

AFFORDABLE HOMES STRONG COMMUNITIES

CONSULTATION PAPER

Treasury management by housing associations

July 2006

Introduction

The Housing Corporation introduced its treasury management policy for housing associations in 1999. We are now consulting on a replacement of that policy. The review recognises the changes which have taken place since 1999, both in terms of the Corporation's regulatory approach, and also the increasing financial sophistication of many associations.

We welcome comments on the general approach proposed and specifically on the following aspects of our proposals:

- our basic expectation on treasury management by housing associations;
- the classification of associations for treasury management purposes; and
- regulatory engagement in relation to treasury management by housing associations.

Where respondents do not agree with the proposed approach, we welcome alternative suggestions which work within the Corporation's general regulatory approach.

This consultation paper was published on 14 July 2006. We would like to receive responses by 6 October 2006.

Background

In 1999 the Housing Corporation published two circulars, Treasury management – regulatory policy and Financial derivative instruments – regulatory policy.

Treasury management – regulatory policy specified the Corporation’s expectations of associations, in terms of treasury management, at that time, but also included a significant amount of good practice material.

Financial derivative instruments – regulatory policy focused on our expectations. The circular divides associations into three groups as follows:

- any association may enter into originating loan documentation which incorporates options allowing the association to fix, cap or otherwise hedge variable interest rates, without the necessity for an amendment to its rules;
- any association wishing only to purchase a free-standing cap or series of caps in order to limit its exposure to increases in interest rates may undertake a narrow rule change to that effect by registering the amended rule in approved format; and

- any association wishing to use the full range of free-standing derivatives permitted by the Corporation may undertake a wider rule change.

When we issued the Regulatory Code in April 2002 we included the expectation that associations demonstrate that ‘financial policies and procedures are evident’ and that they ‘operate a framework that effectively identifies and manages risks’.

In March 2006 the Corporation published Treasury management for housing associations: Good practice guide. This document provides guidance on strategic, governance and operational aspects of treasury management.

We now intend to update our approach to housing associations’ treasury management so that it is aligned with the less prescriptive approach which the Regulatory Code introduced.

Proposed policy on treasury management

Basic expectation on treasury management by housing associations

Our basic expectation in this area will be set out in a circular and will reinforce the Regulatory Code, requiring all associations to have the skills, knowledge and experience, at both board and officer levels, as well as the systems and access to independent advice, necessary to identifying and managing the treasury risks to which they are exposed. The circular will emphasise that, subject to them operating within the framework of our policy, it is entirely for associations to decide how they identify and manage their treasury risks.

Our current expectation that derivative instruments should be entered into solely for the purposes of managing treasury risk, rather than for speculative purposes, will be re-iterated. To that effect, the policy will not allow associations to enter into derivatives with nominal amounts in excess of their total outstanding and committed debt, other than those associations with a wider rule (see below) who wish to close out an existing position. For example, if an association has outstanding variable rate debt of £10 million, and a further £5 million of such debt in committed facilities, the maximum permitted nominal value of a

variable rate to fixed rate swap would be £15 million. Similarly it would not be acceptable for the swap to have a term in excess of the term of the debt which it is hedging.

Where a finance vehicle has responsibility for treasury management (including raising debt and hedging interest rate risk) for the members of a group structure, the measure of total outstanding and committed debt will effectively be at group level.

Questions

Should this be our basic expectation in respect of treasury management by housing associations?

Should the total outstanding and committed debt comparison with the nominal amount of derivatives always be measured at group level?

Proposals for the classification of associations for the use of derivative instruments

We propose to move to a two-tier structure of associations in our revised policy. We propose collapsing the first and second groups of association in our existing policy into a single group in recognition that there is the same inherent risk to entering into a hedging arrangement whether through loan documentation or on a stand-alone basis, and that we do not at present check an association's procedures and controls prior to approving an application for a narrow rule change. However, an association without the narrow rule change would need to amend its rules before it could enter into free-standing derivative transactions. As now we would not undertake any regulatory work prior to approving an application for a narrow rule change.

The circular would therefore categorise associations into two groups as follows:

- any association may exercise options incorporated within originating loan documentation, or purchase free-standing derivatives, allowing the

association to enter into an interest rate swap to fix¹ or, alternatively cap, a variable rate loan; and

- any association wishing to use any other derivative must undertake a wider rule change (subject to approval by the Corporation).

We recognise that in the past some associations may have entered into derivative transactions which would not comply with the arrangements set out above. We will not revisit those transactions. However, all future derivative transactions would have to be undertaken in accordance with the revised policy following the issue of a new circular.

In line with our assertion that, subject to them operating within the framework of our policy, it is entirely for associations to decide how they identify and manage their treasury risks, beyond the restrictions on the first group of associations described above, we will not specify which derivatives an association may use.

Additionally we will allow associations with a wider rule to enter into financial transactions which are denominated

¹ By purchasing what is commonly known as a 'vanilla interest rate swap', ie a generic interest rate swap in which one party pays a fixed rate and one party pays a floating rate (usually Libor), and does not include index-linked or cancellable options.

in currencies other than sterling. The Corporation has in the past approved a very small number of specific foreign currency transactions. Regardless of the results of this consultation exercise, the Corporation will not re-visit those transactions. We would expect associations entering into such transactions to immediately undertake a currency swap to remove any exposure to foreign exchange rate movements.

Associations which currently have the wider rule would automatically be classified within the second group of associations. They would, however, need to undergo a further rule change should they wish to enter into a broader range of derivatives, instruments which are not denominated in sterling or to hedge fixed rate debt.

Questions

Are we correct to move to a two-tier structure to classify associations for the use of derivative instruments?

The draft policy allows the first group of associations to only enter into what are generally referred to as 'vanilla' interest rate swaps and caps to manage their exposure on variable rate debt. It does not allow those associations to hedge fixed-rate debt. Are we correct in taking that approach? Alternatively should we allow associations which do not have a wider rule to:

- enter into other types of derivative transactions, including index-linked arrangements;
- hedge fixed-rate debt;
- purchase collars as well as being able to purchase caps?

Is it correct that an association which has an updated wider rule, should be able to enter into whichever derivatives it decides is appropriate, including, for example, cancellable swaps?

Is it appropriate that associations with an updated wider rule (and only those associations) should be able to enter into financial transactions which are denominated in currencies other than sterling? If it is appropriate:

- are we correct to expect that associations entering into such transactions should immediately undertake a currency swap to remove any exposure to foreign exchange rate movements?
- should we prescribe which currencies associations may transact in?

Regulatory engagement

We intend to retain a regulatory process by which we will assess the treasury management arrangements of an association. As currently, we will only approve the application for a new or updated wider rule change if we are satisfied with those arrangements.

We propose to change the approach we take to assessing treasury management arrangements prior to approving an application for a wider rule. At present the process is fairly burdensome for an association, as it must complete a questionnaire and supply considerable amounts of additional information, following which our staff conduct a desk based review (and a visit to the association in most instances). In line with our move towards greater use of self-assessment and self-certification, we propose to cut down this process considerably. We will focus on self-certification, and on the means by which an association satisfies itself:

- that there is a sound business case for the use of derivative instruments, in order to more effectively manage its exposure to treasury risks, and

- that it has available the skills, experience, expertise and access to independent advice appropriate to its actual and proposed treasury activities.

Annex 1 sets out questions, taken from Treasury management for housing associations: Good practice guide, which an association's board may use to help satisfy itself in these respects, answers to which could form part of the evidence presented to the Corporation to support an application for a wider rule change. These questions should be read alongside the good practice guide itself.

We recognise that whilst an association may have suitable treasury management arrangements in place at the time of applying for a wider rule, circumstances can change such that the treasury management arrangements in place are no longer satisfactory. The Corporation will, through reviewing data collected via an association's financial returns and treasury management reports, together with our knowledge of an association's circumstances, determine whether we need to directly engage with an individual association in relation to its management of treasury risks. The Corporation will rely wherever possible on data collected in existing financial returns,

and on reports which an association already produces for its own management purposes.

Again in line with our regulatory approach, in addition to appropriate regulatory engagement with individual associations, we will from time to time use the data we collect to produce thematic reviews on the treasury activities of associations², making use of expertise both internally and externally to the Corporation.

Questions

Are our proposals for regulatory engagement in relation to treasury management by housing associations appropriate?

² Only in exceptional circumstances, when we are producing thematic reviews, will we request information additional to that which an association produces for its own purposes.

Next steps

We invite views on our overall approach and the proposed changes as detailed above. Subject to responses we propose to publish a circular setting out our expectations in November 2006.

Please send written comments and responses by Friday 6 October 2006 to:

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Annex 1

Suggested questions for housing association boards

1. Is there sufficient expertise/knowledge within the board to understand and challenge treasury management proposals?
2. Are treasury management personnel appropriately qualified and trained by a professional body such as the Association of Corporate Treasurers?
3. If officers are recommending the use of derivative instruments to manage interest rate risk, has the board received proper advice, to ensure it understands the proposal and its impact on the business, both in the short and long term? How will officers ensure that the association achieves value for money and that the instruments are not overpriced?
4. What is the level of independent oversight over the treasury function?
5. What is the association's risk strategy and appetite and how is this defined?
6. Is there a documented and approved treasury policy?
7. Are all appropriate treasury risks included within the association's overall risk policy framework?
8. Is there appropriate segregation of duties and appropriate delegation with regard to treasury duties?
9. How are banking and funding relationships managed and monitored?
10. Is adequate reporting produced, as set out in Appendix A1 [to the good practice guidance]?
11. What is the policy with regard to free standing and embedded derivatives?
12. To what extent is independent advice obtained/required in the process of obtaining new facilities?
13. How often is the treasury function reviewed by internal audit?
14. Is the internal audit performed by individuals with appropriate skills and experience?
15. Is the coverage and independence of internal audit review appropriate?

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