



Scottish Housing
Regulator

**Treasury
Management**
April 2012

Regulatory Guidance

Summary

This sets out how we expect Registered Social Landlords (RSLs) to act, when considering using derivatives as part of their treasury management strategy. This guidance applies to all RSLs and it comes into effect from the date of publication.

It covers:

- Expectations on Treasury Management
- Range of Permitted Derivatives
- Option to use derivatives in loan agreements (Embedded)
- Free-standing derivatives
- Rule Changes and Documentation
- Types of Derivatives

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1. Introduction

- 1.1 The treasury function in an RSL includes the management of its cash flows, its banking, money market and capital market transactions, and the effective control of the risks associated with those activities in pursuit of the optimal performance consistent with its business objectives.

Treasury management refers to the set of policies, strategies and transactions that an RSL adopts and implements to raise finance at acceptable cost, and to manage its cash resources and interest rate risk.

- 1.2 The objective of good treasury management is to ensure that RSLs always have access to sufficient resources to operate their business; and that these are available in a timely manner, at reasonable cost.

2. Expectations of Treasury Management

- 2.1 Good governance means taking informed, transparent decisions and managing risk. This means RSLs identifying risks that might prevent them from achieving their objectives and managing these risks to mitigate their effects, wherever possible. Governing bodies should ensure that RSLs have effective systems for risk management, internal control and audit.

- 2.2 We have the following expectations of all RSLs in managing their treasury management function and the use of derivatives:

- a) RSLs must only use derivatives to reduce or manage treasury risks and not for speculative purposes. There must be a corresponding risk which justifies the use of each derivative.
- b) RSLs must have access to adequate treasury management skills, knowledge and experience at both board and officer levels. These should be backed up by a robust treasury management policy and accompanying procedures, along with effective controls and monitoring.
- c) Independent advice must be obtained from a suitably qualified person, registered with the Financial Services Authority before entering into derivatives transactions.

- 2.3 It is recommended that an RSL's treasury policy should adopt the key recommendations of CIPFA's *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (2011 Edition) (2011)*.

3. Risk Based and Proportionate Approach to Regulation

- 3.1 We regulate RSLs in accordance with our risk and proportionality framework. This means that we will take account of each RSL's individual circumstances and the regulatory risks involved to ensure that our respective duties are met. It also ensures that we focus our resources where they will be used to best effect, thereby minimising the burden of regulation. This guidance provides the framework for RSLs entering into a range of permitted derivative transactions.

4. Range of Permitted Derivatives

- 4.1 Derivatives can be used by all RSLs provided they have adopted the appropriate rules and are restricted to Caps, Collars and Interest Rate Swaps. These may be used to reduce or manage treasury risk but not for speculative purposes. Appendix 1 contains an outline of the various types of permitted derivatives.
- 4.2 RSLs may only enter into interest rate or inflation linked derivatives denominated in sterling. We do not consider it appropriate for RSLs to seek interest rate hedging in foreign currencies as this can add another dimension of risk in the form of exchange rate risk.

5. Use of Derivatives

Option to use derivatives in loan agreements (Embedded)

- 5.1 RSLs with existing loan agreements or new loan agreements that they are about to enter into will usually contain clauses within the loan agreement that provide for the ability to enter into certain derivatives directly with the lender as an embedded part of the loan.
- 5.2 When this embedded option is available within a loan agreement, RSLs may enter into Caps, Collars, index linked and Interest Rate Swaps provided all the following conditions are met:
- a) Speculative trading is not allowed. Derivatives must only be used to manage treasury risk. There must be an exposure which the derivative can be matched against.
 - b) RSLs may not enter into a derivative when the nominal amount is in excess of their total outstanding and committed debt. For example, if an RSL has variable rate debt of £20 million and an additional £10 million of committed facilities, the maximum permitted nominal value of a variable to fixed rate swap would be £30 million.
 - c) In the case of Forward Rate Agreements, loans do not have to be drawn down prior to a derivative being entered into, but there must be a loan commitment in place and an expectation backed up by a business plan projecting that debt will be drawn down to match the derivative that is to be entered into.
 - d) The counterparty providing the derivative must have a long term credit rating of at least single A. (An explanation of credit ratings is contained within Appendix 2).
 - e) The governing body must fully understand the implications of entering into an embedded interest rate transaction and consider if it is in the best interest of the RSL and understand the associated risks.

Free-standing Derivatives

- 5.3 Free standing derivatives, also known as stand-alone derivatives, can be transacted with many recognised financial institutions whether you borrow from them or not. The derivatives that are entered into are free-standing legal contracts and not embedded into any loan documentation. The transactions are normally subject to a standardised International Swaps and Derivatives Association (ISDA) master agreement between the parties. (An explanation of ISDA master agreements are set out at section 7).
- 5.4 The advantage of this approach is that the RSL may possibly achieve finer pricing by being able to use the wider financial market rather than be restricted to a specific lender. Free-

standing derivatives are also portable and can be preserved, even when a loan is refinanced, therefore avoiding potential early settlement costs.

- 5.5 RSLs should note that although free-standing derivatives may have some advantages over embedded derivatives in terms of pricing and portability, a provider (counterparty) of derivatives is likely to require security to cover potential mark to market exposure¹. Counterparties may consider providing the RSL with an unsecured element of mark to market exposure, but this will depend on the individual circumstances of the RSL and the credit approval of the counterparty. RSLs need to track movements in these agreements and have an awareness of the potential impact for cross default that they could have on existing loans.
- 5.6 RSLs should be aware of the relevant exposure limits set by the counterparty. In the event that a counterparty requires additional security to cover the potential mark to market exposure, then the RSL must apply to us for consent under Part 9 of the Housing (Scotland) Act 2010, in accordance with our other guidance.
- 5.7 RSLs may only enter into free-standing derivatives if they can satisfy all the conditions noted in section 5.2 above which apply to embedded derivatives and in addition the following:
- a) A rule change will be necessary to allow RSLs to enter into free-standing derivatives.
 - b) The necessary systems of reporting and control need to be in place so that the RSL can demonstrate that it is not exposing itself to unnecessary risks by entering into derivative transactions.
 - c) Legal advice is required before entering into an ISDA master agreement with a counterparty.

6. Rule Changes and Documentation

- 6.1 When options to use derivatives are embedded in an existing or new loan agreement, RSLs do not usually require a rule change. However, RSLs must take their own legal advice on this matter to ensure they have the appropriate powers.
- 6.2 RSLs considering the use of free-standing derivatives will require to have in place wider rules which provide specific power within their constitution to ensure their legal validity, as lenders are likely to insist on this requirement. The governing body should seek independent legal advice and then approach us to request consent to the rule change.

RSLs should refer to the SFHA's model rules for guidance when requesting a rule change.

7. ISDA Master Agreement

- 7.1 RSLs intending to enter into swap and derivative instruments will most likely utilise the ISDA master agreement. ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association. The ISDA Master

¹ The counterparty will regularly mark to market a derivative to establish its current value in the market. This allows the counterparty to assess potential exposure to the RSL should the derivative be terminated prior to maturity.

Agreement provides the legal basis for transactions between financial institutions in many of the world's commodity and financial markets. The ISDA Master Agreement is a bilateral framework agreement. This means it contains general terms but does not, by itself, include details of any specific derivatives transactions the parties may enter into. The ISDA Master Agreement is a pro-forma which is not usually amended apart from entering the names of the parties on the front and completion of the signature pages. However, it also has a manually produced schedule in which the parties are required to select certain options and may modify sections of the Master Agreement if desired. RSLs must seek legal advice when completing an ISDA Master Agreement.

8. Applications for a Wider Rule Change to use Free-Standing Derivatives

8.1 RSLs applying for a wider rule change will require to:

- seek our agreement for the use of free-standing derivatives;
- certify that they have access to the skills, knowledge and experience at both board and officer levels to fully understand the risks associated with free-standing derivatives;
- certify that they have in place a robust treasury management policy and procedures, supported by effective controls and monitoring; and
- certify that they have access to independent advice from a suitably qualified person, as defined in section 2.2.

8.2 Applications for rule changes should be submitted to us for consideration. There is no pre-set format for the information required. However, when we assess submissions we will place particular emphasis on the skills, knowledge and experience available to the RSL at both board and officer levels when considering treasury matters. Evidence of a robust treasury management policy and procedures, along with effective controls and monitoring, will be essential to obtain agreement to the adoption of the wider rules.

Appendix 1 – Types of Derivatives

1. Interest Rate Swaps

- 1.1 A swap contract is an agreement between two parties to exchange a series of cash flows between each other. For example, party A agrees to pay a fixed rate to Party B and Party B agrees to pay a variable rate to party A. On each settlement date the rates are compared over the period of the swap and a cash amount is paid. As swaps do not involve the actual transfer of any assets or principal amounts, a base must be established in order to determine the amounts that will periodically be swapped. This principal base is known as the “notional amount” of the contract.
- 1.2 A Swap is not a lending facility. It is an interest rate management tool that can be used in conjunction with any variable rate lending facility, including a facility with another lender. An RSL’s underlying lending facility will continue to be governed by the terms and conditions set out in the facility agreement. It is also important to remember that a Swap only affects the base interest rate applicable to your underlying lending facility. It has no effect on margins or other fees payable under the facility. An RSL will remain obligated to pay those fees and margins no matter what happens with the Swap.

2. Forward Rate Agreement (FRA)

- 2.1 An FRA is a legally binding agreement between two parties to determine the rate of interest to be applied to a notional loan. The agreement will specify the future date (the settlement date) when this notional loan is to start, and how long it will last for (maturity date). An FRA enables an RSL to borrow in the future at a pre-agreed rate of interest, it therefore provides certainty and allows an RSL to plan its cash flow. When an FRA is taken out, it is an absolute obligation and will come into force even if an RSL does not draw down the originally anticipated loan. An RSL therefore, needs to accurately work out its cash flow for the future to prevent incurring potential costs of breaking out or amending the start dates of the original FRA.

3. Interest Rate Options

- 3.1 An interest rate option differs from a FRA in that it is a right but not an obligation to enter into an agreed interest rate at some pre determined date. Thus a borrower could arrange an option for a fixed rate loan but could walk away if the loan were no longer required or if for example interest rates had dropped below the strike rate of the option. In doing so it would lose the fee it had paid the counterparty however if rates have fallen then the benefit of the lower fixed rate can be greater than the loss of the up front fee. Conversely if rates have risen then the borrower can call up the option and then have access to a committed fixed rate loan at a lower rate than available in the market.
- 3.2 An interest rate option does not commit the RSL in the way a swap or FRA does, however it gives the RSL a right but not an obligation to hedge at an agreed rate (the strike rate). If the strike rate is advantageous to the RSL in comparison to the prevailing market rate on a preset date(s), the option will be exercised and the transaction will turn into a swap. If market rates are not advantageous to the RSL, the option will be allowed to expire and the market rate will be paid. The most common maturity ranges for an option are 1 year to 5 years.
- 3.3 There are variations of interest rate options:
 - A Cap can be set as an upper limit on interest costs over a period of time.
 - A Floor is an agreement where the seller agrees to compensate the buyer if the interest



rate falls below the agreed floor rate.

- A Collar is constructed by buying a cap and simultaneously selling a floor at lower strike price to the cap. The net impact is to constrain the floating rate of interest between the upper (cap) and lower limits (floor). The benefit of a collar is that whilst it limits the exposure it is not as expensive as buying a cap.

4. Cancellable Swaps

- 4.1 A cancellable swap is where the issuer has the right at periodic intervals to terminate the fixed rate within the loan and substitute a variable one. This right, once exercised, is irreversible. The benefit of this type of swap is that they usually offer better rates than swaps without cancellable options. The downside is that the purchaser can never be sure how long the swap will remain in place before it is cancelled as the cancellable option may be exercised by the issuer or not at the pre-agreed dates. These should be limited to a small part of any loan portfolio.

5. RPI Linked Swaps

- 5.1 An RPI linked swap will lock the RSL into paying a fixed real interest rate i.e. the conventional interest rate minus inflation, e.g. 3 month Libor minus RPI over the same period.

Appendix 2 – Credit Ratings

1. Credit Ratings Categories

- 1.1 A number of credit agencies in the U.K. publish credit ratings, such as Moody's, Standard & Poors and Fitch. The ratings can be used by investors to provide an opinion on the relative ability of an entity (counterparty) to meet its financial commitments.
- 1.2 Various categories of credit ratings can be provided, but RSLs should concentrate on the long-term ratings which are more appropriate to the term of derivatives and generally fall into the following categories which are termed Investment Grade:
- **AAA** - Highest credit quality, extremely strong capacity to meet its financial commitments. Highly unlikely to be adversely affected by foreseeable events with a very low propensity to default (but not zero)
 - **AA** – Very high credit quality, very strong capacity to meet its financial commitments. It differs from the highest rated only in that the propensity to default is greater.
 - **A** – High credit quality, strong capacity to meet its financial commitments but is more susceptible to the adverse effects of changes in circumstances and economic conditions.
 - **BBB** – Good credit quality, adequate capacity to meet its financial commitments but adverse changes in circumstances and economic conditions are more likely to impair its capacity.

Ratings below BBB are termed Speculative Grade where there are varying levels of possible credit risk developing.

2. RSLs should only deal with counterparties that have a minimum 'A' credit rating.

- 2.1 Credit ratings are updated on a regular basis by the agencies, it is therefore important that ratings are checked on a regular basis. This can usually be done through the agencies websites or through a treasury adviser.