

Public Finance Ratings



Research: The Housing Finance Corporation Ltd.

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ISSUER CREDIT RATING

The Housing Finance Corporation Ltd.

Issuer Credit Rating A+/Stable/A-1

Issuer credit rating history:

June 24, 2004 A+/A-1

Major Rating Factors

Strengths:

- Housing association borrowers typically are strong credit counterparties with no history of defaults;
- Loans are secured by fixed and floating charges over social housing properties, and there is a robust level of asset overcollateralisation;
- Prudent lending policy; and
- Competent, albeit relatively new, management team.

Weaknesses:

- Low reserves relative to comparator banking organizations;
- Exposure to single sector, with some borrower concentration risk;
- Prudent lending criteria, relative to other lenders, which has reduced business growth in recent years; and
- Small staffing numbers, which heightens vulnerability to staff turnover.

■ Rationale

The 'A+' long-term corporate credit rating on U.K.-based not-for-profit lender The Housing Finance Corporation Ltd. (THFC) reflects the general creditworthiness of THFC, but is not necessarily applicable to any specific debt issuance associated with the entity.

THFC is a dedicated, not-for-profit lender to the U.K. social housing market. It has a high quality loan portfolio, and a broad diversification of borrowers and properties across the U.K. social housing sector in terms of size and location. THFC's loan book is extremely stable and reflects a microcosm of the U.K. social housing market, with no experience of cash default or economic loss to date. In this capacity, THFC functions as more of a loan aggregator than traditional lender. Furthermore, it provides a public-policy role, which differentiates it from other lenders by having close links to government, the sector regulator (The Housing Corporation), and the National Housing Federation (NHF; the sector's trade body), although no formal support is provided by these entities. THFC's not-for-profit status also provides it with a degree of flexibility and conservatism. THFC has, in the past three years, expanded into an agency role, managing and structuring housing debt transactions that provide some fee income and limited diversification from its lending activities.

THFC provides well-structured loans, which are principally secured by way of a fixed charge over several hundred thousand U.K. social housing properties. It uses conservative lending covenants (relative to the market), with a minority of loans secured by a floating charge and £5.8 million (\$10.6 million) of dedicated reserves.

Loan payments to THFC are received one month in advance of THFC's obligation to pay on its debt obligations, providing a small debt service cushion and a source of additional investment income. Significantly, THFC does not take on funding risk, as debt is not raised until loan mandates are agreed.

THFC's management team is competent, although relatively new, and has been instrumental in the reorganization of the "new" THFC. As part of this reorganization, it has developed a bespoke internal scoring system for grading the credit quality of borrowers, which is indicative of the transparency of THFC's lending approach. The system is used as a key determinant in lending decisions, and correlates reasonably well with Standard & Poor's ratings on the sector. That said, the THFC credit model is focused more on sizing ultimate loss—a key difference from Standard & Poor's credit approach, which focuses more on default risk and timeliness of repayment. Despite there being a small staff, credit monitoring is competently managed.

Negative pledges on all debt restricts THFC and its subsidiaries from borrowing or creating any charge that might rank in priority to its existing debt, all of which is secured on a floating charge (that is, all debt must rank *pari passu*).

THFC's reserves of £5.8 million are low in comparison with the reserves of potential comparator banks. Furthermore, liquidity and financial flexibility, although adequate relative to the current asset profile, are relatively limited.

THFC has a narrow line of lending business, which focuses entirely on the U.K. social housing sector and presents a single-industry risk. There are also significant obligor concentrations, as the top 10 borrowers account for 25% of the total loan book.

THFC's competitive position in the funding market is relatively weak, making its business strategy potentially difficult to achieve, while a relatively small staff leaves it vulnerable to turnover and key-person risk.

The covenants required by THFC are conservative in comparison with those of other funders, which, in terms of sourcing new loans business, may leave it at a competitive disadvantage. There is, however, a risk that in attempting to grow the business, THFC may dilute credit terms and/or diversify into relatively riskier areas of business such as regeneration, potentially weakening asset quality. THFC is also exploring the potential for an early redemption of part of its high-coupon loan book, which could result in a matched reduction in its funding and loan books.

■ Outlook

The stable outlook reflects the credit quality and geographical diversity of the loan portfolio, taken in combination with the relatively transparent lending methodology applied by THFC. The affordable-housing-sector funding market is a low-margin business, but THFC may be able to place itself more strategically as a low cost, niche player with a long-term perspective and strong relationships within the sector. Standard & Poor's will continue to monitor the new business that THFC achieves in terms of area of operation, the strength of its loan covenants in relation to those that already exist, and the credit quality of new borrowers. It is also expected that THFC will gradually build a higher level of reserves and additional liquidity over time.

■ Business Profile

THFC is a niche lender dedicated to the social housing sector, and is different from any other lender, or previously rated entity, because:

- It is a not-for-profit entity, incorporated under the Industrial & Provident Societies Act with limited liability. This means that on a winding up, the reserves must be returned to THFC's borrowers.
- It was set up by industry regulator The Housing Corporation, the NHF, and the private sector to encourage funding to the registered-social-landlord (RSL) sector in 1987.
- It has a public-policy role that helps to differentiate it from other traditional lenders to the sector.
- It enjoys close links with government (through the Office of the Deputy Prime Minister and the Treasury), the Housing Corporation, and NHF, although there is no formal support from any of them.
- It acts as an aggregating financial intermediary, which diversifies the risk to those that lend to THFC and allows access to the capital markets for RSL borrowers that would ordinarily not be able to do so owing to their size. (This improves cost effectiveness for borrowers through economies of scale).
- It funds itself through borrowing from banks and issuing bonds to the capital markets.
- It requires borrowers to pay interest payments and principal repayments one month in advance of the due date of THFC's own financial obligations, which enhances internal liquidity.

■ Business Description

THFC has a book of social-housing loans of about £1.5 billion (\$2.75 billion). It lends to more than 130 RSLs of varying sizes (the total number of RSLs in the sector is about 5,000, although about 90% of these are extremely small and have no future debt requirements and no development activity). Many of its loans date back to the first years of THFC in the late 1980s and early 1990s, when its competitive position was much stronger than is now the case. Set up in 1987, THFC was one of the first private lenders to the social housing market and was an early innovator, with the first full securitization and the largest-ever index-linked bond issue in social housing. It also introduced the European Investment Bank (EIB; foreign currency AAA/Stable/A-1+) to the sector. THFC also manages several of the structured social housing transactions, including the Haven Funding PLC and Haven Funding (32) PLC, Sunderland (SHG) Finance PLC, and Harbour Funding PLC bonds. Some of THFC's existing borrowers have recently tapped existing facilities for additional funds, but THFC has not lent to a new borrower for more than 12 months.

Despite the expansion of conventional lending sources, which have competed principally on price and relaxation of covenants, THFC has failed to keep pace with the bank market. As a result, THFC's market share has experienced steady erosion since the early to mid-1990s.

Management.

THFC has a very small operational team of nine experienced professionals, the CEO arriving two years ago as part of a concerted effort to reposition THFC through a drive to increase its revenues and develop a positive business strategy. The team is experienced in social housing, banking, accountancy, and corporate treasury functions, with associated professional qualifications. Standard & Poor's believes the management is appropriately qualified for the size and nature of the business, although the small size of the staff does leave it vulnerable to staff turnover risk, even though back-up knowledge is generally well shared across the team.

■ Ownership and Legal Status

THFC is a not-for-profit Industrial & Provident Society. It is owned by its non-executive board members, the six of whom hold directly (or via their employers) a fully paid £1 share in THFC. This represents the total share capital (not including reserves) of THFC. THFC has no explicit government support, other than the nomination of a board member from the sector regulator, The Housing Corporation, which is a nongovernmental departmental body.

Regulation.

THFC is not formally regulated by the Financial Services Authority (FSA), but is subject to its oversight as an Industrial and Provident Society. This could be viewed as a positive factor in that less regulation may leave THFC with a freer hand to run its business. FSA regulation aims to protect the consumer and the market, rather than the bank or lender, and therefore the traditional banks may have more restrictions imposed on their business by the regulator. The lower level of regulation of THFC by the FSA could also be viewed as a negative factor, however, as the FSA may have less of an overview of the areas of new business that THFC may decide to become involved in, and therefore the element of risk may increase owing to limited oversight. THFC's day-to-day close working relationship with The Housing Corporation, and its board representation, although not a formal regulatory relationship does, however, give some comfort.

Corporate governance.

THFC is governed by a board with seven voting members, which includes a nominee from both The Housing Corporation and the NHF. There are four independent board members, and one executive member (THFC's CE). All members have equal votes, and all are required to act for THFC. In Standard & Poor's opinion, the board members exhibit an appropriate, relevant, and mixed skill set. They may only serve a maximum of three consecutive three-year terms of office. Nominated board directors can serve an unlimited tenure, up to an age limit of 70, unless reconfirmed annually. The Board Chairman must be re-elected annually for a five-year maximum term. The governance terms are currently under review by THFC, with a view to making sure arrangements continue to reflect best practice.

Separate committees exist for credit, audit, remuneration, and personnel issues. The credit committee approves all new loans, whether to existing or new borrowers, which should help to ensure that lending is impartial and without bias. Under its rules, a board meeting can be deemed to constitute a quorum with only two board members in attendance, which Standard & Poor's believes to be a risk that does not adequately reflect governance best practice. The board of THFC recently resolved, however, that all decisions must be made by a quorum of at least three directors, and in practice the majority of board members are actively involved in all internal decision making.

■ Group Structure and Strategy

Structure.

THFC operates as a group structure, with a service company--T.H.F.C. (Services) Ltd.--providing all the administrative and management services to THFC and its main subsidiaries. These subsidiaries are individual special-purpose vehicles set up for the specific purpose of individual capital markets bond issuance. The subsidiaries are separately constituted legal entities and are entirely owned by THFC. In practice, there is very little difference in the credit quality of the loans held by each subsidiary, and a number of obligors have separate loans granted by different subsidiaries. Consequently, there is considerable overlap in the obligor pools. In future, THFC may set up separate subsidiaries for lending to nontraditional businesses such as key-worker accommodation schemes in order to ringfence these high-risk loans or investments in unregulated businesses, much as RSLs do.

Strategy.

In recent years THFC has lost market share as other funders competed more aggressively on price and covenant packages. In a period of relative stagnation for THFC, the only increase in loans has arisen from taps to existing customers. In future, THFC intends to use its credit rating as the main driver of its future business strategy, setting up a warehousing debt facility with the ultimate aim of refinancing this on the capital markets. By obtaining a credit rating, THFC aims to achieve a more competitive cost of funds and wider investor access that might otherwise have been closed to it.

The midterm objective for THFC is to draw itself back into the mainstream of funding the affordable housing sector in the U.K. It is also considering, but may not proceed with, widening its lending remit to include lending to regeneration and key-worker schemes, and general-needs core business. Although regeneration and key-worker projects are priorities for Government housing policy in the U.K., and lending to these projects will heighten THFC's public-policy role, this type of project does carry greater inherent risk. Standard & Poor's believes that if THFC develops in this direction, it may risk diluting the credit quality of its existing loan portfolio. Therefore, it is expected that reserves, or liquidity, would grow appropriately to reflect these higher risks.

Generally, THFC has focused on the traditional small and midsize housing associations, which are likely to have less experienced management teams and boards than larger RSL organizations. They are also likely to have less sophisticated information systems and financial management. On the positive side, such associations tend to be involved in less diversification and development activities, helping to balance out some of the operational risk.

THFC plans to remain focused on the U.K. social housing market, in line with its rules. THFC's aim is to achieve an annual surplus in the region of £250,000. (In the financial year ended March 31, 2004, THFC achieved an annual pretax surplus of £189,000).

THFC has a good reputation as an administrator and security trustee of structured housing transactions, and it aims to increase its activity in this area of operation. In financial 2004, it received £183,000 in management fees for these services. THFC's success in increasing its share of the structured-housing-transactions market depends on the ability of the capital markets to compete with bank financing, mainly on price.

■ Asset Quality

All of THFC's loans are secured and covenants are conservatively structured. THFC's borrowers can choose to secure their lending by either a fixed charge over specified properties, or by a floating charge, subject to asset coverage tests. The majority of its lending is carried out via a fixed charge over properties. THFC amended its trust deed in financial 2003 in order to permit its borrowers more flexibility to use spare borrowing capacity in existing pledged security to raise new borrowing from THFC. This might influence existing customers to extend their loans with THFC, rather than refinance them elsewhere.

THFC and its subsidiaries pledge security to their respective investors in the form of a floating charge over its assets (that is, the social housing loans book), and the reserves of about £5 million. All of THFC's secured creditors, including institutional investors and lenders, legally rank *pari passu*, and have the benefit of over-collateralization over secured asset values compared the the value of THFC's loans.

In terms of the quality of the loans offered as security for THFC's borrowing, there have been no defaults within the sector to date (although this does not include loan restructuring). This is due in part to the early intervention and supportive framework of the sector regulator, in instances where housing associations face financial pressures.

THFC exhibits no sector diversification. It is restricted by its own rules and regulations, which only permit it to lend to registered social landlords. Furthermore, THFC does not lend to "nonmature" large-scale voluntary transfer associations, which are generally more risky than traditional associations due to their being 100% debt financed on transfer and having higher maintenance requirements.

THFC has two key loan covenants based on asset coverage and asset-specific income coverage. Assets are typically valued on a market value basis (subject to tenancies), which is generally about two-thirds of the actual open market value. THFC requires periodic revaluations of individual security portfolios to ensure that secured assets provide coverage valued at least 150% of the outstanding loan balance. In practice, the well-seasoned nature of the lending and associated security means that there is typically a cushion over and above this 150% threshold. THFC covenant arrangements ensure income coverage is sufficient to meet interest repayments.

Approximately one-third of THFC's lending is to associations with housing stock based in London and southeast England, a region that has high property values and a high demand for affordable housing. Overall, THFC's loan portfolio is generally representative of the social housing sector as a whole.

The top 10 largest borrowers are a mixture of sizes and have differing levels of development activity and geographical operation. THFC is, therefore, not particularly exposed to any one area, and its lending policy has resulted in a relatively balanced portfolio.

Standard & Poor's believes that THFC's asset performance is in part determined by its internal credit scoring process. The scope of Standard & Poor's review, therefore, included a validation of THFC's credit approach, an assessment of the predictability of its internal credit scoring model to evaluate credit risk appropriately, and a review of the adequacy of its monitoring and control procedures.

■ Profitability

THFC is a not-for-profit organization. Under its rules it cannot trade for profit, but any annual surpluses are accumulated as reserves. THFC's aim is to make a steady surplus each year in order to grow reserves.

In financial 2004, THFC made a surplus before tax of £189,000 (2003: £60,000). This represents a significant fall compared with pretax profits of £573,000 in 2002. Profits declined owing to the impact of lower interest rates on THFC's free one-month float (resulting from THFC being paid one month in advance of its obligations), and the absence of new issue fees. In addition, operating expenses were higher, reflecting the reorganization of personnel and the implementation of new systems. Following the completion of these actions, it is expected that THFC will record a higher surplus in financial 2005, subject to new business being generated. It should be noted that THFC has never returned a deficit throughout its operating history. In the event that no new business is generated in 2005, Standard & Poor's expects THFC to still be able to record a surplus.

THFC's net interest margin, unlike a commercial bank, is effectively zero, reflecting the exact balance of lending interest income to interest payable. Other income received reflects interest income on the free one-month float and fees related to THFC's arrangement of new issues and management of third-party portfolios. The monthly float, which is conservatively invested in cash accounts at major U.K. financial institutions, together with interest on reserves, produced interest income of £655,000 in financial 2004, compared with £727,000 in the previous year. Fees receivable and other income totaled £964,000.

Operating expenses were £1.48 million in financial 2004. Although THFC has moderately high overhead costs that account for 97% of its noninterest revenues, part of this reflects the buildup of staff in anticipation of future growth. In the event that THFC is unsuccessful in its transition strategy, it could wind down with relatively limited additional expense owing to the small size of its team and the maintenance of a small leasehold office (there is no branch network). Reflecting the limited income sources and the fixed nature of the majority of the expense base, cost growth is carefully controlled. Although it is a not-for-profit organization, virtually all of THFC's surpluses are subject to taxation.

■ Asset Liability Management

All THFC funding is sourced from banks or direct from the capital markets. THFC has good relationships with its own funders, including the EIB.

Standard & Poor's considers the biggest weakness in THFC's financial structure to be the size of its available liquidity. If a borrower defaulted on interest payments for a significant period, and if THFC could not realize the borrower's collateral, then THFC's reserves could be severely reduced, depending on the extent of its exposure to the borrower in question. In a worst-case scenario where its two largest borrowers defaulted before THFC had managed to crystallize its security (the timing of which is estimated at 12 months), THFC would have no revenue reserves with which to cover the respective interest payments. Unless the bank was able to organize an additional liquidity facility, committed but available at call, this could bring about the default of THFC itself. THFC has no alternative liquidity facility. Standard & Poor's notes, however, that the bank has had no liquidity issues throughout its existence. Virtually all interest payments are made by direct debit and the one-month liquidity buffer has proved to be sufficient.

In effect, THFC takes no interest-rate risk. Its own borrowings are on-lent immediately to RSLs, on a substantially identical interest and principal repayment profile. Nevertheless, THFC's income stream is exposed to a certain level of interest-rate risk in terms of its earnings as its investment income (that is, interest payments received one month in advance of due date) is adversely affected by lower interest rates. THFC tries to mitigate the effect of this risk through periodically reviewing its hedging policies and making prudent assumptions in the budget. It does not, however, make use of derivative funding, other than interest rate swaps, forward rate agreements, and purchased interest-rate options. Most of its interest income is fixed at short-term (less than 12 months) rates.

In addition, the large majority of THFC's liabilities (about 90%) are due in more than 10 years. There are three key principal refinancing peaks--in 2016, 2023, and 2025--that could drive some income volatility, although in practice

most RSLs refinance rather than pay down debt. Absolutely no currency risk is taken: all borrowing and lending is conducted in British pounds sterling.

Standard & Poor's considers that the new management team has made good progress in ascertaining the potential operational risks that a small organization might face. These risks are reviewed by the board on a regular basis.

■ Capitalization

THFC's reported equity-to-assets ratio was a low 0.4% at March 31, 2004, unchanged from the previous year. In addition, the absolute size of THFC's capital base, at just £5.6 million, is small. Furthermore, Standard & Poor's considers the financial flexibility of THFC to replenish its reserves in the event of a stress scenario to be limited. THFC's capitalization, therefore, does not compare favorably with a commercial bank. The weak nature of THFC's capital base is, however, partly mitigated by the very low-risk nature of the loan book.

All of THFC's lending is secured lending; its rules prohibit it from lending on an unsecured basis. For the majority of its portfolio, THFC has a fixed charge over identified pledged assets. In addition, THFC's asset-coverage covenant is required to be at least 150% and any release or withdrawal of security is not permitted if coverage levels are less than 200%. The current asset coverage is about 190%.

The Housing Finance Corporation Ltd. Financial Performance					
	--Year ended March 31--				
(£000s)	2004	2003	2002	2001	2000
Revenues					
New issue fees*	148	15	201	218	229
Annual fees¶	729	693	689§	615§	567
Investment income	655	728	799	910	903
Other income**	141	129	146	85	75
Total revenues	1,673	1,565	1,835	1,828	1,774
Expenditures					
Staff costs¶¶	740	646	575	523	516
Directors' costs	93	161	112	107	105
Legal, trustee, and registrar costs	211	297	220	196	228
Premises	75	85	47	31	42
Other	365	316	308	226	158
Total expenditures	1,484	1,505	1,262	1,083	1,049
Profitability					
Surplus before tax	189	60	573	745	725
Tax	47	28	170	215	206
Surplus after tax	142	32	403	530	519
<p>*New issue (arrangement) fees are charged to existing borrowers as well as new borrowers for additional facilities. ¶These fees are index linked. §These years saw an increase in fees owing to the Sunderland Finance bond issue (2001 issuance). **Income is received from managed transactions. There can be an element of interest rate mismatch, although the trend has been positive, about £20,000 a year, in favor of THFC. ¶¶Staff costs do include an element of bonus payment, which will not be paid in the event of targets not being achieved.</p>					

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