

**Report of the Director of Financial Resources**

**Gentoo - Derivative Transactions**

**1. Purpose of Report**

- 1.1. To set out and consider the request for the Council to agree to a widening of the borrowing powers of Gentoo, which includes the use of derivative transactions.
- 1.2 As this is a technical issue, and does not involve expenditure by the Council amounting to over £250,000 or has any direct impact on two or more Wards of the Council, this is not considered to be a key decision and as such can be taken using delegated powers.
- 1.3 However, given the level of political interest in the relationship between Gentoo and the Council, and the activities of Gentoo, it was considered appropriate that the proposal should be the subject of review by this Committee prior to the Council taking the decision under the proposed use of delegated powers.

**2. Background Information**

- 2.1 The Council received a request from Gentoo Sunderland on 21st October 2008 to make changes to its Memorandum of Association in respect of a clause relating to widening its borrowing powers in line with Circular 01/07 from the Tenants Services Authority (TSA) - (previously known as the Housing Corporation). The existing clause is set out in Appendix 1 with the amended clause set out in Appendix 2 for the Council to consider and approve, if in agreement.
- 2.2 The Gentoo Housing Group, advised by Hugo Stephens of Cobbetts, have been in discussions with the TSA about adopting the 'wider' rules and have been given permission to change the Memorandum of Association of both Gentoo Housing Group and Gentoo Sunderland.
- 2.3 The reasons for this change, according to Gentoo, is that the changes will provide:
  - flexibility in seeking funding;
  - better value for money;
  - the ability to use new financial products; and
  - place the Group in a stronger position should they wish to re-finance.
- 2.4 Gentoo requires the Council's agreement to changing the Memorandum of Association of Gentoo Sunderland before it can formally receive approval from the TSA.

### **3. Due Diligence**

- 3.1 The request from Gentoo is very technical and complex in nature. As a result the Council has had to carry a long and in depth review of their proposal to satisfy itself that the 'wider' powers are appropriate, beneficial to the company and ultimately to its tenants and that the additional risks involved by using the new 'wider' borrowing powers are suitably identified and will be managed effectively by Gentoo. With this in mind, advice and guidance has been sought from a number of different sources and due diligence has been carried out by:
- 3.1.1 Corresponding directly with Gentoo on a number of occasions in order to:
- clarify information;
  - establish their intentions and appetite for risk;
  - establish the actions they have taken and have put in place, now and in the future, to manage the risks should their proposals be acceptable to the Council.
- 3.1.2 Receiving legal opinion from the Chief Solicitor and following up specific issues with specialist, independent legal advisors, Trowers and Hamlins LLP.
- 3.1.3 Obtaining advice and views from the Council's independent Treasury Management Advisors (Sector Treasury Services Limited).

### **4. Findings**

- 4.1 A significant number of RSL's have adopted the wider borrowing powers in terms set out by the Tenant Services Authority (TSA) which were introduced in 2007. Many other RSL's have been using the wider powers as permitted by the Housing Corporation (now replaced by the TSA) prior to 2007. The requested powers from Gentoo are the standard conventional paragraphs approved by the Tenant Services Authority for the purposes of borrowing and the request from Gentoo is therefore not seen as unreasonable.
- 4.2 Some of the wider powers available to an RSL, particularly the use of derivatives, means that there is more risk involved in managing these arrangements. To mitigate these risks, adherence to TSA regulations will be necessary and will require specialist advice. The regulations specify that the wider powers, particularly the use of derivatives, must not be used for speculative purposes and that a RSL can only use a derivative where it is exposed to a risk against which the derivative instrument can be matched. The use of derivatives should therefore be set out clearly in the RSL's Treasury Management policy detailing the specific risk that the derivative is being used for or 'hedged' against.
- 4.3 Legal advice received is that the Council should not be seen to be exerting undue influence or control over Gentoo in this area of its operations and should therefore act carefully to avoid to be seen to becoming too involved in its operations. The Council does have a duty to consider the request to ensure that it is reasonable and is in the best interests of the company and its tenants but if the Council acts unreasonably or is seen to be influencing Gentoo policy and operations then it could run the risk that it could be treated as a shadow director.

One of the major implications of this status is that the Council could be held liable for the wrongful trading of Gentoo in the event that Gentoo became insolvent. In this worst case scenario this could mean that the Council and / or its officers could incur liabilities which would otherwise be restricted to Gentoo and its officers alone. This possible shift in liabilities in certain circumstances, although remote, is a position the Council would clearly wish to avoid.

- 4.4 The Council does not want to obstruct access to cheaper financing transactions available to Gentoo from using these wider powers that would ultimately benefit the company and its tenants.
- 4.5 Assurances have been obtained from Gentoo that it has the necessary expertise both in-house (Officers and Board members) and externally (Traderisks - Treasury Management Advisers) to manage the risks involved in negotiating, acquiring and using the wider borrowing powers. Gentoo has also taken several actions, at the request of the TSA, to ensure that the TSA will grant their approval to using the wider borrowing powers, subject to the Council giving its consent. The feedback and assurance received from Gentoo on this issue is set out below for information:

*"In general all requirements for new derivative transactions will be assessed, analysed and proposed through the annual treasury plan. Where circumstances dictate, a separate report containing this information may be submitted to the Board for approval. All proposals will be drafted and independently assessed by our external treasury advisors. Following Board approval our treasury advisors will be responsible for obtaining prices and transacting the approved instrument."*

- 4.6 As this area of treasury management is complex there is a recognition that access to independent specialist treasury advice is key to ensuring Board members are sufficiently and independently informed about all treasury risks and specifically those associated with derivative transactions. Independent training has been arranged for Board members in addition to in-house training provided by suitably qualified officers. The officers responsible for monitoring, reviewing and assessing treasury operations are qualified accountants with either specialist treasury qualifications or are experienced in treasury management operations.

Taking these issues into account the Board considered and confirmed on 20<sup>th</sup> July 2007 that:

*"the Group has the skills, knowledge and experience, at both Board and officer levels, as well as the systems and access to independent advice, necessary to identify and manage the treasury risks to which the association is exposed, in terms of both its actual and proposed treasury activities, including the use of derivatives".*

This confirmation was made following the assessment of evidence submitted to the TSA demonstrating compliance to eight specific criteria in relation to the wider rule application.

- 4.7 The Gentoo Board receive and approve the Treasury Management policy and plan each year and are, as such, made aware of the type and limits of loan

instruments used by Gentoo each year. Separate Treasury Management reports are also provided to the Board when circumstances dictate. Gentoo has also indicated that their appetite for risk has not and will not change should the wider powers be granted.

- 4.8 The TSA, as the regulatory body, has a role in these arrangements by requiring that Gentoo has proper arrangements in place to manage the risks appropriately and they also have to be satisfied that Gentoo has the appropriate processes and skills in place to manage the wider borrowing powers. They stipulate, for instance, that the wider borrowing powers can not be used for speculative purposes and that derivatives are used solely for the purposes of 'hedging' arrangements. They have also required Gentoo to carry out certain measures in advance before they were willing to consider to recommend their approval. Gentoo has confirmed that all of the issues raised by the TSA have now been fully addressed in line with their requirements, as detailed below:

*"I can confirm all actions set out by the TSA (email of 22 May 2008) have now been taken. The latest treasury policy was approved by the Board on 13 March 2009. This was drafted in conjunction with our external treasury advisors, Traderisks and conforms with all best practice guidance issued by both CIPFA and the TSA. As mentioned above, the policy sets out the mechanism by which the Board approve the hedging policy. This is done through the approval of a target mix for fixed, variable and index-linked debt within the annual treasury plan. The treasury procedures have been updated and the treasury management reporting regime has been reviewed. Should the Council provide their consent the TSA will review the latest treasury policy and assess its suitability in making its final determination."*

- 4.9 The TSA also exercises regular scrutiny over the finances of RSL's. It has a regulatory code against which RSL's are periodically assessed and as part of that assessment the TSA will look at the RSL's use of its wider borrowing powers and check that the RSL maintains its internal expertise and reporting arrangements. If the TSA finds that a RSL has used its 'wider' powers inappropriately then it has a wide range of sanctions it can impose. In extreme cases it could ultimately involve stepping in and appointing people to run the RSL at board or executive level.

In practice however there should be appropriate checks and balances in place within the RSL itself to ensure that the powers are used properly and are in accordance with TSA regulations. Also, funding providers would not enter into a transaction with an RSL if it thought the RSL would exceed its powers by doing so. They are well aware of the regulations placed on RSL's and as such they would want to satisfy themselves that the necessary power is expressly included within the RSL's constitution.

- 4.10 There is also no known incidence or allegation of any RSL misusing or abusing their wider borrowing powers.

## 5. Conclusions

- 5.1 The above findings and information indicates that all of the necessary checks and balances are in place in accordance with the regulations set out by the TSA and that the Council can take added assurance by the fact that Gentoo has indicated that their appetite for risk will not change with the adoption of the new wider powers.
- 5.2 Expert professional advice has been taken which states that no other RSL has been denied these powers. In fact not to grant the powers could be construed as undue influence over Gentoo's policy and operations and could in certain circumstances compromise the Council, (as a shadow director), which is a risk that the Council would not wish to take.
- 5.3 The advice received shows that no RSL has abused the wider powers. The TSA role is clear in this area and it can, if need be, enforce appropriate controls if the RSL exceeds its powers.
- 5.4 The Council does not want to deny Gentoo access to more cost effective funding arrangements which could benefit the company and ultimately its tenants.
- 5.5 The Council has sought and received assurances from Gentoo that it has the appropriate arrangements in place and that it also has the necessary expertise and knowledge at both officer and board level to operate and manage the new wider powers in accordance with the regulations.

## 6. Reason for the Decision

- 6.1 To allow Gentoo more flexibility and scope in their financial arrangements and to enable them to secure the optimum arrangements in compliance with the Tenants Support Authority (TSA) regulatory framework for the benefit of the company and ultimately its tenants.

## 7. Recommendation

- 7.1 Committee having reviewed the proposal agrees that the Director of Financial Resources can grant the request from Gentoo and thereby changing the Memorandum of Association of Gentoo Sunderland as outlined in Appendix 2 \* (including a slight amendment detailed below) of the report by making this decision under the use of delegated powers.

\*In Appendix 2 - the word "**financial**" is to be inserted in the first sentence of the document as follows:

Subject to this Clause 6 the Company may enter into and perform any **financial** derivative transaction on such terms as the Company thinks fit for the purpose of hedging or otherwise managing any treasury risk or other exposure of the Company.

**8. Background Papers**

Memorandum of Association of Gentoo Sunderland – Clause 6

Tenants Support Authority – Circular 01/07

Trowers Hamlins LLP – advice

Sector Treasury Limited – advice

Traderisks correspondence (Gentoo's Treasury Management advisors)

Gentoo correspondence