# Hexagon Housing Association

**Board of Management**

***29th September 2015***

**Agenda Item 11**

***Review of Treasury Policy***

**Lead Board Member – Debbie Bankole Williams**

**Report from Finance & IT Director**

#### *Summary*

Sets out the reasons for updating Hexagon’s Treasury Management Policy to:

* Provide greater clarity on when to fix future interest rates
* Allow for surplus cash to be invested in larger amounts
* Allow for surplus funds to be invested in AAA rated Money Market Funds in the same way as term deposits with banks (ie without specific prior approval by the Board)
* Reflect recent changes in the way that counterparty risk is assessed

#### *Recommendation*

The Board is recommended to approve the updated Treasury Management Policy, incorporating the changes to:

* Section 1.2.6 (Board override)
* Section S1.1 (to align with 12 months already allowed under S1.3)
* Section S1.2 (to clarify the EBITDMRI test)
* Section S1.3 (to allow for surplus funds to be invested in Money Market Funds and in larger amounts)
* Section S1.4 (to allow for changes the format of Capita’s counterparty advice)
* Section S3 (combination of the above)

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| ***1.0*** | ***Introduction*** |
| 1.1 | Hexagon’s Treasury Management Policy (TMP) was due for its annual review in July 15, but this was deferred to September to allow for consideration of a review of the interest rate aspects of the policy at officer level. This has now been done, with assistance from Capita (Hexagon’s treasury advisors). |
| 1.2 | The Policy is working well in most areas, but there are three areas which need review, as explained below. An updated copy of the TMP, showing all recommended changes, is attached. |
| ***2.0*** | ***Review of the Interest Rate Management Strategy*** |
| 2.1 | The current TMP states that “Hexagon seeks to put in place fixes which allow the business plan to withstand both a 1% increase in real interest rates and a 1% drop in inflation without the key ratio of EBITDMRI falling below 110%”. This means that, unless the Board agrees otherwise, if the business plan fails the EBITDAMRI test officers need to arrange for a further interest rate fix, either by standalone derivative or by fixing within an existing variable rate loan.  However, the TMP also states that Hexagon “ will retain a sufficient degree of flexibility to take advantage of unexpected, potentially advantageous changes in the level or structure of interest rates, or inflation.” |
| 2.2 | In January 2015, long term UK swap rates fell to a level that had not previously been seen, which provided an potentially advantageous opportunity for fixing future interest rates, even though this was not required by the EBITDMRI test. Having been considered by Urgency Committee, a report was brought to Board at the end of January. The Board decided not to do another fix. |
| 2.3 | In July 2015, the business plan updated for rent reductions announced in the Summer Budget failed the EBITDAMRI test, but the Board agreed that it would be inappropriate to enter into further interest rate fixes until the plan had be revised for mitigating actions. |
| 2.4 | As with any policy, the Board can agree to override the TMP if there is a good business case for doing so, and in fact it did so in July. A policy would not be fit for purpose if the Board was regularly agreeing to override it, but this is not the case with the TMP, which has been in place in substantially the current form since September 2011. |
| 2.5 | The question is whether the TMP should be reworded to become more ‘black and white’ as regard interest rate management. The Policy has been revised to say that failing the EBITDAMRI test requires a fix, and passing the EBITDAMRI test precludes further fixes (see revised section 1.2 on page 11 of the TMP). However, having consulted the Lead Board Member, the wording in clause 1.2.3 on page 3 about having a degree of flexibility to take advantage of unexpected changes has been retained. Clause 1.2.6 has been added on p4 of the TMP to make it clear that the Board has the power to override the TMP if there is a sufficiently strong business case. |
| ***3.0*** | ***Changes needed to allow for investment of substantial surplus funds*** |
| 3.1 | In common with the rest of the social housing sector, Hexagon is increasingly raising finance via bond loans rather than by bank loan.  Unless an element of deferral is built in, bond loans have to be drawn as soon as they have been completed. Bank loans can be arranged in advance and drawn when needed (although there are commitment fees to be paid on the undrawn amount).  The increasing use of bond loans, together with the requirement to have funds arranged 18 months ahead of need, means that Hexagon is likely to have substantial amounts surplus cash in the months following completion of a bond loan. This is the case at the moment, when we have £17m of funds from the AHF bond loan, as well as £2m on deposit with Santander and £3m with our clearing bank (NatWest). |
| 3.2 | The current TMP sets a limit of £2m to be placed on deposit with any one institution other than the clearing bank. This would mean finding nine further institutions which meet the Association’s counterparty risk requirements, and undertaking banking due diligence with each (a process which takes 2-3 weeks). It is recommended that the TMP be revised to raise the limit to £5m with any one institution (provided this is no more than 33% of the total).  Placing £5m with any one institution (rather than the current limit of £2m) increases the amount at risk of that institution fails. However, the risk is limited by the requirement that the funds can only be invested for three months, after which the counterparty risk has to be reassessed (see below). |
| 3.3 | The current TMP allows funds to be invested in Money Market Funds, but only if the funds have been approved by the Board and after appropriate advice has been taken. Hexagon has so far not needed to use Money Market Funds. AAA rated Money Market Funds have a lower counterparty risk than single institutions, and provide instant access to Hexagon’s money. Because of the lower risk, it is recommended that:   * a higher limit if £15m be applied to investments with AAA rated Money Market funds. * that decisions to invest in Money Market Funds, within the parameters of the TMP, be delegated to officers in the same way that deposits with single institutions are. Officers would have to take advice from Capita before investing.   Section 1.3 of the TMP has been revised to reflect these recommendations, and paragraph 15 on page 22 has been deleted. |
| ***4.0*** | ***Counterparty credit risk*** |
| 4.1 | Capita provide a weekly creditworthiness list of institutions that are suitable for placing deposits of up to 12 months. This list is checked before any funds are placed on deposit or before a deposit is re-invested.  Section 1.3 of the TMP has been revised to reflect recent changes in the way that this list is produced. |

Phil Newsam

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