Form
 - 1992 Local Currency Form
 - 2002 Form
- Schedule to ISDA Master Agreement
- Credit Support Annex (CSA) to Schedule (if margin applies)
 - 1994 NY Form
 - 2016 VM Form
 - 2018 IM Form
- Paragraph 13 to CSA

Derivatives Documentation

- Confirmation for each Transaction
 - Short Form Confirmations
 - *Subject to a negotiated ISDA Master Agreement and Schedule*
 - Long Form Confirmations
 - *Typically used for interest rate caps or one-off transactions*
 - *Incorporates the ISDA Master Agreement into the Confirmation by reference and typical ISDA Schedule terms **are included** in the Confirmation*
 - ISDA Definitional Booklets – *2021 ISDA Interest Rate Derivatives Definitions*

Derivatives Questions?

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