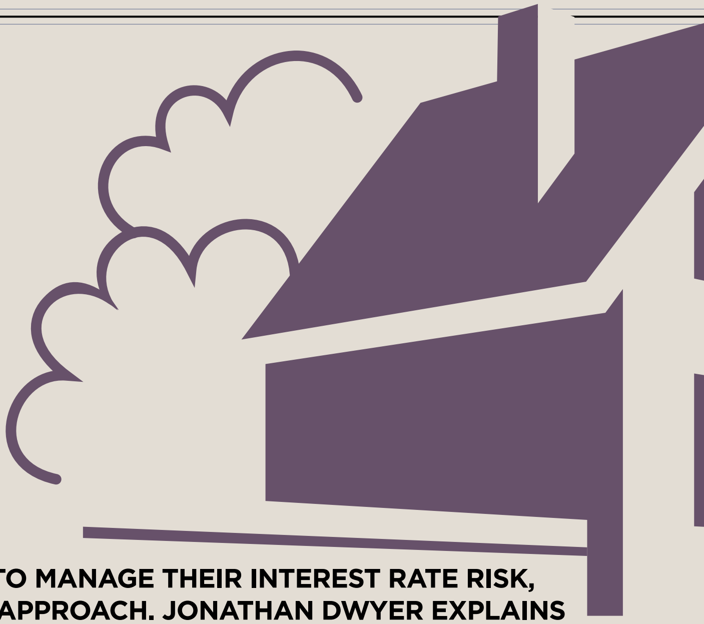


HOME INSURANCE

HOUSING ASSOCIATIONS TRADITIONALLY USED DERIVATIVES TO MANAGE THEIR INTEREST RATE RISK, BUT THE FINANCIAL CRISIS HAS MADE THEM REASSESS THEIR APPROACH. JONATHAN DWYER EXPLAINS

Derivatives, mainly interest rate swaps, have been an important tool for managing the interest rate risk of housing associations in England and the Netherlands, especially as borrowers have wanted to closely align the term of their interest rate hedging with the life of their housing assets. Since the credit crunch in 2008, however, and the sudden reduction in interest rates, housing associations have begun to use them in different ways – partly because they are increasingly borrowing from the capital markets and significant collateral is required to be held against the derivative positions.

The social housing sector in England

English housing associations, which are generally private, not-for-profit companies and charities, own more than 2.5 million housing units, providing homes for rent below market rent levels. Many also provide homes for ownership, generating income from the sale of homes, and some provide market rental units, student accommodation, and care and support services.

The sector is financed by £67bn of debt facilities – of which £55bn is currently drawn – and £51bn of public grants and retained reserves. The majority of the debt consists of long-term bank facilities with maturities up to 30 years. But the proportion of capital market debt has increased since 2008, with wholesale bonds and private placements now totalling more than £11bn (16.5%). There is an increasing emphasis on raising debt and generating income as public grants used to build new properties have reduced.

The sector is regulated by the Homes & Communities Agency, which is an economic regulator focusing on financial viability, governance and value for money. This provides assurance to lenders and investors, as it aims to ensure that social housing's assets are protected. The sector protects the interest costs on its debt by typically hedging 70% in the form of fixed interest rates and interest rate derivatives.

Unlike the UK corporate sector, banks have been willing to lend to housing associations at a fixed rate. This is partly because of the fallout from the 1988/91 Hammersmith and Fulham Council ultra vires legal case, where the risk around derivatives was poorly controlled. Over the past 10 years, housing association borrowers have used derivatives to increase the flexibility of their hedging, however, taking advantage of increased competition to drive down interest costs.

The social housing sector now spends £10bn on derivatives, and 50 out of the largest 400 housing associations have undertaken derivative transactions. The interest rate derivatives are predominantly long-term, up to 30 years, with an average term of 17 years. They include vanilla interest rate swaps, cancellable structures, basis swaps and some inflation-linked hedging.

What happened in 2008?

As the derivatives are long-term, with a potential credit risk to the banks, the International Swaps and Derivatives Association facilities were customarily negotiated with a credit support annex, which required collateral once the mark to market had exceeded the unsecured threshold. Unusually, housing associations were able to use property, as well as cash collateral, to manage the mark-to-market fluctuations.

Following the collapse of investment bank Lehman Brothers in September 2008, interest rates fell dramatically. This meant that a number of housing associations

THE NETHERLANDS' PERSPECTIVE

Housing associations play a prominent role in the Dutch housing market with 33% of all properties in the Netherlands owned by 400 housing associations, totalling 2.4 million units. They are financed by €80bn of bank debt, which is generally for five-year terms, most of which is guaranteed by the Social Housing Guarantee Fund. The Central Fund for Social Housing (CFV) regulates the sector, monitoring its solvency and performance.

To match the assets (houses) and liabilities (interest rates), Dutch housing associations have tended to transact long-term interest rate swaps of between 30 and 50 years. As in England, the banks generally required a credit support annex – but this did not allow property to be used as collateral, just cash. Initially, the Netherlands' housing associations weathered the storm in 2008, with the assistance of their regulator, CFV. But in 2012, Vestia, one of the largest housing associations, had to find €2.5bn cash to manage its mark-to-market position. The Dutch government stepped in and a rescue plan was put in place, which included selling off some of the housing stock. Vestia was an extreme case with gross derivatives of €20bn for just €6bn of debt and it is currently the subject of a fraud investigation. But the case shows the potential financial pressures the sector was under.

As a result, restrictions have now been put in place in the Netherlands. Derivatives are limited to interest rate swaps for fixed-rate payers and there are buying caps as well as maximum terms of 10 years. Importantly, housing associations must demonstrate they have the cash, or the debt facilities, to fund the collateral for a 2% fall in interest rates. It is not clear how this will impact the Netherlands' social housing sector but, as is the case in England, social housing borrowers are showing renewed interest in the capital markets with a number being awarded a strong credit rating.

suddenly had to find collateral for derivatives (see graph, right) at a time when they did not have property in place, meaning they had to use nearly £400m of cash. What is more, housing sales slumped, which increased housing associations' working capital requirements, and the credit crisis meant that new debt was difficult to raise. Finding the cash for the mark-to-market collateral calls was a tough challenge and the regulator worked with housing associations to manage this potential liquidity crisis so that no housing association failed. The regulator also introduced quarterly reporting on the collateral calls and the impact this had on a housing association's liquidity.

How is interest rate risk being managed now?

Long-term interest rates have fallen to a 300-year low since 2009, largely as a result of quantitative easing. The collateral requirements for derivatives have increased by a factor of more than four times to £1.7bn, with a total mark to market of nearly £2.4bn. But housing associations are now managing this risk better since they have secured property as the majority of collateral and embedded some of the derivatives into the underlying debt, eliminating the requirement to provide collateral. Some housing associations are now repaying bank debt with long-term bonds, which can include restructuring and cancelling the interest rate swaps. Importantly, boards and treasury committees receive regular reporting with stress tests on the impact of changes in interest rate levels on collateral calls – preferably using scenarios that include a simultaneous slowdown in sales and a reduction in the availability of finance.

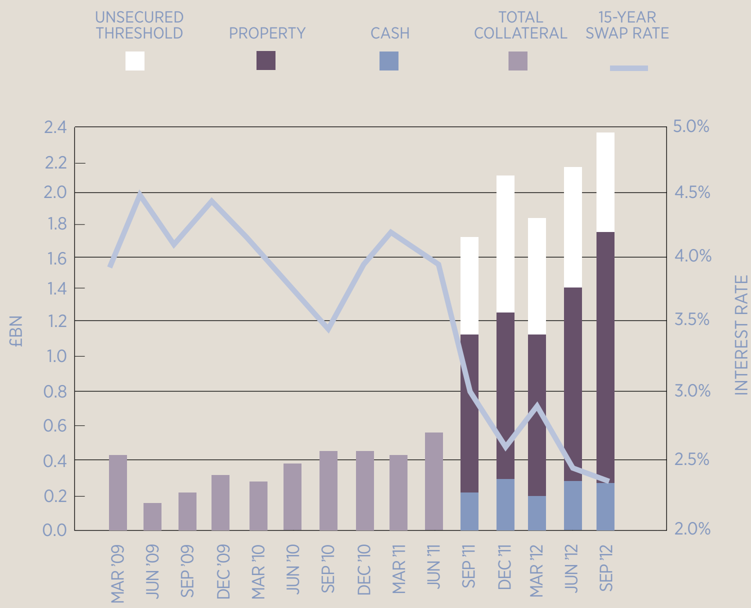
The future

The social housing sector is now increasingly using the capital markets to finance its debt, since banks will generally lend less than 10 years under the new economic and regulatory conditions. More than 20 borrowers issued over £4bn of bonds in 2012 – greater than the previous three years combined. The dearth of long-term sterling issuance has attracted investors to the sector, but another important factor is that housing association issuance is highly rated (most are AA), asset-backed and listed. This appears to hit the 'sweet spot' for insurance companies and pension funds under Solvency II.

Bond issuance should reduce the need for long-term interest rate swaps, with their high mark-to-market volatility. But the social housing sector cannot remain too complacent about the risk for collateral calls. Hedges are long-term and the mark-to-market volatility will only reduce slowly.

English housing associations face further challenges in 2015. Ten years after the UK corporate market, the social housing sector will have to adopt fair value accounting for derivatives. It is not certain what effect this will have on the sector's loan covenants or the instruments it uses to hedge – whether those are derivatives or embedded into loan facilities – but executives and boards will be considering the impact well ahead of 2015. Some housing associations that issue bonds are already required to adopt fair value accounting for derivatives under FRS 26, *Financial Instruments: Recognition and Measurement*. From this, it is apparent that there is potential for significant year-to-year volatility in reported surplus or deficit.

DERIVATIVES – MARK TO MARKET/COLLATERAL



This graph shows the mark-to-market liability owed by housing associations to banks on interest rate derivatives. This is split between the unsecured threshold, property and cash collateral, except prior to September 2011, when only the collateral is shown. The 15-year swap rate is shown as a proxy for the average term of the sector's interest rate derivatives.

Jonathan Dwyer is head of private finance for the Homes & Communities Agency