

Social Housing Report

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Bridgecourt & Company
29 Farm Street
London W1J 5RL

Telephone:
+44 (0)20 7347 7700

Fax:
+44 (0)20 7347 7701

Web:
www.bridgecourtandco.com

Author:
Robert Robinson
robert.robinson@bridgecourtandco.com

Rating Agencies' Differences in Approach to Housing Association Credit Risk

The recent decision by Affinity Sutton to withdraw its public 'A/stable' rating from Standard & Poor's, while at the same time maintaining its 'Aa2/stable' rating from Moody's, has highlighted the agencies' different approaches to rating social housing associations.

Understanding these differences is important because housing associations are increasingly expected to seek funding from the international capital markets as UK bank lending becomes less available.

A credit rating is an opinion on the risk of default, in other words the risk of not being able to re-pay financial obligations when they become due.

These ratings can be given to individual institutions such as housing associations, or to specially structured financial instruments such as bonds secured on housing association assets.

Housing associations have a somewhat unique status in that they are independent entities that can become insolvent, yet they benefit from a favourable system of regulation that to date has successfully prevented any notable defaults.

Furthermore, because housing associations are not-for-profit organisations without shareholders requiring them to maximise financial returns, operating margins are typically low and gearing also tends to be low relative to the assets they own. Having said this, housing associations are increasingly operating in un-regulated and profit-making areas, and have

exposure to market forces for housing sale and rental income. The recent different rating actions taken by Standard & Poor's regarding Sanctuary Housing and Home Group, has highlighted the potential credit impact of different exposures to housing sales income in an uncertain market.

A housing association could therefore be described as a hybrid organisation, a combination of a corporate entity and a government-supported entity.

Different assumptions and methodologies for assessing liquidity management and the degree of implied government support can therefore lead to different rating outcomes.

The three main rating agencies are Standard & Poor's, Moody's, and Fitch.

Standard & Poor's and Moody's have public ratings on several housing associations. All three agencies have public ratings on specially structured financial instruments secured on housing association assets.

There are some differences in the ratings outcomes between Standard & Poor's and Moody's for certain publicly-rated housing associations, which in part reflects the differences in methodologies between the agencies.

S&P

Standard & Poor's rating reflects the agency's opinion of the likelihood of a housing association not being able to meet an obligation on its due date.

It does not, however, reflect directly the degree of loss suffered by a creditor in the event of default.

The likely amount of money an investor can expect to receive after a period of time can be assessed in a separate 'recovery' rating.

Government support is factored into Standard & Poor's rating, and this underpins the investment grade ratings that have typically been given to housing associations.

Having said that, measures of business performance such as operating margin, debt service requirements, future financial commitments and supporting liquidity arrangements are also given significant weight in the rating decision.

This results in a wider range of ratings for housing associations across the investment grade category.

Moody's

The Moody's rating reflects the likelihood of default and the probability of financial loss, and its rating approach tends to put more emphasis on the role of government support.

Moody's applies its joint default analysis methodology for rating UK housing associations, which was first introduced a few years ago and resulted in rating upgrades for a number of government-related entities including UK housing associations.

This approach considers the housing association's own risk of default and the risk of default by the UK government.

It then considers the default dependency between the two, and estimates the probability of government support.

With the strong likelihood of government support and the low probability of financial loss, Moody's ratings tend to be several rating notches higher than Standard & Poor's.

However there is less of a spread of housing association ratings given by Moody's, as they tend to be clustered at the very high investment grade level, and therefore there is less credit differentiation in general between associations.

Summary of differences

The different rating outcomes reflect the different methodologies between the agencies, which can become particularly pronounced in a somewhat unique sector such as the housing association sector.

In a sense the different approaches could be seen as complimentary, with the Standard & Poor's rating emphasising shorter term cash flow issues, while the Moody's rating emphasises the longer term recovery prospects.

Rating benefits

If a housing association seeks alternative sources of funding, having a good credit rating that explains its strong credit story will be an important element in its funding strategy.

Housing associations may also find it beneficial to take a more pro-active approach to developing relationships with investors both in the UK and overseas, in order to achieve better costs of funding over the longer term.

Investors are keen to find places to put their money, particularly where there is transparency and greater certainty regarding measurement of the risk they are taking.

Having a credit rating may also help secure better costs of funding from banks, as banks are likely to become more discriminatory between housing associations in terms of the potential different risk profiles associated with lending them money.

The pricing of housing association-issued debt will, however, not just be a function of credit ratings but will reflect market conditions at the time, which takes into consideration other measures of risk.

Types of risk

The current financial crisis relates to a reduction in available liquidity, and is in part driven by the lack of transparency and uncertainty regarding lenders' exposure to losses from complex debt instruments that have been created in recent years. This in turn has made lenders less willing to lend to each other.

Liquidity risk in this sense is different from credit risk, as it reflects lenders' cash needs to meet their future obligations.

Liquidity risk reflects a number of factors including size of issue, history of trading of a particular type of issue, the complexity of the issue structure, and the size of the investor community willing to acquire such issues.

Assessing liquidity risk is perhaps less straightforward than assessing credit risk, as there are no available liquidity ratings in the same way there are credit ratings.

Nevertheless, building and maintaining relationships with the investor community will allow housing associations to address any information gaps that may exist in investors' understanding of credit and liquidity issues associated with the sector.

This should help secure better costs of funding for housing associations – something that is becoming increasingly important in the current funding climate.

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