

# Property derivatives come of age

The growth of interest in property derivatives should not be a surprise, say **Andrew Petersen** and **Gordon Peery**

**I**t is an interesting time for property and the markets in which participants buy, sell and finance property around the world.

A property down cycle began in 2008, however, the property finance story is not one of complete doom and gloom. Throughout 2008, tremendous growth of a relatively new derivative instrument has been witnessed, that enables investors and portfolio managers to gain immediate exposure to property or hedge property risk without buying or selling property. Property derivatives have been launched in the past, debuting on the London Futures and Options Exchange in the early 1990s. But due to a combination of bad timing and scandal over false trades (designed to create the impression of higher activity) their launch crashed. Despite this initial failure and despite the ongoing credit crunch biting, proponents of the property derivative market are optimistic, buoyed by a period of record trades in the property derivatives market (currently a trillion dollar market) as dealers, institutional investors, portfolio managers, pensions, hedge funds, insurance companies and other end users turn from bricks and mortars to derivatives.

## THE MARKET

Property is the largest asset class in the world, and the ability of investors to gain immediate, inexpensive exposure to property without traditional transaction costs gives derivatives a significant advantage over more traditional property-related investment tools. What may come as a surprise, however, is that, across the globe, it is the UK that leads the property derivatives market, due to the availability of well-established property indices that form the basis of trades in this area. After their widespread introduction in the market in the UK in 2005, commercial property

derivative volumes reached £3.7bn with accelerating growth. In 2006 there were 360 transactions (five times as many as the previous year), while the volume actually increased more than sixfold in the space of 12 months. Further, at the start of 2007, the value of property derivatives based on the Investment Property Databank (IPD) Index reached a cumulative notional of some £7.6bn.

## DEFINITION

A property derivative is an instrument with a price and value derived from a published property index referred to as a reference obligation or underlying. As such, these products derive value from an underlying asset or event, with users of derivatives either passing unwanted risk to a willing counterparty, which assumes that risk for a price, or taking on risk in exchange for a payment. A simple example of a derivative is an option, a basic building block of more complex derivatives. In the case of a share option, one party, the holder of the option, pays a premium to obtain the right to purchase (or sell) an underlying asset—a quantity of ordinary shares. The other party, the writer of the share option, receives the premium as payment for the option and in turn for that payment becomes obligated to perform — *ie*, to transfer the shares at a price upon the exercise of the option. In this way, options and other derivatives are used to manage or take advantage of risk relating to such shares. Derivatives may also be based on other assets as well: a bond, a commodity, a form of currency, or an index, such as a commercial property index.

## FLEXIBLE AND INNOVATIVE INVESTMENTS

Over-the-counter (OTC) property derivatives, which may be used as a synthetic

## IN BRIEF

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- Derivatives in the property area overcome numerous disadvantages of traditional property investment.

investment or for hedging or leverage purposes, can be tailor-made to fit portfolio needs and thus offer innovative and flexible hedging techniques to portfolio managers and institutional investors holding illiquid property investments. Such hedging techniques and capabilities range from protecting parties against increases or decreases in the commercial or residential rental markets to enabling investors to gain immediate exposure to investment-grade real estate throughout the world. Innovation in this area enables transaction participants to obtain whatever maturity or leverage that is desired such that the market and underlying indices are the only boundaries. Instead of incurring the cost of buying and selling physical property, the investor or fund manager may simply purchase a customised product with returns based on an underlying index of real estate values. Derivatives in the property area thus overcome numerous disadvantages of traditional property investment such as transaction lead time, credit and liquidity market seizures, availability and immovability of real property assets and high transaction costs. While the provider of the derivative still performs credit analyses to compile a credit profile of the end user, that process is streamlined and less time-intensive than the typical due diligence and credit check performed by a property acquirer or lender in a cash market setting.

## THE GLOBAL MARKET

The use of property derivatives has expanded internationally to include the launch of indices in nearly 20 countries, involving properties in countries such as Australia, Austria, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands,

Norway, Portugal, Spain, South Africa, Sweden, Switzerland and the UK. As stated, the market in the UK has long been the leader in property derivatives, but increased use in the US has led to the initial licensing of six dealers by the National Council of Real Estate Investment Fiduciaries (NCREIF) and a programme of continuing licensing. Further in early 2007, NCREIF licensed its indices for property derivatives to numerous parties, with no less than seven broker-dealers trading property derivatives based on NCREIF data.

Moreover, underlying this expected increase in use and market activity, February 2008 witnessed an exciting development in the US with the launch of a cross-industry led Real Estate Derivatives Special Interest Group (RED-SIG, see [www.red-sig.org](http://www.red-sig.org)). RED-SIG is a new industry alliance established to offer insight and perspective on the use and implementation of US commercial real estate derivative products and to facilitate the exchange of information on the use and implementation of commercial property derivatives. The work being done in this area is based on the continuing acceptance of property derivatives in the market. Notwithstanding credit seizures in the market, the use of derivatives continues to be a fundamental investment tool and natural complement to alternative forms of investment. Moreover, property derivatives have spread to Asia. The Hong Kong property derivative market commenced in 2007 and property derivatives have priced in Japan. 2008 further witnessed the record-breaking largest property derivative traded in Asia to date between Goldman Sachs and Lehman Brothers Global Real Estate Group. Elsewhere, the property derivative market in Australia is said to be about to flourish soon.

### DOCUMENTATION

There are essentially three levels of documentation in a typical property derivatives trade. At the top of the documentation hierarchy is the Master Agreement, a document with content that never changes; its dispute resolution and other broad terms apply to every trade unless varied by the parties. The Schedule to the Master Agreement and the Credit Support Annex vary the terms of the Master Agreement in several important respects. Finally, the economics of each trade and other details are evidenced by Trade Confirmations, which are essentially one or more contracts operating under the umbrella of the

Master Agreement as modified by the Schedule and the Credit Support Annex (CSA), and which further tailor the transaction to fit the needs of the parties and the derivative product. The most important, recent development in the property derivative marketplace is the recent publishing by the International Swaps and Derivatives Association, Inc (ISDA) of definitions specifically for property derivative transactions; these definitions allow practitioners to describe trades in shorthand within Trade Confirmations, further streamlining the documentation and lessening transaction costs related to this derivative.

### ASSOCIATED RISKS

Notwithstanding the spectacular growth of property derivatives in the UK and bright signs for continued growth across the globe, certain macro- and deal-level risks relating to property derivatives remain.

■ *Counterparty Risk.* As with other derivatives, the property derivative is subject to counterparty risk and there is no central regulation of the property derivatives practice at the present time. Counterparty risk is the risk that a party to a derivatives trade will not fulfil its contractual obligations. Since H2, 2007, credit rating downgrades for banks as derivative counterparties have been a concern for the first time in the modern history of the derivatives trade. End users should pay particular attention to this threat and involve their derivatives advisers in a timely manner. A primary way to manage counterparty risk is to require counterparties to enter into a bilateral CSA that calls for the counterparty to post collateral.

■ *Documentation Risk.* While property derivatives are not as document-intensive as commercial property transactions or securitisations involving property, derivative traders typically initiate the documentation, which must be carefully reviewed by qualified legal counsel that is experienced with ISDA documentation, in general, and the 2007 Property Index Derivatives Definitions in particular.

■ *Risks Specific to Derivatives.* Given the massive global losses associated with collateralised debt obligations with subprime mortgage underlyers in 2007 and beyond, a number of macro system risks are faced by participants to trades. Parties may continue to be slow to accept price and trade derivatives in the short

term, and derivatives may be subject to increased government for self-imposed regulation in the long term.

■ *Pricing Risk.* Some indices used in property derivative transactions are based in part on valuations, which may not be accurate. Because the underlying property may be difficult to price, the pricing and hedging of property derivatives is difficult and fraught with various commercial risks. NCREIF (and other property derivative indices) is based on valuations, which are subjective. Valuations are "corrected" upon the sale of an index property, and the conversion to the transaction value can add considerable volatility to the index. Moreover, members of an index report their own data and interim values and index sponsors requirements may vary.

Real estate remains one of the last major asset classes not subject to a fully developed, global derivatives market. In 2005, observers predicted that the maturation of the property derivatives market would take up to five years. Almost three years on, the advantages of property derivatives are there for all to see, resulting in impressive returns and record market activity. Furthermore, despite the ongoing credit crunch, property derivatives in Q1 2008 had their best ever quarter, trading at record levels, and are, perhaps for the first time in their history, positioned as a true alternative property financing instrument whose growth potential is second to none.

In the post credit crunch world, where investors need to understand risks, returns and flexibility, property derivatives will play an important role in assisting such investors and manage risk. Consequently, the potential for property derivatives to supercharge global capital flows seeking rewarding property opportunities across the globe, is there for all to see. Property derivatives have finally come of age.

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