



CIRCULAR

Treasury management by
housing associations

April 2007

01/07

This Circular is for the attention of:

- Registered social landlords; less than 1,000 properties
- Registered social landlords; 1,000 properties or more
- Co-ownership societies
- Co-ownership equity sharing societies
- Almshouse charities
- Abbeyfield societies
- Co-operatives
- Registered social landlords' solicitors

Relevant Legislation: N/A

Regulation and/or policy requirements:

Housing Corporation Regulatory Code and Guidance

This Circular replaces Circular numbers:

Circular 04/99 Treasury Management Regulatory Policy

Circular 05/99 Financial Derivative Instruments Regulatory Policy

Note

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

Summary

Sets out the Housing Corporation's expectations of housing associations relating to treasury management.

1 Definitions

N/A

2 Corporation expectations

Introduction

The Regulatory Code says, "Housing associations must operate a framework that effectively identifies and manages risks, identifying all major risks that might prevent them achieving their objectives, with the necessary arrangements to manage risks and mitigate their effects."

Management of treasury risks is a fundamental aspect of housing associations' risk management frameworks. For some associations the primary focus will be on cash management, but for others the most significant risks will arise from the operation of substantial portfolios of private finance.

Some associations will seek to manage their exposures to treasury risks by using derivative

instruments. However the use of derivative instruments is not itself without risk.

This Circular therefore sets out the Corporation's expectations on treasury management, and also in terms of the derivative instruments which associations are allowed to use.

Basic expectations on treasury management

Housing associations must 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.

Housing associations must use derivative instruments solely for the purposes of managing treasury risk, and must not use them for speculative purposes. Therefore where an association is using a derivative the association must be exposed to a risk against which the derivative instrument can be matched.

The effect of that expectation is that an association would not be able to enter into derivatives with nominal amounts in excess of their total outstanding and committed debt, other than those associations with a

wider rule which 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.

The Corporation's concern in this respect is with the actual comparative position at any given point in time, rather than a theoretical comparison of the nominal amount of existing derivatives and the balance on existing debt at some point in the future.

Associations may wish to enter into derivatives to manage other exposures, for example to hedge RPI-linked cash flows, rather than exposure to changes in interest rates. Again the general principle applies that there must be an exposure present against which the derivative instrument can be matched.

Our general expectation is that the comparison of the nominal amount of a derivative would be compared with the underlying exposure at a group level. However we recognise that there are circumstances where this would not be appropriate. It is for each group to come to a judgement as to whether it is appropriate

to make the derivative/underlying exposure comparison at the group level, or whether it is more appropriate to make the comparison at the level of individual associations.

Use of derivative instruments

Historic position

Circular 05/99 Financial Derivative Instruments – Regulatory Policy introduced a three-tier system setting out the derivative instruments that associations were allowed to use:

- 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.

Current position

We no longer believe that there is any need for a separate second tier and consequently our expectations on the use of derivative instruments from this point forwards are:

- any association may exercise options incorporated within originating loan documentation which allows the association to fix, cap or otherwise hedge variable interest rates, or to swap from fixed to variable rate debt¹; and
- any association wishing to use a wider range of derivatives (including free-standing derivatives) may undertake a wider rule change.

Associations previously operating under the narrow rule (second tier associations as classified by Circular 05/99)

Associations which have previously gone through the narrow rule change process have the power within their rules to purchase a free-standing cap or series of caps in order to limit their exposure to increases in interest rates. We will continue to allow those associations to enter into such transactions. However we will not in

future approve narrow rule amendments for other associations. Of course such associations would be able to apply for the wider rule change to enable them to use free-standing derivatives.

Associations wishing to use a wider range of derivatives

As stated above, an association wishing to use a wider range of derivatives may undertake a wider rule change.

Some associations have already gone through such a process (to obtain the 'old' wider rule) in accordance with the expectations previously set out in Circular 05/99. Those associations are able to continue to purchase and use derivative instruments as allowed by their existing rules, and subject to any conditions agreed with the Corporation at the time of the rule change being approved.

From this point on, an association may, however, undertake a wider rule change (to obtain the 'new' wider rule) which will allow it, subject to compliance with our basic expectations on treasury management, to use whichever derivatives it decides are

¹ Subject to the association having the appropriate power within its rules.

appropriate, including entering into fixed to variable rate swaps. The process which the Corporation will apply to the assessment of applications for such a wider rule change is set out below in Section 3.

Financial transactions denominated in currencies other than sterling

Until now we have not as a general rule permitted associations to enter into financial transactions denominated in currencies other than sterling. However, we have on occasion given approval to associations entering into specific transactions in foreign currencies.

We recognise that associations may wish to raise funds in non-sterling markets. From this point on, associations with the 'new' wider rule will be permitted to enter into agreements to raise funds in the following currencies:

- the euro; and
- the US dollar.

Any association entering into such agreements must simultaneously undertake

a currency swap to remove any exposure to foreign exchange rate movements.

An association wishing to enter into normal business transactions denominated in a foreign currency, e.g. to purchase goods, should consider the treasury management implications of those transactions².

3 Regulatory approach

Our basic regulatory approach, in accordance with our general approach, will be to rely on self-certification by associations, backed up by targeted engagement with individual associations. Associations will be required to submit evidence to support certifications, but we will not be prescriptive about the form which that evidence might take. We anticipate that in considering the use of derivatives, associations will have considered the suitability of all aspects of their treasury management arrangements, so the evidence they submit to us will not in the main have to be newly created. Regulation staff will, however, be willing to discuss the evidence to be submitted to ensure that it meets our expectations.

² Including having the appropriate power within its rules.

Assessment of applications for a wider rule change

The board of an association which is applying for a wider rule change is required to:

- set out its business case for the use of derivative instruments beyond those which all associations can use; and
- certify that it has 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 the association is exposed, in terms of both its actual and proposed treasury activities, including the use of derivatives.

The association will be required to submit evidence in support of those certifications in terms of:

- governance arrangements in respect of treasury and private finance matters;
- identification and management of treasury risks;
- board expertise and knowledge;
- executive/officer expertise and knowledge;
- access to independent professional advice;

- appropriateness of treasury policies and procedures including delegation of authorities and segregation of duties;
- monitoring and reporting arrangements; and
- internal audit (or similar) arrangements (including the knowledge and experience of those providing the service) in terms of treasury management.

Where an association is applying for the 'new' wider rule, having previously been through the 'old' wider rule change application process, we will agree, on a case by case basis, to what extent we can rely on information previously submitted, supported by the association's self-certification regarding changes to personnel, policies, procedures etc in the intervening period.

We will usually undertake a desk-based review of the evidence submitted although it is possible that we might on occasions wish to meet with officers of an association to discuss the rule change application.

On completion of our assessment we will either:

- approve the rule change application unconditionally;

- approve the rule change application but with conditions attached, for example if we require actions to be taken before any new powers within the amended rules are exercised; or
- reject the rule change application, in which case we will set out our recommendations which the association would need to implement before submitting a subsequent rule change application.

Ongoing regulation

We will collect information about associations' treasury activities via financial returns submitted to the Corporation (principally the FVA – the electronic version of the annual financial statements), and from Self Assessment Compliance Statements (SACS). Our assessment of that information, together with our knowledge of an association's circumstances, will determine whether we need to engage with individual associations on issues relating to treasury matters. Where we need to collect further information to support that engagement we will endeavour to rely on information that an association prepares for its own purposes.

4 Enquiries

Enquiries about this circular should be directed to:

- a member of the Regulation team at your local field office; or
- FAEnquiries@housingcorp.gsx.gov.uk.

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