

ISDA Documentation Arrives in Property Derivatives

Standardised documentation to facilitate growth of market

Volumes in Q1 2007 reached £2.9bn providing an indication that the market has begun to grow exponentially. Standardising the confirmation documentation will help to reduce costs of implementing the trade, increase transparency and improve liquidity.

Choice of process to resolve an index disruption event

In scenarios where there is a change in the index referenced in the property derivative, the new ISDA documentation allows counterparties to choose to resolve the issue through either an ISDA meeting or a calculation agent determination. It is not clear which will be the preferred choice.

Confirmations fixed for American and European indices

Due to the fact that there are differences between some American and European indices there are two forms of the confirmation: Form X (American) and Form Y (European). The main differences are that some American indices allow for republication and index prices are linked to publication dates rather than measurement periods.

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ISDA Documentation Arrives

On May 4, 2007 the International Swaps and Derivatives Association published the Property Index Derivatives Definitions. At the same time, ISDA also published new confirmation forms for Total Return Swaps and Forwards. ISDA also expect to publish an options confirmation template this summer.

We expect that this market development will greatly facilitate the rapid growth of this market. For a more detailed introduction to the property derivatives market please refer to the publications: a *Property Derivatives Handbook* and *Property Derivatives* published on 22 January 2007 and 23 April 2007 respectively.

In this report we discuss the impact of standardised documentation,

What has been standardised?

The documentation needed to complete a property derivative transaction comprises of the Master Agreement, the Schedule and the Confirmation. It is the Confirmation documentation, which has been standardised and it is available for both Total Return Swaps and Forward contracts in European and American Forms.

Which indices can be used?

In annex A to the 2007 ISDA property index derivatives definitions, a list of index providers are laid out as follows:

- In the US: the Standard & Poor's Case-Schiller, Office of Federal Housing Enterprise and NCREIF indices.
- In the rest of the world: the Investment Property Databank indices and the Halifax House Price

On the next pages we discuss the main points, which the new ISDA documentation on property derivatives grappled with and finally addressed in a manner acceptable to the market participants.

Index disruption event

A key area during the discussions to finalise the ISDA documentation were the provisions relating to an index disruption event where the methodology for calculating the index is changed or, worse still, the underlying index ceases to be published.

Likelihood of index ceasing to exist is low

We consider the likelihood that the index will cease to be published as remote since the demand for these indices are driven from numerous sources including: benchmarking the performance of real estate portfolios and, of course, property derivatives. Further, in the unlikely event that the index provider becomes insolvent, the most value in any liquidation process would be selling the data for the purposes of preparing indices.

Turning to a change in the calculation methodology, as Berwin Leighton Paisner pointed out in a recent article, *Property Derivatives – the end of the beginning* this could have a greater impact on derivatives, which are referenced to relatively immature indices, since any change in the method of calculation can have material effects. This is not the case for the sizeable and robust UK All Property Index, but may apply to other smaller indices.

Changes in the index disruption event introduced by ISDA

Previous to ISDA documentation, if there was a material change to the index and the counterparties could not agree on a substitute index then they would agree to a no-fault termination.

With the arrival of ISDA, the counterparties have a choice of disruption procedure:

- at the determination of the Calculation Agent...

We consider that parties who choose the calculation agent route are likely to each appoint a calculation agent and this will then raise the possibility that the two calculation agents cannot agree on a substitute index. In this scenario the agreement would be terminated as at the date of the index disruption event.

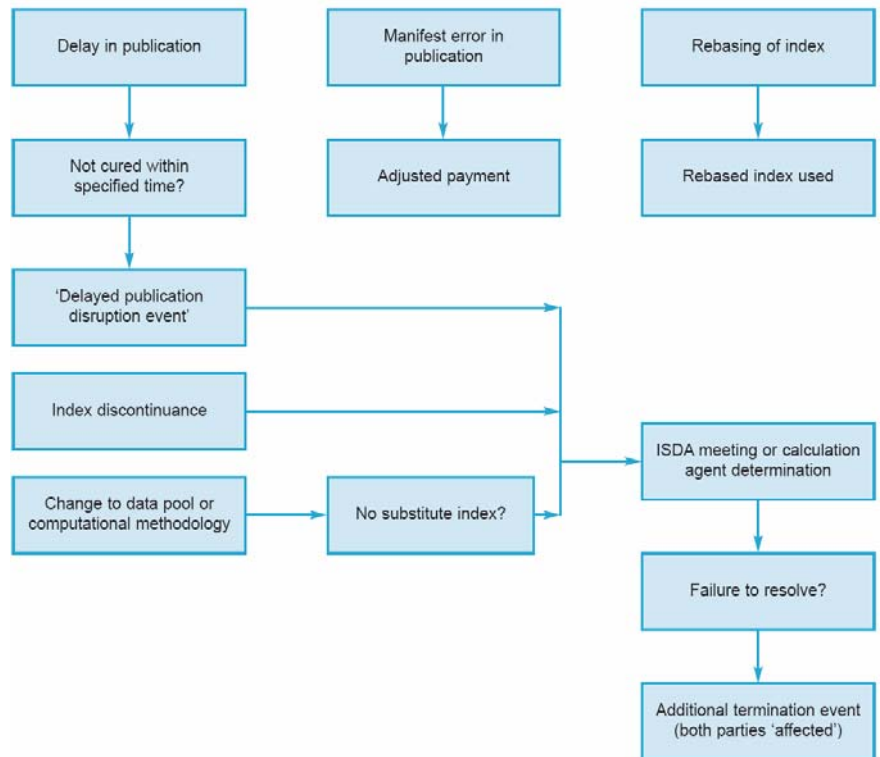
- ... or an ISDA meeting

If parties elect for the ISDA meeting then ISDA will organise a meeting of “major market participants” to be held within 30 days and to be comprised of at least 5 market participants. This meeting will try to agree on a replacement index which will aim to ensure that the counterparties are in the same, or as far as possible, economic position as they would have been without the disruption event. To the extent that the meeting cannot agree on a replacement index or that ISDA overrules the meeting's recommendation then the agreement would be terminated as at the date of the index disruption event i.e. the same procedure as the scenario when the calculation agreements cannot agree. It is interesting that ISDA have effectively underwritten a solution which will be acceptable to the market.

It is not clear yet which, if either, will be the preferred choice for settling index disruption events. On the one hand, counter parties might prefer the calculation agent route since it provides them with more control in the event of an index disruption event. On the other hand, the ISDA meeting will attempt to resolve the issue with the aim of finding a market based solution.

In Chart 1 below indicates the steps taken when an index disruption event occurs. Above we have discussed the most interesting issues i.e. changes to the computational methodology. Also shown in the chart for completeness are more typical issues such as an error in publication and a rebasing of the index.

Chart 1: ISDA process for addressing issues relating to the underlying index



Source: Benwin Leighton Paisner

Form X (American) vs Form Y (European)

Due to the fact that there are differences in the American and European indexes, the confirmations have been published in two forms X and Y. We provide the details for these two forms in the Appendix.

The primary differences between these two forms are:

Form X allows for:

- republication;
- the index prices are linked to publication dates rather than measurement periods and
- that floating amounts accrue from the scheduled publication date to scheduled publication date and are payable on the same date that the property amounts are payable

Form Y on the other hand:

- does not provide for republication,
- index prices are linked to measurement periods and
- that floating amounts accrue between dates which are specified by the parties

What is republication?

As discussed above Form X allows for republication of the index which allows the index provider to amend the index level. To help understand the impact this might have the following example from ISDA should help: an index value for January is first published in March and then republished monthly until June, if the parties elect for republication then the relevant value will be the June level whereas if the parties choose not to have republication then it will be the March value.

Republication is available only on the Standard & Poor's Case-Schiller indices.

Index prices linked to publication dates rather than measurement periods

Form Y confirmations refer to measurement periods for pricing indexes which are defined as any period agreed by the counterparties thereby allowing for complete flexibility. Form X on the other hand refers to an index price which is the most recently published.

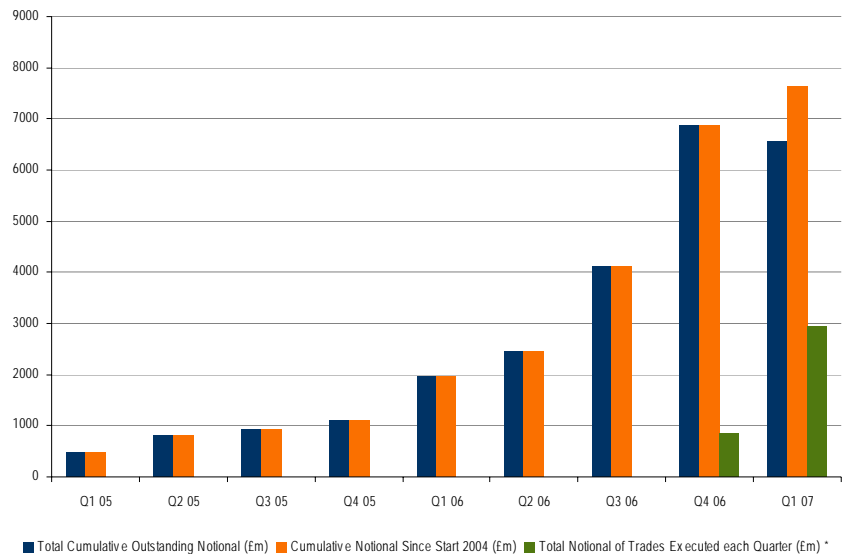
Impact on the Property Derivatives Market

As can be seen in the chart below the volume of property derivatives traded on the IPD indices have begun to grow exponentially. IPD have just begun to publish volumes transacted in each quarter which shows that Q1 2007 produced total transactions valued at £2.9bn.

It is anticipated that the ISDA documentation will facilitate the rapid growth of this market by:

- Reducing the length of time and expense of implementing a trade since there is an off the shelf product which decreases the need to negotiate as many terms.
- Greater confidence and transparency in the market from both existing and potential participants since the ability to exit initial positions, without leaving any residual risk, is enhanced due to standardised documentation.
- ISDA documentation agreed for all market participants. Previous documentation was agreed mainly by dealers whereas the ISDA documentation provides input from all market participants.
- Increased trading as a consequence of the above bullet points will lead to further liquidity in the market.

Chart 2: Property Derivative Trading Volumes on the IPD Indices



Source: IPD

* IPD have only begun to publish data of trades actually executed in the quarter and so far have only published the data points for Q4 2006 and Q1 2007.

15 May 2007

Date:
 Final Property Amount Payment []
 Date:
 Republication: Not Applicable
3. Floating Amounts
 Floating Rate Payer: []
 Floating Rate Payer Payment Dates: Each Floating Rate Payer Period End Date.
 Floating Rate Payer Period End Dates: The [] day of each [], [], [] and [], from and including [], to and including [], with No Adjustment.
 Floating Rate Option: []
 Designated Maturity: []
 Floating Rate for the initial Calculation Period: []%
 Spread: Plus/Minus []%
 Reset Date(s): The first day of each Calculation Period
 Floating Rate Day Count Fraction: []

4. Initial Amount
 Initial Amount: *[Applicable/Not Applicable]*
 Initial Payer: *[Property Amount Payer/Floating Rate Payer/Not Applicable]*
 Initial Payment: If Initial Amount is applicable, then two Business Days after the Effective Date, the Initial Payer will pay the Initial Payment Amount to the other party
 Initial Payment Amount: []

5. Other
 Disruption Procedure: [Calculation Agent Determination] [ISDA Meeting]
 Business Day Convention: Modified Following
 Business Days: []
 Calculation Agent: []

6. Notice and Account Details

Contact Details for Notices:
 Property Amount Payer: []
 Floating Rate Payer: []
 Account Details:
 Property Amount Payer: []
 Floating Rate Payer: []

7. Offices
 Property Amount Payer: []
 Floating Rate Payer: []

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