FRESH faced ideas for housing finance

The completion in March of a £970m securitisation by Finance for Residential Social Housing PLC (FRESH) added a further notch to the UK government's campaign to privatise public sector activities. Following on from its sale of ministry of defence properties and rail transport stock (and preceding the proposed sale of student loans) this time the government's focus was on its provision of finance to the Housing Associations of England and Wales. Permjit Singh reports.

While their roots can be traced back to the 12th century, housing associations came to prominence in the wake of the UK's industrial revolution and urbanisation in the 19th century. They are the primary mechanism for providing government-subsidised housing for low income families or, say, the elderly, who may be unable to qualify for mortgage finance to purchase their own home and therefore live in rented accommodation. Housing associations account for 1m of the 7m rental properties in the UK—the remainder coming from local authorities and the private sector.

Housing associations enjoy a privileged position. They are able to charge affordable rents that are below those found in the private sector; while a significant part of their income (52% of gross rental income in 1995) comes through the government's housing benefit system (which subsidises rents). These features have resulted in a commendable record of payment of rents.

Housing associations also qualify for government grants to develop and maintain property—which are interest free—repayable only on disposal of the underlying asset and subordinate to private sector loans. The position of housing associations is further strengthened by demand for accommodation outstripping supply—there are very limited numbers of void properties. Secondly, because housing association are incorporated either as charities or Industrial Provident Societies, they are not liable to pay out dividends to members. Instead, surplus income is reinvested.

Government financing of housing associations has been channelled through government-created regional regulatory bodies, called the Housing Corporation (in England) and Housing for Wales (for Welsh housing associations). By the end of January this year, these bodies had, collectively, extended approximately 38,000 loans to around 1,000 housing associations with a book value of £972m (£913m of which had been extended by the Housing Corporation).

Approximately 95% of the loans are fixed interest annuities and the remainder are at a variable rate of interest. The majority of interest rates and remaining terms to maturity of the fixed rate loan portfolio range from 8% to 16% and from 15 to 60 years respectively. The current weighted average coupon and maturity is 11.20% and 37 years respectively.

The FRESH securitisation enabled the government to refinance these loans through the private sector. The FRESH deal was seminal, in that it paves the way for further securitisations to occur in the private housing sector in the United Kingdom.

The Asset-Backed Securities and Transaction Structure

The asset-backed securities (Notes) are divided into two main classes according to the interest rate basis. That is, the Series 1—comprising 95% of all loans—which receive a fixed rate of interest as well as principal generated by the portfolio's fixed rate loans; and Series 2 which receive a variable rate of interest as well as principal from the portfolio's variable rate loans—5% of all loans.

The securitisation transaction was structured as a pass-through. Interest derived from the loans is passed through to investors along with scheduled principal repayments (which are divided pro-rata among investors) semi-annually in March and September. Unscheduled principal prepayments are passed through as and when they arise.

Unscheduled principal repayments by housing associations in respect of Right to Buy (RTB) options being exercised by tenants are all passed through to the Series 1 class A2 Notes.

The RTB option enables tenants to purchase their tenanted property, or to increase their equity in the property. In each case the housing associations can prepay a proportion of their loan.

The A2 Notes are exposed to this prepayment risk as the corresponding RTB loans would be prepaid at a price of 100 whereas the A2 Notes were issued at a price of 120.2. If the RTB loans are consolidated, however, a prepayment penalty applies, thereby mitigating the prepayment risk to investors in this class of Notes. Consolidation is the process where numerous fixed rate loans to a housing association are consolidated into a single loan.

Compared to the A1 Notes' spread of 60 basis points, the additional 20 basis points spread offered to the A2 Note holders over the benchmark Gilt reflects the prepayment risk of the A2 Notes.

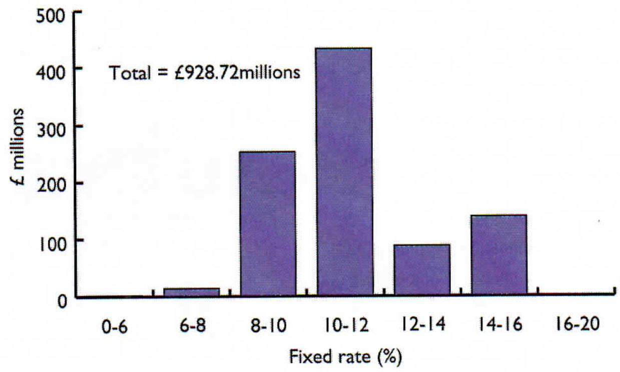
Duff and Phelps point out that historically around 3% of eligible RTB options have been exercised, although the housing market has not been conducive to tenants exercising their option. Other unscheduled principal prepayments are subject to a prepayment penalty for costs FRESH may incur as a result of prepayment. Duff and Phelps' stress analysis of prepayments suggests only a marginal impact on cash flow to rated Notes.

The rate of interest payable on the Notes is based upon a weighted average of the interest rate of the underlying fixed and variable rate loan portfolios—less an agreed margin. Interest on almost all of the variable rate loans is based on the UK government's variable National Loan Fund rate.

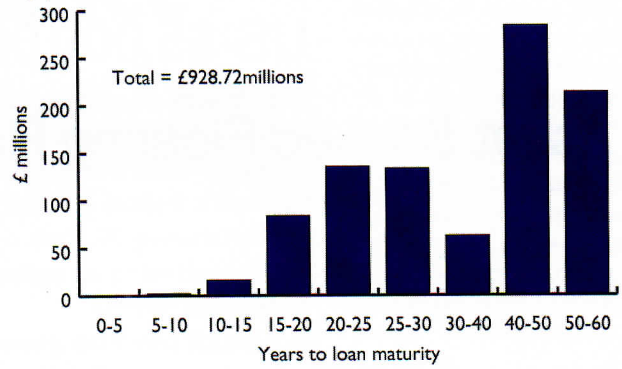
As at 26 March, the fixed rate yield on the Notes was 11.126%. This is substantially in excess of corresponding market rates and hence the Series 1 Notes were issued at a premium. At the time of issue, yield spreads on the Series 1 A Notes over the benchmark government Gilt (8%, 2021) was 60 basis points for the A1 Notes and 80 basis points for the A2 and A3 Notes.

Tenors are different depending on the series. The average lives of the Series 1 A and B Notes are approximately 29 years each, based on assumed prepayments. However the A2 Notes' average life, owing to their greater expected prepayment rate, is approximately 20 years. The rate of interest on the Series 2 Notes will be at a variable rate of 1% over the 30 year National Loan Fund rate.

(1) Distribution of fixed rates on loans



(2) Distribution of remaining years to loan maturity



Credit Enhancement and transaction risk factors

Credit enhancement is in the form of a senior/junior structure of Notes, typical of UK mortgage-backed securities. Principal and interest on the B Notes are subordinate to the A Notes.

Unusually, however, there is a further layer of unrated C Notes, which represents 1% of the loans and are subordinate to the B Notes. The combination of A3, B and C Notes provide a layer of credit support equivalent to 9% and 8% of the loans for the Series 1 and 2 AAA rated Notes respectively.

Housing associations also qualify for government grants to develop and maintain property—which are interest free—repayable only on disposal of the underlying asset and subordinate to private sector loans.

DEAL DATA

Notes	Rating*	Amount £ m	Maturity	Average life (years)	Issue price	issue spread over Gilt (b. pts)	interest rate basis
Series 1							
A1	AAA	727.9	Mar 2058	29.3	127.039	60	fixed
A2	AAA	115.9	Mar 2058	19.8	120.204	80	fixed
A3	AA	37.1	Mar 2058	29.3	124.620	80	fixed
B	BBB	37.1	Mar 2058	29.3	122.136	100	fixed
Series 2							
A1**	AAA	40.9	Mar 2058	21.20	102.762	n.a.	variable
B**	BBB	3.1	Mar 2058	21.22	97.204	n.a.	variable
Series 3							
C	unrated	9.7	Mar 2058	54.2	100.000	n.a.	undisclosed

* Equivalent ratings have been assigned by S & P, Moody's, Duff & Phelps and Fitch except Series 1 B Notes have been rated Baa3, Series 2 Class A have been rated AA1 and Series 2 Class B Notes have been rated Baa3 by Moody's
** current coupon = 6.50%; n.a. = not applicable
references: Duff and Phelps—preliminary new financing report/Standard & Poor's—Structured Finance report

Further comfort can be obtained from there being no current arrears in the loan portfolio and an extremely low credit loss experience—only one loan (for £0.5m) having been written-off in the last fifteen years.

Duff and Phelps, in their rating analysis, point out however that loan performance data is limited. But it is believed the need for and use of loan extensions and/or reschedulings have been rare.

A further risk factor is the lack of representation or warranty given by the Housing Corporation and Housing for Wales regarding the validity, sufficiency or enforceability of loan security. This risk is exacerbated by the uncertainty surrounding security documentation for 12 per cent of the loans. However, a process of matching mortgage documentation to all loans is underway. A sample audit (1% of loans), prior to loan consolidation, suggests security cover for the loans is very high, at four to five times the outstanding loan balance.

Consolidation of loans is expected to reduce the security cover level to a minimum of 130% of the loan outstanding, based on an open market existing use valuation basis. Offsetting this reduction in security cover however is the benefit of improved security documentation following consolidation, removal of housing associations' right to prepay RTB loans at par, and, according to National Westmister bank (NWB), an enhanced yield to all investors in the Series 1 Notes.

Standard and Poor's, in their rating analysis, note that no details are available on the condition of the properties serving as collateral for the loans. Accordingly, their analysis has assumed a condition below the sector average.

The B and C Notes also provide liquidity support (for example, in the event there are delays in the receipt of Government housing benefit payments covering rental payments), by deferring interest payments on them until after the senior Notes have been paid. In addition, there is a £2.5 million liquidity facility.

NWB, who won the mandate in February to securitise the government's loans, will be the primary servicer of the transaction—although it has delegated day-to-day administration to Guardian Mortgage Services.

To-date, NWB has arranged approximately £3bn of private sector finance to the housing associations, as well as holding £1bn of housing association loans on its own balance sheet. They will also, along with other co-lead managers, act as market makers in the Series 1 and 2 Notes.

As illustrated in figure 1, Orchardbrook Limited is a special purpose vehicle created specifically to facilitate the transfer of loans between the Housing Corporation and Housing for Wales bodies. Following purchase, it acquired legal title to the loans and related security which was also equitably assigned to FRESH. Royal Exchange Trust Company has been appointed Trustee for the Note investors.

The 29 year average life of the A1 Notes will appeal to pension and life funds seeking to match their long-term liabilities in addition to their low risk.

Early interest in the deal was noted from both these groups. Asset-backed funds also expressed an interest in the A1 Notes. Geographically, interest was widespread—extending to Europe and the USA through the exercise of Rule 144A. The greater prepayment uncertainty surrounding the A2 Notes made them more appealing to arbitrage and asset-backed accounts than the traditional institutional investors. ISR