BRIDGECOURT
& COMPANY

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

Back to the future – Should housing associations be considering securitisation?

Various types of securitisations developed over the past decade to meet an increasingly sophisticated range of investor demand, these also included UK social housing backed transactions (although there has been limited recent new issuance in the face of cheap bank lending). Securitisations in essence can spread financial risk and make the financial system work more efficiently. They can reduce the risk of default through the use of special purpose vehicles, debt tranching, and dedicated liquidity or cash reserves, and furthermore they can separate the risk of corporate bankruptcy and defaults between different classes of debt.

Having said that, securitisations, particularly highly structured deals, have been associated with recent problems in the international financial markets. In part this is due to a lack of transparency and limited data availability linked to certain complex deals. However securitisations cover a range of different approaches, structures, and asset classes, and it is important to differentiate between them. Social housing transactions, for example, are relatively straightforward and transparent in their structuring and the quality of the data used in credit modelling is good.

The growth in the wider securitisation market coincided with an extended period of low interest rates, and increasing values of assets underpinning securitisations. This in turn allowed more debt to be borrowed against these continually rising values through regular refinancing. In an environment of increasing leverage, based on expectation of available liquidity and strong asset values, underlying credit risk appeared to become a less important part of the pricing process. Furthermore, the increasing leverage magnified any shortcomings in the underlying credit fundamentals, and where there was over concentration of risk in certain areas, such as the US sub-prime mortgage market, this became a particular problem.

Although credit risk criteria remained essentially the same throughout this period, bank margins and bond spreads narrowed between the different rating categories associated with securitisations. Key risks around correlation, lack of disclosure regarding the underlying assets, and leverage, still existed and if anything became more profound. The pricing of risk reflects a number of factors including underlying credit fundamentals, availability of liquidity, and market sentiment, and it is fair to say that until recently the market appeared to put greater emphasis on the availability of liquidity than on underlying credit factors. Over the past few months, however, there has started to be a re-alignment of the risks that drive pricing, for example pricing is more likely to reflect the risks of illiquidity. Price levels are expected to continue to adjust to the changing conditions, uncertainties, and market perceptions for some time.

Market illiquidity has contributed to a major slowdown in recent transaction activity, but investors still have funds available and at some stage will have to invest in new transactions without being unduly exposed to uncertainties and unquantifiable risks. UK social housing has strong story to sell to international investors to this effect. Housing associations themselves are strong credit counterparties, and furthermore the assets underpinning securitisations are typically conservatively valued and the rental income streams are stable and predictable and supported by reliable data.

As pricing is expected to become increasingly aligned to credit fundamentals, this should work in the favour of UK social housing associations compared to organisations in other asset classes. To maximise this advantage, social housing associations should be able to quantify as far as possible the risks they are exposed to. This will include, for example, exposure to non regulated sectors and the assumed level of support between regulated and non regulated areas, as well as the impact of a downturn in the UK housing sector, in particular at local level where there may be particular concentrations of buy to let properties or relatively little headroom between regulated social housing rent and market rent.

As well as straightforward corporate debt issues directly linked to the credit standing of a particular association, housing associations may also want to consider once again securitisations that may attract even higher credit ratings and better pricing. It is expected that credit rating agencies will continue to look positively on the sector both in terms of ratings of housing associations and ratings of transactions secured on housing association assets.

At a time of some uncertainty around future sources of funding and the costs of funding, it may be worth housing associations taking a more pro-active approach to developing relationships with investors both in the UK and overseas. As well as explaining their strong credit story, associations may wish to develop structures and approaches that provide competitive funding costs that also balance risk and return for investors. Investors are keen to find places to put their money where there is transparency and greater certainty regarding the measurement of the risk they are taking. Housing associations meeting these criteria may be well placed to turn the current turmoil in the financial markets to their advantage.

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