

HOUSING CORPORATION REGULATORY CIRCULAR



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Note: 'housing association' is used as a generic term for registered social landlords. 'Corporation' means Housing Corporation.

TITLE: Treasury Management – regulatory policy

SUMMARY: This circular provides guidance on compliance with the Regulatory Code in respect of treasury management.

THIS CIRCULAR IS FOR THE ATTENTION OF:

(tick to indicate which)

- ✓ Registered Social Landlords; more than 250 properties
- ✓ Registered Social Landlords; less than 250 properties
- ✓ Co-ownership Societies
- ✓ Co-ownership Equity Sharing Societies
- ✓ Almshouse Charities
- ✓ Abbeyfield Societies
- ✓ Co-operatives
- Local Authorities
- Registered Social Landlords' Auditors
- Registered Social Landlords' Solicitors

• **Relevant Legislation:**

NHF: Financial Risk Management – Focus on Treasury, March 1999

CIPFA: Treasury Management in Public Services –Code of Practice & Cross-sectional Guidance Notes 2001

• **Regulation and/or Policy Requirements:**

N/A

• **This circular replaces circular number:**

N/A



1 Definitions

N/A

2 Corporation Expectations

Introduction

At 31 March 2001 private sector lenders had committed more than £23.2 billion of loan finance to registered social landlords (RSLs), of which £17.4 billion had been drawn down. The remainder was in the form of committed facilities. Levels of private finance are projected to increase substantially for the foreseeable future. Consequently effective treasury management will necessarily assume ever greater significance. For many RSLs the management of financial obligations associated with their debt portfolios will be the most significant element of treasury management. Nonetheless, the policies contained in this circular are equally relevant for RSLs whose main treasury activities focus on cash management and investment of surpluses.

This circular sets out:

- a) the treasury management issues which an RSL should address;
- b) the range of treasury management risks, including those which are inherent in secured borrowing from the private sector and the investment of surpluses with private sector borrowers;
- c) the essential elements of a treasury policy;
- d) the Corporation's requirements on treasury management policy;
- e) the Corporation's monitoring arrangements for RSLs' treasury activities including risk management.

The Corporation expects each RSL to adopt comprehensive written policies which are appropriate to the nature and extent of the treasury activities undertaken. All RSLs will need to review their financial procedures to incorporate, as appropriate, the policies on treasury management referred to in this circular and thereafter to critically review and upgrade their policies and procedures on a regular basis.

It is the responsibility of the RSL's governing body to ensure that the treasury risks that the RSL faces are identified and their significance assessed. It is also the governing body's responsibility to ensure that there is adequate awareness and understanding of these risks at both governing body and officer level, and that independent professional advice is readily available, where appropriate.



Finally, the governing body is responsible for ensuring the formulation and implementation of treasury management policy and treasury management procedures and controls appropriate to their operational needs and in accordance with legislation, relevant regulations and best professional practice.

RSLs will need to identify which elements of treasury management apply to their operations and from that determine the policies, procedures and control structures that are required. RSLs are strongly advised to consult the National Housing Federation's publication 'Financial Risk Management - Focus on Treasury', published in March 1999, and/or the 2001 CIPFA Code of Practice for Treasury Management in Public Services and its accompanying Guidance Notes. Both publications acknowledge that smaller associations may have limited treasury activities and few specialist staff resources. Nevertheless, the principles which they espouse are universally relevant to RSLs of all types and sizes.

Treasury management risks

Some of the key risks are listed below:

- Interest rate - uncertainty of future cash flows which are dependent on, or sensitive to, movements in interest rates or the change in valuation of interest rate sensitive assets and liabilities.
- Inflation - uncertainty of future cash flows which are sensitive to inflationary or deflationary conditions.
- Liquidity - insufficient cash holdings or easily realisable short term investments to meet financial obligations as they fall due.
- Counterparty exposure - inability of an organisation, with which the RSL has contractual relationships, to meet its obligations to the RSL when they fall due.
- Fraud or error - potential for the fraudulent misappropriation of funds or the loss of funds through human error.
- Basis or timing mismatch - assets and liabilities which are sensitive to external influences e.g. inflation, will re-price or re-value in different time periods or on differing bases which could adversely affect the relationship between investment income and debt charges in the short term.
- Lenders' covenants - inability to satisfy lenders' covenants in respect of, for example, interest cover ratio or capital gearing triggering cross default covenants in other loan agreements.
- Management - failure of the governing body and senior executives to fully understand the implications of transactions which they are endorsing or which will be made under authority delegated by them to members of staff.
- Systems - failure of internal systems or procedures to effectively control transactions and the cash flows which are generated by them, or to accurately record and report them.

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- Banking system - failure of the banking system to process transactions correctly or in a timely manner OR the failure of the RSL's clearing bank and the resultant loss of monies lodged temporarily in the RSL's bank accounts.
- Political risk - a change in Government or regulatory policy affecting, for example, the tax position, revenue generation potential or grant support regime of RSLs.
- Foreign exchange - where funds are raised in any currency other than Sterling the RSL would be exposed to movements in the foreign exchange rate between the currency of the loan and Sterling. In general RSLs are proscribed from entering into financial transactions which would expose them to foreign exchange risk, including those denominated in Euro. However, in exceptional circumstances when such a transaction is permitted any such exposure must be fully hedged and net exposures must be Sterling denominated.

N.B. This is not an exhaustive list. Each RSL may also have unique risks.

Treasury management policies

Section 1 of the Corporation's Regulatory Code and Guidance sets out our requirements in respect of finance and viability. A treasury policy statement is an essential part of a suite of financial policies.

The treasury policy statement should be approved and formally adopted by the governing body as part of the RSL's rules, standing orders or financial regulations. The policy statement should be critically reviewed by the governing body on a regular basis and formally considered on an annual basis.

There are four universal principles of treasury management which should be the drivers of policy and central to the policy statement:

- **Compliance** with statute, regulation and best practice;
- **Security** of financial assets;
- Provision of adequate **liquidity** to meet financial obligations;
- **Effectiveness and efficiency** in the use of financial resources.

The combination of these principles should be heavily weighted towards the minimisation of risk, the preservation of asset value and liquidity levels and the minimisation of costs within those parameters. The maximisation of returns should be of secondary importance.

The approved policy should comply with the provisions of this circular. The treasury policy statement should include:

- a) a definition of the approved activities of the treasury function;

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- b) the process for the formulation of treasury management strategy, including interest rate management strategy;
- c) approved methods of raising capital finance e.g. bank debt or bond issue;
- d) approved sources of finance e.g. banks, building societies etc;
- e) a list of approved counterparties to whom surplus cash may be lent or specific criteria for their selection and the limits of exposure to each;
- f) a list of approved financial counterparties or explicit criteria for their selection and the limits of exposure to each;
- g) a definition of the types of financial instrument to be used and the extent of their use, including those to be used for interest rate exposure management;
- h) policy on the use of external intermediaries such as brokers and fund managers;
- i) policy on the internal delegation of authority with explicit lists identifying officers or posts;
- j) policy on liquidity specifying minimum working capital, cash contingency requirements and control of debtors and creditors;
- k) policy on debt maturity profile and re-financing risk management;
- l) requirements for review and reporting of the policy and the treasury operations which it controls;
- m) policy on the use of the banking system and periodic competitive tendering for the provision of banking services.

The NHF and CIPFA publications provide further details.

When determining interest rate exposure RSLs should consider which assets and liabilities are sensitive to interest rate movements and the significance of that sensitivity. The policy should address such matters as the mix of fixed and floating (or index linked) interest rate assets and liabilities; the maturity profile of the debt and investment portfolios; the possible, probable and most likely future interest rate scenarios and their effects on future cash flows; the level of financial exposure which the RSL is willing to accept and the ability to respond to changes in the interest rate environment. Policy on the management of interest rate exposure should be reviewed regularly to ensure that it remains appropriate and effective in current circumstances.



Treasury management procedures and controls

To implement and ensure continued compliance with policy, RSLs should develop and adhere to effective procedures and controls. Treasury procedures should be detailed, specific and in writing. It is good practice to produce a procedures manual as a reference document. The procedures manual should be reviewed regularly and amended as frequently as is necessary to ensure that controls are effective and current.

Key operating procedural controls include:

- Separation of duties such that no one individual can initiate, confirm, record and settle a transaction.
- Specific and unambiguous delegation of authority.
- Diversification of exposure.
- Adherence to rigorous credit quality criteria in the selection of counterparties.
- Authorisation of transactions by a senior person to whom authority has been delegated by the governing body and who has not been involved in arranging the transaction.
- Full documentation of all transactions to provide a transparent audit trail.
- Regular and timely reporting of treasury activities to the executive and members.
- Detailed job descriptions which include specific authority limits, accountability and responsibilities.

This is not an exhaustive list and should not be regarded as a check list.

RSLs should develop a reporting structure which ensures that senior officers and members are kept fully informed of treasury activities. The nature and frequency of the reports produced will vary according to the level and scope of treasury activities undertaken but must facilitate fully informed and timely decision making by those responsible for policy and operational matters:

- The governing body of RSLs with active treasury operations should receive a report of significant transactions undertaken at each meeting, ideally at least quarterly.
- A formal statement of treasury department activities should be prepared annually providing an overview of the past year's activity and performance against expectations and targets. It should also set out a short term plan for the forthcoming year and a medium to longer term plan for three to five years forward. Significant longer term issues such as re-financing requirements and the need to maintain sinking funds should also be included.
- RSLs with no external debt and which are not developing should maintain and regularly review a cash flow forecast for at least the forthcoming



twelve months. A report of the cash flow forecast position and the policy for the investment of working capital surpluses and cash backed reserves should be presented to the governing body annually.

Annex A sets out an illustrative reporting structure correlating financial risks, relevant treasury policies and management objectives. It also suggests examples of reports that could be produced, which RSLs should use them, their frequency and audience. The structure illustrated might be appropriate for the larger and more complex RSLs. It is not exhaustive. Each RSL should develop a reporting framework which reflects its own activities and ensures that the governing body and senior officers are fully informed in their decision making.

Each RSL should establish its own internal compliance procedures appropriate to the level of its own operations. These should include both internal and external audit as appropriate. Governing bodies of RSLs should confirm annually to the Housing Corporation, through the Self Assessment Compliance Statement, whether they comply with all aspects of Section 1 of the Regulatory Code.

In addition to regular internal audit compliance checks, RSLs should periodically conduct a thorough review of their treasury systems and risk identification and management policies and procedures. This may best be achieved through the use of an independent adviser or the external auditor, as a periodic additional audit task. However, if there are appropriately skilled individuals in the internal audit function they may also be tasked with periodic system reviews. In intervening years the external auditor should test compliance against policy, procedures and control systems.

Credit policy

RSLs should formulate and adhere to a rigorous and prudent credit policy in the selection of their financial counterparties. This policy should encompass the providers of private finance, those institutions with which surplus funds are invested and the providers of banking, hedging, leasing and other financial services.

RSLs should be highly risk averse. Credit policy should ensure that counterparty credit risk (the risk that a financial counterparty will be unable to fulfil its obligations as they fall due) is reduced to the lowest level practicable without impeding the ability to fulfil necessary financial operations. In practice this will mean adopting a policy which sets out specific credit quality parameters by which counterparties will be selected. Those parameters should be pragmatic and draw on the best available market intelligence. In most instances this will mean using established credit rating agencies and setting minimum acceptable ratings for counterparties.

Regulation of the treasury management function of RSLs



The Corporation will, as far as possible, incorporate the monitoring of RSLs' treasury functions into the existing processes of regulation. We will minimise the requirement for additional reporting.

- **Regulation.** RSLs are required to certify in their Self Assessment Compliance Statement that they comply with requirements set out in the Regulatory Code. 1.2 of the Regulatory Code requires that associations must operate a framework that effectively identifies and manages risks and this should be read to include treasury management activities. Regulation of these requirements will be through the normal course of regulatory activities.
- **Reporting requirements.** Annex A sets out general reporting arrangements. RSLs with active treasury operations should already be preparing these reports as part of their internal financial control regime. The Corporation's quarterly and annual financial returns incorporate our reporting requirements for RSLs to which they apply. In the future the Corporation will take as active a monitoring role as is, from time to time, considered necessary.

RSLs with more than 250 housing units are required to report full details of their external debt and any derivative transactions into which they have entered through the annual Private Finance Regulatory Return.

4 Assessing Compliance

The Annual Viability Review completed for each lead regulated association includes an assessment of the capital structure and treasury management. Any issues arising from this may be followed up as part of a Financial Sustainability Review.

5 Enquiries about this circular should be directed to:

Enquires about this circular should be addressed to the Assistant Director (Financial Regulation) at Maple House or to the Assistant Director (Regulation) at the Corporation's regional offices.

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Annex A

RISK, POLICIES & REPORTS

Risk	Policy	Objective	Report	Frequency	Completion	Committee	Housing Corp
Liquidity	Liquidity Investment	Ensure solvency Security Liquidity/flexibility Yield	Cash flow forecasts on a 12-month rolling basis	Quarterly	All RSLs	Yes	Yes
Refinancing Covenant	Borrowing	Interest basis, Maturity, Committed nature, Funding source, Cost, Covenant compliance	Debt summary Covenant report	Quarterly/annually	Developing RSLs. Any other RSL with private finance	Yes Yes	Yes No
Interest Rate ----- Derivative	Interest rate management	Identify risk, Analyse sensitivity, Manage exposure ----- Understand and control hedging strategy	Gapping report Interest rate forecast ----- Derivatives report	Quarterly ----- Quarterly	RSLs with private finance ----- Any RSL using derivatives	Yes ----- Yes	No ----- Yes (Revised quarterly returns)
Counterparty	Counterparty	Credit criteria and security, Establish capacity, Monitor exposure	Counterparty report	Quarterly/annually	All RSLs with external debt or investment	Yes	No
Systems	Procedures & Controls	To ensure that all treasury exposures are identified, quantified and reported in a timely, accurate and efficient manner, review at least every two years.					