Blogs
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Asset Management ADVocate

Re-Proposed Rule 18f-4: Using Morphology to Delineate Commitment Agreements

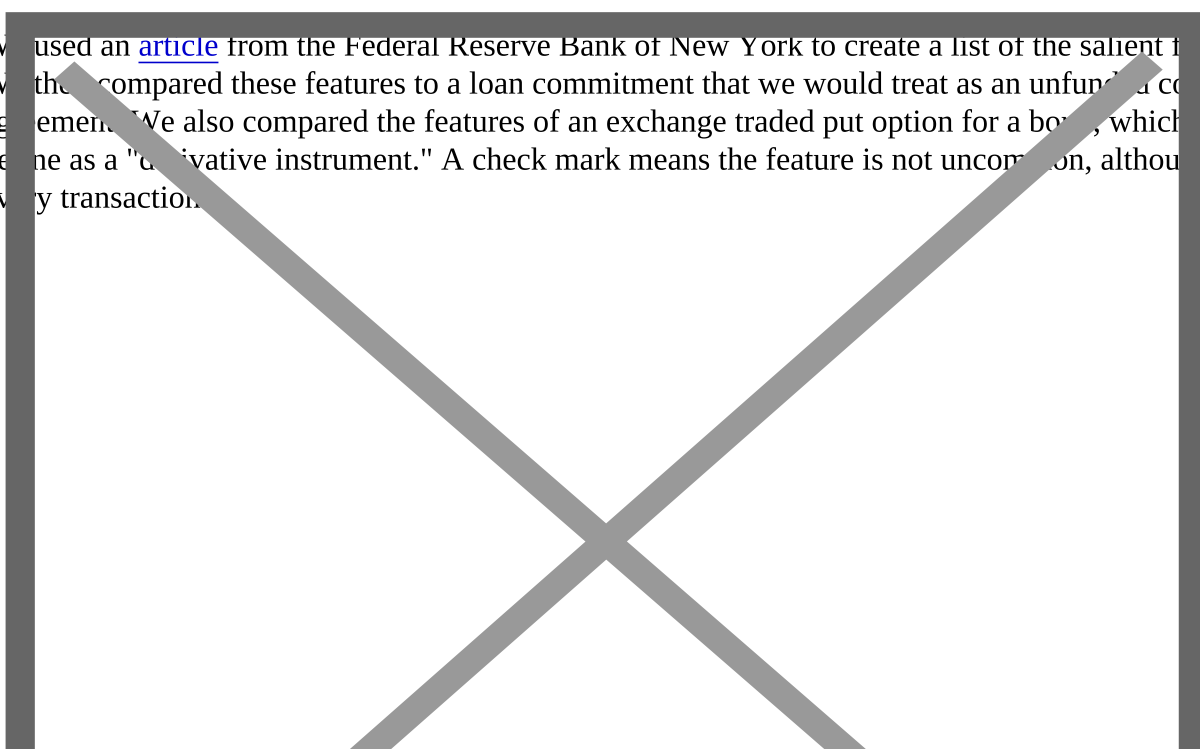
Our last post began to consider why some firm and standby commitments entered into by investment companies (including business development companies) may have "leveraging effects" while others do not. The Securities and Exchange Commission ("SEC") needs to identify the essential differences between these commitments to delineate when re-proposed Rule 18f-4 should treat a commitment as an "unfunded commitment agreement" rather than a "derivatives transaction." Our last post showed that loan commitments share, at a minimum, the same interest rate risks as other types of commitments, so any absence of leveraging effects must depend on other factors.

Commitment Morphology

One approach to classifying things is to compare their structural features. As noted in an earlier post, the SEC intends to continue to treat the fixed commitment made in a "to be announced" (a "TBA") trade for mortgage-backed securities ("MBS") as a derivatives transaction under Rule 18f-4. Thus, TBAs provide an example of a commitment that the definition of unfunded commitment agreement should not include. By comparing the features of a TBA to those of loan commitments that might be included as "unfunded commitment agreements," we can understand what differentiates the two types of commitments and then evaluate whether each difference could produce different leveraging effects. Some may argue that the difference is obvious: a TBA is a commitment to buy a security rather than to make a loan. The security in a TBA is just a pool of mortgages, however, which are loans to home owners. Unless someone can explain why a commitment to make a loan differs from a commitment to buy the loan once it has been made, we do not consider this a meaningful distinction. Either way, the fund ends up exposed to the risks of the loan.

Potentially Relevant Features

We used an article from the Federal Reserve Bank of New York to create a list of the salient features of a TBA. We then compared these features to a loan commitment that we would treat as an unfunded commitment agreement. We also compared the features of an exchange traded put option for a bond, which Rule 18f-4 would define as a "derivative instrument." A check mark means the feature is not uncommon, although not found in every transaction.



emphasize that the table is a demonstration of method; not a logical proof. Others might provide more discerning comparisons. Our point is that the Division of Economic and Risk Analysis should undertake this exercise and provide the results to the Division of Investment Management. When defining an unfunded commitment agreement, only the features unique to, or uniquely absent from, loan commitments are significant, which are the last four features in the table. Nevertheless, brief explanations of some other factors are in order.

- *Negotiability of Terms*. The lender can negotiate every possible term (tenor, rate, covenants, representations, conditions, etc.) of the underlying loan before entering into a loan commitment. Only six terms (agency, maturity, coupon, price, par amount and settlement) can be negotiated in a TBA. A put option is for an outstanding security, so only the terms of the option are negotiable.
- *Relation of Forward/Strike Price to Expected Market Value*. In a loan commitment, both the borrower and lender should expect the market value of the loan to equal its face value when the loan is drawn. A put, in contrast, has a strike price intended to be higher than the market price of the underlying bond when the put is exercised.

To Be Continued

Our next posts will consider the unique features of loan commitments in terms of their potential leveraging effects, as we work towards a better refined definition of an "unfunded commitment agreement."

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