Double threat to RPs with exposure to cancellable swaps: should they exit these deals?

Registered providers with exposure to cancellable swaps face risks on a number of fronts.

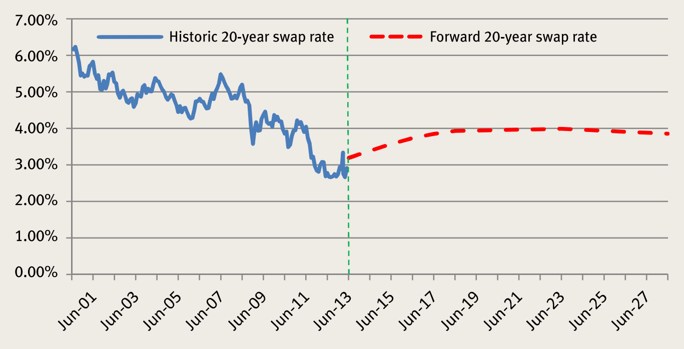
- Interest rates might rise to a level that would make it economically sensible for banks to cancel them.
- The cost of buying back the option to cancel could rise as interest rates rise.
- The introduction of IFRS accounting rules could cut off RPs' options to restructure hedging without affecting their income and expenditure accounts.
- The same new accounting rules may prevent RPs from treating cancellable swaps as hedging which could push their mark-to-market movements into income and expenditure accounts, possibly putting pressure on loan covenants.

Interest rates

The current low interest rates mean cancellable swaps have a positive mark-to-market value for the banks, and so the banks will not choose to cancel them unless rates rise substantially.

The low rate environment makes an option to cancel swaps relatively useless for the bank and so its currently cheaper for landlords to buy the options back.

Historic and forward looking 20-year 6-month libor swap rate



If interest rates continue to rise, the higher they go the more likely it is that banks will want to cancel the swaps, and consequently the greater the value of the cancellation options.

But so long as interest rates don't reach the level where it is economically logical for banks to cancel swaps, RPs will continue to pay the agreed fixed rates.

Nathan Pickles, partner at Centrus, said: 'The bank will only cancel the swap if it makes economic sense to do so, which will mean that the underlying swap has to have a negative mark-to-market for the bank at a cancellation date.'

So how high would interest rates have to go before banks would consider cancelling?

Mr Pickles said: 'You can get a sense of this by looking at market implied forward interest rates and applying yield curve shocks to test under what scenarios the cancellable swaps will be cancelled.'

He said: 'In many cases forward interest rate expectations are so low that cancellable swaps are not expected to be cancelled if actual rates follow the market expected forward rates (see graph) we can be almost certain that such a scenario will not actually play out in reality, hence the importance of stress testing your portfolio'

But he added: 'An important point is that the risks of cancellable hedging must be seen in the context of the wider treasury portfolio and the business plan. It is not really possible to say whether a particular RP is materially exposed without taking a holistic view of their wider financial position.'

IFRS threat?

Changes to accounting rules under IFRS are also worrying some RPs but Mr Pickles said this concern may not mean action is required: 'I would say that IFRS is causing RPs to revisit their underlying treasury risk exposures, and cancellable hedging is particularly in focus given we appear to be reaching a turning point in the interest rate cycle.

'We are not advising clients to restructure cancellable swaps and incur the associated transaction costs purely for accounting reasons.

'The accounting tail should not wag the treasury dog. But we are encouraging clients to ensure they fully understand the risks associated with non-vanilla hedging, and to consider restructuring as an option where the exposures are determined to be too large.'

How Genesis neutralised the cancellable swaps which hedged 20 per cent of its debt

In the wake of the HCA's research into the sector's exposure to cancelleable/callable interest rate hedging we asked Robert Kerse how he had dealt with the issue at Genesis.

Mr Kerse is now finance director at Circle but was finance director at Genesis when it restructured its hedging.

As a result of the changes he made there are now no cancellable (callable) options allowing counterparties to cancel hedging and less than 1 per cent of Genesis' debt is RPI linked.

This was not the case when Mr Kerse joined in May 2011 because, like many other housing associations, Genesis had increased its hedging between 2006 and 2008 when interest rates started rising.

At beginning of this period libor had been around 3-3.5 per cent and many housing associations had a significant amount of floating rate debt.

Mr Kerse said: 'As interest rates rose toward 6.5 per cent people found that they weren't going to meet their interest budgets.'

One solution was to hedge against further rises in interest rates but this had become increasingly expensive on a vanilla fixed rate basis.

He said: 'At that time the 30 year swap rate (the fixed rate to be paid in exchange for libor) would have been about 5.5 per cent.

'But by selling options – giving the counterparties an option to cancel the deal if it became unfavourable to them – that rate was knocked down to say 4.5 per cent.'

He said: 'I think this was done to save money in the short to medium term, but with potentially adverse impact on cash flow in the medium- to long-term.

Many chose to ignore the fact that the most likely moment a bank would cancel these swaps would be at the time when housing associations needed them the most.'

These options give banks the right to cancel swaps at certain points ranging from every quarter to every five years.

Genesis had long dated interest rate swaps (hedging changes in interest rates) with a notional value of £250 million in relation to which it had sold cancellation options to the counterparties, hedging about 20 per cent of its drawn loans.

European step-up

In Genesis' case the optionality went both ways.

Mr Kerse said Genesis' portfolio also contained 'step-up' options at the same date as some of the cancellation options.

These do the opposite of cancellables and give banks the right to increase – in the case of Genesis, double – the notional size of the swap.

This would be likely to happen when a bank is making money out of a swap (the fixed rate paid by the housing association is higher than the floating rate paid by the bank – as it is now) and so could potentially double the

Landlords could see £4 billion of debt stripped of interest rate protection if rates rise

Banks have the option to cancel the interest rate hedging on about 7 per cent (£4 billion) of the sector's debt according to the Homes and Communities Agency's latest quarterly survey.

This means landlords could be stripped of interest rate protection on some of their debt just as interest rates become punitive.

The HCA survey found that 35 per cent of registered providers (RPs) managing over 1,000 units were affected.

Another risk is that landlords using these complex derivatives could be caught out by new accounting rules because they may not be considered 'genuine' hedges.

On average each of the RPs has £41 million of cancellable hedging.

But this will not be uniform with some RPs – or their subsidiaries – believed to have between 30 and 100 per cent of their debt fixed with cancellable hedging.

Swaps

The HCA's data shows 96 of the 274 RPs that take part in its quarterly survey were exposed cancellable swaps. This compares to 49 RPs which have entered into standalone swap deals.

> "Some outliers have much higher levels of exposure with a few subsidiaries believed to have 100 per cent of their debt cancellable"

These standalone deals are considered to be more sophisticated transactions because RPs have to manage the risks associated with them.

Cancellable swaps are seen as complex derivatives and the HCA figures show that these transactions have been entered into by many RPs that have not used standalone derivatives. Instead the cancellable hedging has been embedded into bank loan agreements

Background

Hedging, or fixing, is done to protect landlords from paying higher interest rates.

Financial instruments called swaps are used to provide this protection.

These involve landlords paying a fixed rate to a bank and, in return, the bank paying the Landlord a variable (libor) interest rate in return, which offsets the interest paid on underlying floating debt.

The life, or term, of the swap would generally match the term of the underlying loan it was set up to hedge.

Cost saving

Between 2006 and 2008 several landlords moved to fix their floating rate debt because short-term interest rates were high.

To further reduce the cost of hedging a number of landlords agreed to sell so-called 'options' to banks which allowed banks to cancel swaps in return for letting the Landlord pay a lower fixed rate.

If cancelled this would return the housing association to paying interest on the underling bank loan on a variable rate basis.

The more frequently the bank could call upon this option to cancel the swap (ranging from every three months to every five years) the lower the fixed rate paid by the housing association.

Exposure

The HCA said 35 landlords had between 11 per cent and 30 per cent exposure to cancellable swaps.

However some outliers have much higher levels of exposure with some housing group subsidiaries believed to have 100 per cent of their debt cancellable.

The situation might not look too bad on a sector-wide view but the stress could be much higher at an individual level

The HCA has not disclosed the ratio of cancellable debt to normal debt across the 96 affected housing associations.

The sector itself has increased its hedging from 65 per cent of its loan book in 2011 to 70 per cent in 2012.

According to the HCA's global accounts the sector's interest rate costs rose by 13 per cent to £2.4 billion in 2012 which led to an increase in its aggregate interest rate from 5 per cent to 5.2 per cent.

size of a deal in which a housing association is out of the money.

Cost

Mr Kerse said that the existing accounting regime worked in his favour: 'We took the view that we weren't making fundamental changes to hedges so there was no profit or loss to go through the income and expenditure account.'

He said: 'There was an economic cost we had to crystallise when we marked to market at the new swap rate.

'But in our case this economic cost resulted in paying a higher fixed rate coupon over the term of the new swap so there were no large one-off payments to put through the accounts.'

He warned: 'After 31 March 2014, even if you do what we did and don't pay up cash to break swaps, you are likely to have to recognise that cost in your accounts as if it had been incurred. In Genesis' case, if the new rules were in place, I probably wouldn't have been able to do it all at once which is what we did in late 2011.

'The cost of removing the option to cancel was relatively very low, as we chose to do this at a time when rates were historically low and worth less to the counterparties.'

The option to cancel a swap deal rises in value as it becomes more likely to be used.

A bank is likely to cancel a swap if it is losing money on it.

This would be when interest rate swap rates rise above the fixed rate being paid to them by housing associations.

That is a long way from happening at the moment as interest rate swap rates are still only just above all-time lows, so banks are making money.

Mr Kerse said that because counterparties were reaping the on-going benefits from interest rate swaps – due to falling interest rates – the value of the option to cancel the deals had fallen.

He said: 'We sold the options in 2006/08 and then bought it back again in 2011 and over that period their value had fallen with reference to the long-term interest swap rates.

'So the fixed rate coupon we ended up paying is more advantageous than if we had entered into vanilla fixed rate swaps back in 2006/07.'

Genesis did more than remove the cancellation option.

Mr Kerse said: 'We changed the underlying swaps in order to match them up with its amortisation profile for a perfect interest rate hedge.'

The valuation of the options and the swaps was not straight forward.

Mr Kerse said: 'There is a market rate for these options but the banks will add a trading spread on it too.

These were wider trading spreads than we were prepared to pay so we got financial advisers to make sure we were paying a fair rate.

'Essentially it was a logical and simple process to do but the result is that the fixed rate you are paying will go up.

'The question is whether you are prepared to pay more for certainty over your future interest rate costs. Your projected level of business plan headroom is an important consideration of whether it is appropriate to continue to hold swap cancellation risk.'

He said: 'You should review the risk position of any options that you have sold at least annually to assess how likely it is that the bank will call it and what effect it would have on your interest rate payments if they did – and that affects your decision making, as does the expense of doing it.'