

Social Housing Report

September 2009

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

Credit Risk & Government Support

The sector's relationship with government has come under increasing scrutiny in recent months, with a controversial legal judgement that RSLs should be treated as public bodies, and improvements to RSL credit ratings reflecting strong levels of government support.

The advantages to RSLs of strong government support may in part be offset by compromising their independence. Furthermore this support is not necessarily a static arrangement that can always be relied on, and can be affected by changes to the economic and political environment.

RSLs, the government and lenders have all benefited from the current situation which has allowed RSLs acting as independent landlords to develop mixed housing portfolios, while lenders have provided cheap private funding on the assumption that government support and regulation would prevent defaults. The government has benefitted by attracting significant amounts of private finance into affordable housing without this borrowing being counted on its own balance sheet.

These cosy arrangements persisted during relatively benign times, when there was no incentive to scrutinise any potential inconsistencies.

A more challenging economic environment, rapidly declining public finances, increasing costs of funding, and the recent public status legal ruling have, however, served to bring the relationship between independence and government support into sharper focus.

It is perhaps therefore timely to examine the role of government support, how it is assessed from the point of view of credit analysts, and the implications associated with changes to this perceived level of support.

Rating Changes

Following a decision to refine its criteria for analysing government related entities (GREs), Standard & Poor's recently amended its ratings for a number of GREs on a global basis. Notwithstanding S&P's decision to put the UK government's rating on negative outlook and its decision to downgrade a number of UK property-backed transactions, S&P has increased its public ratings for UK RSLs.

According to S&P this reflects both improvements in their stand-alone credit profiles, and the application of its revised methodology which gives greater emphasis to government support. The consequence is that the rating differences between S&P and Moody's are likely to be reduced. Moody's ratings reflect 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.

As a result Moody's RSL ratings have typically been several notches higher than those of S&P. Although it does not yet have any public RSL ratings, Fitch recently published its approach to rating RSLs.

In a similar way to S&P (but unlike Moody's), Fitch's rating methodology does not factor in recovery post-default. Fitch's rating outcomes for RSLs are therefore likely to be more akin to S&P's ratings. That said, the option of having a third rating agency opining on the corporate creditworthiness of individual RSLs should be of benefit to the sector and to investors keen to lend to RSLs.

Assessed Factors

All three rating agencies identify 'ongoing and extraordinary' government support as crucial factors that underpin the strong ratings that have been given to RSLs to date. In an attempt to bring some transparency to its rating approach, S&P has introduced a matrix for assessing government support.

It is intended that the matrix will help investors distinguish between the different levels of support factored into GRE ratings across different sectors and jurisdictions. The assessment is determined by considering:

- The importance to government in terms of the GRE's role with regard to national policy objectives, and consideration of its impact on wider economic and social factors;
- The strength of its link to the government in terms of ownership, the role of government in determining strategy for a particular GRE, and the system of supervision and regulation.

The analysis also factors in not just the willingness, but also the ability of a government to provide timely extraordinary support, ie. financial bail-outs. The recent Homes & Communities Agency decision to provide grant funding to enable certain RSLs to 'flip' housing for sale to housing for rent was identified as a good example of how regulatory invention can help avert financial distress.

Moody's has highlighted the high probability of government intervention in the event of an RSL getting into severe financial distress. It also pointed out that the consequences of default could have an adverse effect on the cost of funding, not just for RSLs but also for other UK-based GREs. The cost of preventing a default is therefore minimal compared to the potential additional costs if a default occurred.

Rating volatility

Despite attempts to improve rating transparency and granularity between ratings, those that factor in a significant amount of government support have a degree of subjectivity associated with them. This subjectivity can be exacerbated by different perceptions of support in different countries, and local judgements regarding the relative importance of certain industries to a particular government.

If there is a tendency to perceive most GREs (regardless of the sector) to be important to government, then attempts to demonstrate granularity between ratings will be difficult. The consequence of this is that ratings may remain high until the government is deemed to be acting in a non-supportive way in a particular sector, which contradicts the original rating assumptions. At that point ratings in the sector (and potentially in other government-supported sectors) may be subject to rapid downgrades, and this may have wider implications for the cost of borrowing.

The 'stand-alone' rating of a GRE is therefore an important consideration in an assessment of how far its overall rating could fall if the government failed to provide its assumed level of extraordinary support.

Ratings that give greater emphasis to government creditworthiness and to the likelihood of government providing support may be at risk of greater volatility in the event of changing economic and political circumstances, and indeed in the event of changes to the government's own credit standing.

This article first appeared in Social Housing in September 2009

Disclaimer

This report has been issued by Bridgecourt & Company Limited and has been provided to you solely for your information and should not be considered as an offer, or solicitation of an offer, to sell, buy or subscribe to any securities or any financial instruments.

This report is intended for use by professional and business investors and issuers only. Any information and opinion contained in this report has been based on sources believed to be reliable, but, neither Bridgecourt & Company, nor any of its directors, employees, or affiliates accepts liability from any loss arising from the use of this information and opinion.

Any opinions, forecasts or estimates in this report are judgments made at a point in time, and there can be no assurance that future results or events will be consistent with any such opinions, forecasts or estimates. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance.

Information in this report is subject to change without notice, its accuracy is not guaranteed, it may be incomplete, and it may not contain all material information concerning a particular organisation, security or financial instrument. Bridgecourt & Company is not agreeing to, nor is it required to, update the information, opinions, forecasts or estimates contained in this report.

The value of any securities or financial instruments mentioned in this report can fall as well as rise. Investors should seek financial advice regarding the appropriateness of investing in any securities, financial instrument or investment strategies mentioned in this report.

This report may not be reproduced in whole or in part, copies circulated, or disclosed to another party, without the prior written consent of Bridgecourt & Company.