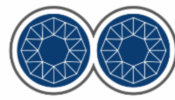

White Paper:

Derivatives in Woningbouwcorporaties

JnB VALUE & INSIGHT

Does the latest stress test review show the Woningbouw Wet has had the desired effect in preventing a recurrence of the Vestia affair, and what if any is the price paid by the industry?

Introduction

The Vestia affair still casts a long shadow over the treasury operations of Woningbouwcorporaties. Four years on from the passing of the law that it inspired, the industry watchdog (Authoriteit Woningbouw) report on the latest stress tests has been published on 19th September. Before reviewing the results, we recap the situation Vestia found itself in, the actions taken, and the law designed to prevent a repetition.

Vestia

By January 2012 Vestia had €6bln in loans and an associated derivatives portfolio with a notional value of €23bln, tenors extending up to 50 years, and a significant number of exotic products. As rates continued to decline in the fallout of the financial crisis the mark-to-market value of this portfolio was underwater to the tune of €9.9bln, leading to liquidity problems due to the CSA agreements that covered a third of this amount, and thus raising the prospect of bankruptcy. The portfolio was also overhedged, and the complexity resulting from the optional and speculative nature of some of the transactions made sensitivity to interest rates hard to measure, and rate changes exponential in their effect.

It was at this point that the government stepped in, represented by the Minister voor Binnenlandse Zaken, Elisabeth Spies. The government was of course already involved by way of the mutualised rescue fund for housing associations, and an implicit state guarantee which was assumed to exist. Spies's first step was to sequester all the assets of Vestia leaving banks with a claim on an empty shell. Spies then offered to negotiate a settlement with the creditor banks. The resulting deal saw the banks agree to take a loss on their claims, while Vestia committed to taking loans to partially pay its debts. In this way bankruptcy was avoided but at the price of higher borrowing costs for housing associations since both the rescue fund and the implicit guarantee had proven to be more honored in the breach.

To compound the problem, it also emerged that the Vestia portfolio had been constructed on collusion and fraud by the treasurer and his financial advisor.

The Law

The key terms of the 2012 law include:

1. Existing Transactions

a. For transactions containing interim market settlement (ie. a CSA or a break clause) associations must hold a liquidity buffer sufficient to cover an interest rate fall of two percentage points (pp);
b. The onus to report any shortfall lies with the association;
c. If the buffer is insufficient to cover a drop of one percentage point, then the association cannot enter into any new derivatives;
d. If the buffer can cover a 1pp fall but not one of 2pp, then no penalty is applied;
e. Break clauses should be considered one year ahead of their applicable date, and the full value should apply;
f. Associations must provide "transparent derivatives reporting" in their annual report;
g. Associations must implement risk management controls.

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2. New Transactions

a. The choice of derivative products open to housing associations is restricted to Caps or Payer Swaps;
b. The Hedge Item can only be a floating loan;
c. Any new transaction should hedge against upward rate moves;
d. New transactions must be denominated in Euros;
e. Maturity can't exceed the loan maturity;
f. Bank counterparties must have at minimum an A rating;
g. In addition, there may be no clauses which might impede the regulator;
h. Only standard the ISDA agreement may be used, and any non-standard existing agreement must be renegotiated;
i. Furthermore, Dutch law must apply to the agreement, as specified in a template provided;
j. The bank must treat the association as an Unprofessional Counterparty (as defined in MiFID).

Observations on the law

Regarding the liquidity buffer requirement, it is not clearly specified what constitutes a 2pp drop in the interest rate; across the whole curve, on the short end, a specific period? The industry consensus appears to be that a parallel shift of the entire curve should be the standard. Furthermore, were an association to fail the test the penalties are by no means punishing. As no bank would treat an association as Unprofessional the penalty for a shortfall in the buffer is moot as associations are effectively blocked from entering into new transactions anyway. Therefore, the only actual penalty is 'name and shame'.

As far as the buffer amounts are concerned we estimate that they will be considerable. The regulation is driven by the example of Vestia, but doesn't allow for the fact they were atypically overhedged. The large size of the buffers creates a significant opportunity cost on the cash withheld, which ultimately means tenants have to pay higher rents. Perhaps regulations designed around a concept of prudency may be better.

The treatment of break clauses insists on the full value being used in calculations where the removal cost is a better reflection of the actual risk. In addition, the law talks in terms of mutual break clauses, which are really more a contractual convention than being truly mutual.

An overall consequence of the above is that housing associations which mitigate their credit risk by entering into CSAs are then punished by having to hold a buffer to cover the liquidity risk, while others who remain open to credit risk have no such obligation.

Over-generalisation from the Vestia case is also evident in the consideration of product types and tenors. The real risk is on the funding of the long-dated assets of the association, not on the intermediate term loans, and swaptions are actually a more effective product in many circumstances. These constraints render the law counter-productive for sound risk management.

A number of the requirements have the effect of driving up borrowing costs for associations without delivering any genuine protection. These include the requirement for euro denomination which removes use of the capital markets outside Europe, the limitation on Hedge Items prohibits the use of bonds or private placements, and the restriction on ISDA contracts which removes guarantees for banks which can reduce costs.

Stress Test 2016

350 housing associations were covered by the test, and all those who required a buffer met the requirements. However, the review notes that the process was slow and painful.

115 of the associations had derivatives positions, and 47 of the outstanding contracts had interim market settlement. In addition, 167 housing associations had embedded derivatives, but as these are considered to carry no liquidity risk they are not deemed a concern.

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Excluding these embedded derivatives, the total notional outstanding across all associations was €13.7bln. To put this in context recall that Vestia had an outstanding notional of around €23bln. To some extent this smaller total may be due to the restrictions in the law, but it is unlikely that associations would have built up Vestia-sized portfolios in their absence. Of this total notional, €3.1bln requires a buffer, and the total buffer held is €2,3bln, while calculation only gives a requirement of €1.1bln.

The 36 associations with break clauses, effective between now and 2020., were required to produce a plan for dealing with these break clauses, and 34 of the 36 did so. This requirement is particularly troublesome for housing associations as in any renegotiation the knowledge and information is weighted in favour of the bank.

Although not directly related to the buffer it is noteworthy that the total mark-to-market value across all associations was €6,1bln out of the money, which represents 50% of the total notional. However, it must be borne in mind that this does not represent a loss, but rather is the flipside of gains on the hedge item and therefore is not a cause for concern.

Conclusion

The stress test review suggests that the law as it stands is based too heavily on the exceptional circumstances pertaining to the Vestia case, rather than reflecting the situation of the industry as a whole. As a result, the requirements are unnecessarily punitive of any derivatives held, providing a blunt safeguard at considerable cost to the housing associations and ultimately their tenants. While this is partly understandable given the circumstances at the time, more reflection and knowledge should permit the development of a more nuanced regulation which reflects market practice, controls where necessary, and minimizes the impact on the broader functioning of housing associations.

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