

## ISDA's 2007 Property Index Derivatives Definitions: A Killer Application for the Property Index Derivatives Market?

*Edmund Parker, a partner in Mayer, Brown, Rowe & Maw LLP's Finance Group, discusses the release by ISDA (the dominant derivatives trade association) of its 2007 Property Index Derivatives Definitions and template confirmations and asks whether they will be the killer application that the property derivatives market has been waiting for.*

The property index derivatives market has remained disappointingly small compared to the size and performance of the traditional property market. Two principal reasons are the lack of standardised documentation and the lack of a homogenous product.

Property is not homogenous. It is not like a tonne of cocoa or a barrel of oil: a prime office block in the City of London is a different asset to one in the West End. Derivatives are financial instruments that derive their value from an underlying asset. So to create a homogenous product, the mainstream property derivatives market has selected the value of an index of property values as the underlying asset from which it derives its value.

All OTC property index derivatives transactions involve the parties taking contrary views on the future levels of an index. Each index has a numeric value based on the values of its underlying component properties, just as the FTSE 100 is based on the values of its chosen 100 equity shares. The recent development of a wide range of high quality property indices (Standard & Poor's and the Office of Federal Housing Enterprise Oversight in the US, and the International Property Databank Limited for commercial property and the Halifax for residential property in the UK) has helped to form a homogenous product leaving a lack of standardised documentation as the market's principal deficiency.

However, on Friday 4th May, ISDA, released the ISDA 2007 Property Index Derivatives Definitions, together with two standard templates: a total return swap template and a forward transaction template.

Each template was provided in two different forms: a Form X and a Form Y.

In each of the two forms of template for total return swaps (which cover synthetic sale and purchases of properties), one party (the total return payer) pays the positive difference in the level of the relevant property index between two dates, with the other party (the total return receiver) paying the amount of any decrease in the value of the index. For example, if the index value has increased from 80 to 85 the total return payer will make a payment based on multiplying this by the transaction's notional amount, and if the index value has decreased from 80 to 75 the total return receiver will make a payment based on multiplying this by the transaction's notional amount. The total return receiver will also pay a floating interest rate linked amount, based on the transaction's agreed notional amount. This is analogous to the total return receiver having borrowed this sum to invest in the property market, taking the hit on any fall in property values and the benefit of an upward market. The total return payer by contrast takes the role of a synthetic lender.

In each of the two template forward contracts, the derivative transaction is linked to the performance of a specified property index (perhaps the easiest analogy is to think of a share index such as the

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FTSE 100 going up and down in value over time), with the difference between the present and future value of the index being settled by the “Long Party” and the “Short Party” on an agreed future date. This template involves the on-selling of future property market risk and is also based upon the transaction's agreed notional amount.

The main differences between Form X and Form Y for each transaction type are as follows. Form X provides that republication (a reassessment of the index value by the index sponsor) applies, whereas Form Y does not; Form X provides that index prices are linked to index publication dates and not agreed index measurement periods, and Form Y the reverse; Form X provides that floating rate interest amounts accrue between the relevant index's scheduled publication dates and are payable with the amount linked to the return on the index, Form Y though provides that amounts accrue during index measurement periods and are payable on the dates specified by the parties.

The 2007 ISDA Property Index Derivatives Definitions fit into ISDA's standard documentation infrastructure. Under this infrastructure the parties enter into an ISDA Master Agreement (the set of standard terms for derivatives transactions), amended by a schedule (a document setting out agreed specific variations). They then enter into one of the two categories and forms of template property index derivatives confirmations described above (although they may of course create their own template confirmation). This confirmation will incorporate the agreed master agreement and the 2007 Property Index Derivatives Definitions. The parties may also choose to provide collateral to control their exposure to each other in the event of a default or termination, under a credit support annex to the master agreement.

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The 2007 Property Index Derivatives Definitions consist of two articles and an annex: Article I, which covers general definitions and interpretation; Article II which covers adjustments and disruptions to the index; and Annex A, which provides descriptions of the most commonly used indices and index providers.

Article I provides general definitions for defining and determining the price of the index, when it is published, what events may constitute an “Index Disruption Event”; the identity and the role of the index sponsor, the amounts payable by each party and when those payments must be made. Article II provides a series of fall-backs for adjustments and disruptions. These cover how to deal with a rebasing of the index; what happens if there is an error in the published level of an index, and/or if the index publisher persists with the error; what happens if there is a delay in publication; and what happens when an index disruption event occurs.

Annex A to the 2007 ISDA Property Index Derivatives Definitions, sets out descriptions of the most commonly traded indices. The annex will be updated from time to time, and parties incorporating the definitions into a transaction will be deemed to be incorporating the most up to date annex. The current version sets out short hand index names for 23 Standard & Poor's Case-Schiller Indices, 11 Office of Federal Housing Enterprise Oversight indices and the Halifax House Price Index, as well as setting out names and disclaimers for the Investment Property Databank Limited, and the National Council of Real Estate Investment Fiduciaries.

So will the new definitions and templates be a killer application? If they gain broad acceptance and generate liquidity yes. Other disadvantages will still remain: for example, the new templates cover only the most popular types of property index derivatives; training and legal advice will still be necessary (at least to begin with); concerns may remain regarding the quality of the indices (do they really match an asset being hedged?); views of the future direction of the property market may also not greatly differ, hindering market momentum. That said, standardised documentation together with high quality and diverse indices may finally bring the property index derivatives market into the mainstream: it worked for equity index derivatives after all!

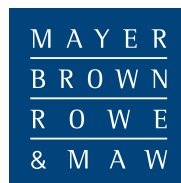
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