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In Practice

PROPERTY DERIVATIVES: THE LAST FRONTIER

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Property derivatives are a relatively recent arrival in the derivatives markets and have attracted significant interest from financial institutions and property players alike. While some obstacles to market development have been identified, many predict that the market will grow. And perversely, the current credit squeeze could provide new opportunities to spur that growth.

What is a property derivative?

Property derivatives are financial contracts which derive their value from the value of commercial property. The values and payment flows of the contracts are linked to commercial property indices, published by the IPD (Investment Property Databank).

It is key that a property derivative involves no acquisition of property, nor of any interest in property. In the most common type of property derivative transaction, an ‘over-the-counter’ swap, one party will agree to pay the other an annual rate of interest on a notional amount of property. In return, it will receive a rate of return on that notional amount based on the performance of an IPD index (most commonly, the IPD All Property Index in the UK). The notional amount never changes hands, and the payments of interest and the index return are netted. So, over an agreed period, the ‘in the money’ party will receive a payment of the difference from the party who is ‘out of the money’.

Property swaps are usually ‘total return’. The return is based on a mixture of the income and capital values of the property which makes up the IPD index.

Pros and Cons

Property derivatives have a number of advantages:-

- Derivative products can also theoretically be used as a hedging tool to insulate against a decline in the value of real property assets.

But there are also disadvantages:-

- Lack of liquidity is an issue. Until recently, there were more parties willing to bet on the property market than against it, so deal levels were low. Banks are reluctant to take positions they cannot hedge;

- Lack of pricing transparency is also a concern and this is a key issue for many potential market participants;

- The IPD indices currently only cover property in the UK as a whole. This does not allow investors to hedge against, for example, property in a particular geographic region. Some argue that more developed indices would allow more bespoke property derivatives products so increasing liquidity and competition.

Market development and trends

According to IPD figures, the total notional amount of property derivatives trades in the first half of 2007 approached £3.8 billion. The number of trades reported for that period, however, was only 243. Figures for the second quarter were significantly lower, doubtless reflecting turbulence in the US sub-prime markets and the global credit crunch.

On the plus side, documentation for property derivatives is now advanced, thanks to the work done by ISDA (International Swaps and Derivatives Association, Inc.) which has published the 2007 ISDA Property Index Derivatives Definitions and template trade confirmations.

It has been reported that some investment banks are looking beyond single country deals to transact pan-European

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property derivatives (again linked to indices published by the IPD). This is a significant development in the potential use of property derivatives.

Another recent innovation in UK property investment, Real Estate Investment Trusts (REITs), has the potential to impact on property derivatives. REITs are tax-transparent corporate entities that invest in property. Although REITs may be viewed as a rival to property derivatives, the Treasury clarified at the beginning of 2007 that derivatives can be used by REITs within their favourable tax-exempt ring fence. Growth in the use of REITs could promote the use of property derivatives in parts of the market that remain wary of them.

There has been some suggestion that property funds are struggling to obtain permission from investors and trustees to use property derivatives, wariness of the concepts being the most likely cause. Also the mandates of some property funds stipulate that they must hold real property and so they cannot make use of property derivatives.

Conclusion

The property derivatives market and the real property market are intimately linked. But, should returns in direct investment tighten and uncertainty creep into the real property industry, investors may look for alternative routes to exposure (particularly in the short term). This could act as a spur to the property derivatives markets. Derivatives arguably have less appeal in a stable market and – rather curiously, given the origins of the credit squeeze – volatility could be exactly what the property derivatives market needs to take off.