Response to Housing Corporation Consultation Paper: Treasury Management by Housing Associations

05-10-2006

CIPFA is pleased to comment on the consultation paper: Detailed comments on the consultation questions follow.

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

CIPFA considers that the expectation of boards of housing associations should be that treasury management is effective and supports the association's business objectives. To this end associations, in addition to having the skills to identify and manage risks, should also have the skills to optimise performance. The aim should be to balance effective risk management with the pursuit of optimum performance. CIPFA recommends this in its Treasury Management Code. CIPFA fully endorses the expectation that derivative instruments are entered into solely for the purposes of managing treasury risk and not for speculative purposes.

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

CIPFA considers that the level at which the limitation on the nominal derivatives portfolio should be measured at the level determined by responsibility for the loan portfolio. If the association operates a group treasury or a group special funding vehicle then the measure should be at group level. If a subsidiary manages its own loan portfolio then the measure must be at subsidiary level. The limit and measures should be applied to each borrowing entity and not simply at the Group level. A subsidiary's responsibility to manage its own loan portfolio to a high standard is particularly important where group default clauses in the loan documentation have implications for the group as a whole.

CIPFA suggests that restrictions on the term for a swap should be determined by the term of an association's facility with its funder rather than the term of the debt, so that it can take advantage of competitive long term interest rates within the time frame of the lenders commitment to the RSL.

CIPFA agrees that an association should not be able to hedge beyond its variable rate exposure since to do so would amount to speculation on future movements in interest rates seems.

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

CIPFA supports a simpler system of classification of RSLs. However we suggest a three tier classification is needed.

For example LSVT associations who do not have the wider rule change may have instruments that go beyond those embedded in their loan agreements (which are agreed by the Housing Corporation prior to transfer).

CIPFA considers that the tiers and freedoms to use various instruments should be linked to having appropriately qualified staff and mechanisms in place for the board to be assured they remain in place.

We suggest three tiers, a narrow tier, a tier enabling use of instruments allowable in loan documents, and the wider rule tier. Tier 1 associations should only have the powers to fix existing floating rate debt. To allow them more powers would require of them a much greater degree of in house sophistication in treasury management. For tier 2 associations, the use of instruments allowable in their loan agreements and which will be embedded in the actual loan facility should be available without having to seek a wider rule change. Tier 3 associations would have the wider rule change enabling both embedded and stand-alone instruments. CIPFA's view is that, even when the wider rule change has been approved, material transactions should not be actioned without the Board receiving an independent report setting out the risks and implications.

The purpose of any derivative is to manage interest rate risk. We have a concern that relaxation in their use could encourage some RSLs to speculate and 'beat the market' and result in financial disaster.

4. 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?

The vetting by the Housing Corporation prior to agreeing the rule change needs to be rigorous to ensure RSLs have the skills, knowledge and understanding to use these tools. The housing corporation should assess the competencies required to undertake this vetting and the use of specialist auditors in this field. The wider rule change should only be entered into if the board has received an independent report on the risks and the audit committee takes an ongoing view on these.

5. 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:

CIPFA has concerns over RSLs having the automatic power to enter into financial transactions denominated in foreign currency. The RSL has no natural foreign currency transactions and therefore introducing foreign currency loans creates additional risk and complexity.

CIPFA suggests that if an RSL did wish to enter into financial transactions which are denominated in currencies other than sterling, there should be a case made to the Housing

Corporation clearly setting out the reasons for this proposal and in particular highlighting how the exchange rate risk was being managed.

6. 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?

This proposal, and that which follows below, are at odds to the earlier stated proposal in the consultation paper 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', as it seeks to effectively impose detailed restrictions about which foreign currencies are transactions. By suggesting (see below) that the Housing Corporation should prescribe which currencies associations may transact in will result in the Housing Corporation becoming the arbiter of associations' individual TM policies and deals.

Exchange rate risk management is hugely more complicated than interest rate risk hedging. As one purpose of borrowing in a foreign currency would be to take advantage of interest rate differentials between currencies, then if the requirement is that the exchange rate risk inherent in the transaction is fully hedged at inception any potential advantage (or disadvantage) will be removed, i.e. the cost of the exchange rate hedge is likely to remove any interest rate advantage.

As we indicated above we do not believe these should be undertaken, but if use of foreign currency loan is allowed we think separate approval should be required from the Housing Corporation before associations can arrange debt in a foreign currency. The association needs to be able to demonstrate it has received appropriate advice and guidance. It may therefore be appropriate to create a fourth tier for associations using loans in a foreign currency.

7. Should we prescribe which currencies associations may transact in?

Foreign currency transactions, if allowed, should be limited to major international currencies for which there are established and liquid cash and derivatives markets in the UK. Therefore, this is likely to limit currencies to the Euro or US dollar, or perhaps other G8 currencies.

8. Are our proposals for regulatory engagements in relation to treasury management by housing associations appropriate?

CIPFA welcomes the less burdensome approach for seeking a wider rule change but is concerned that it may be dangerous to relax the vetting process at the same time as extending the types of derivative products available to RSLs. The self-certification approach relies upon the boards view and they need to be made fully aware of the additional responsibility and accountability that they take on through the self-certification route.

The suggested questions in annex 1, forming part of the self-certification is useful but should take account of the size of the RSL. There are no suggested questions on the performance of the treasury management function. Phrases such as ‘sufficient expertise/knowledge within the board’ and ‘treasury management personnel appropriately qualified and trained’ and ‘has the board received proper advice’ would benefit from further guidance and definition. No questions are included on non-sterling debt and a separate set of questions should be produced for this new and risky area of treasury management.

The guidance might usefully list the balance sheet items (or financial) risks faced by housing associations. This would help associations when undertaking their self assessment to determine whether they should seek a wider rule change.