

Business Engagement Assessment

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Title of proposal	Statutory Consultation on changes to the regulatory framework, May 2014
Lead regulator	<i>Homes and Communities Agency – the social housing Regulator</i>
Contact for enquiries	<i>Referrals and Regulatory Enquiries team 0300 1234 500 (option 2) consultation@hca.gsi.gov.uk</i>

Date of assessment	<i>April 2014</i>	Stage of assessment	<i>Draft</i>
Net cost to business (EANCB)		Commencement date	<i>tbc</i>
Which area of the UK will be affected by the change(s)?	<i>England</i>	Price and present value base years	
Does this include implementation of Red Tape Challenge commitments?	<i>No</i>	Is this directly applicable EU or other international legislation?	<i>No</i>

Brief outline of proposed change in regulatory action

The regulator is updating the regulatory framework in England to reflect existing and future changes in the operating environment of the sector, to ensure it continues to fulfil its statutory obligations. These changes include:

- i) revisions to the Governance and Financial Viability Standard
- ii) introduction of a Code of Practice for the Governance and Financial Viability Standard
- iii) changes to the disposals regime
- iv) changes to the registration criteria

The statutory consultation document also includes changes to the rent standard. However, this is subject to an impact assessment prepared by the Department for Communities and Local Government, rather than by the Homes and Communities Agency.

Why is the change proposed? Evidence of the current problem?

The social housing sector has undergone significant changes in the last few years, and it continues to change. We have published two *Sector Risk Profiles*¹, in June 2012 and September 2013, which identify key risks facing the sector and conclude that the sector is facing increasing number and more diverse range of risks.

Existing registered providers are becoming involved in more diverse and commercial activities. We are also seeing the registration of for profit providers and anticipate that this trend will continue. In addition to activities becoming more diverse, so too are funding streams. Registered providers are no longer relying on bank debt to fund diversification and there are other sources of finance from an increasing range of parties, bring with them different risks.

Operating environment changes

¹ <http://www.homesandcommunities.co.uk/sites/default/files/our-work/sector-risk-profile-120611.pdf>
http://www.homesandcommunities.co.uk/sites/default/files/our-work/sector_risk_profile_2013_full.pdf

Changes to the economic environment are impacting registered providers. Levels of grant funding are significantly reduced, and government initiatives such as welfare reform present risks to registered providers' income cash flows. In order to continue to meet their objectives, registered providers are seeking novel ways to source finance and are diversifying their activities. The new range of diverse activities have brought with them benefits to the sector, however there are risks which need to be managed in order to ensure that the social housing assets are protected.

Legislation Changes

The Housing and Regeneration Act 2008 made provision for profit making providers to be able to register as social housing landlords. This presents a number of challenges to the regulator. Non-profit registered providers, by the nature of their status, must reinvest any profits back into their business. The current regulatory system for issuing consents to dispose of social housing property is underpinned by this. This leaves a gap. There are currently no controls to prevent historic grant and other public investment being distributed out of the sector by transference of social housing from a non-profit registered provider to a profit making registered provider.

In addition, the Regulator's remit for profit making registered providers only extends in so far as it relates to social housing. The Regulator needs to ensure that it is able to regulate and protect the social housing part of the business without overstepping its remit. Profit making registered providers also need to ensure that they are able to effectively manage any risks to the social housing part of their business.

Emerging cases

Although performance of the sector is strong overall the regulator has seen a number of recent cases of poor governance and ineffective risk management, particularly where registered providers have entered into diverse activities without fully understanding the risks to the social housing assets. If not managed this could lead to reputational damage to the individual registered providers and the sector overall. In more extreme cases there are risks of major financial failure with potential impacts on credit ratings, lending rates and funding availability. The sector benefits from reduced funding costs. Ensuring social housing assets continue to be protected is key to ensuring the long term availability of favourable lending terms for the sector.

As a result of the above, the regulator needs to revise the Regulatory Framework to ensure that the regulator continues to be able to meet its statutory objectives and its aim of ensuring that social housing assets are protected.

Which types of businesses will be affected? How many are affected?

As at April 2014 there were 1589 providers registered with the social housing regulator. Of those, 1,093 were non-profit making registered providers with less than 1,000 units and 27 were profit making registered providers.

All registered providers will be affected by the proposed changes to the Governance and Financial Viability Standard. The extent they are affected will depend on the risks to social housing assets within their business. For those registered providers who manage their risks well, the impact will be minimal, for others it will be greater.

The proposals will have a knock-on impact on the tenants of registered providers. Clearly the potential of any loss of social housing may lead to tenancies, on those social housing assets, being vulnerable. It is the Regulator's intention to ensure greater protection of tenants as a

consequence of ensuring that social housing assets are protected through the proposed changes.

The proposals could also have a knock on impact on lenders and other funders. If registered providers better manage the risks then funders will be able to better price loans and have more confidence in a better managed sector. This in turn could see benefits for registered providers in continued beneficial loan rates.

Changes being proposed to the Disposal Proceeds Fund (DPF) element of the consents regime will only directly affect those registered providers who have been designated as profit making on the register, and will only affect them if they acquire stock from a non-profit registered provider.

Changes being proposed to the registration criteria will affect new entrants to the sector and will have no effect on existing registered providers.

How will the change impact these businesses?

Three main options have been considered as part of these proposals: do nothing; changes proposed in the discussion document published in April 2013; changes proposed in the statutory consultation published alongside this assessment:

Option 1 – do nothing

Option 2 – changes detailed in the discussion document “protecting social housing assets in a more diverse sector” published in April 2013², primarily the introduction of ring fencing arrangements, a requirement to have recovery plans, and changes to the disposals regime for profit making registered providers.

Option 3 – changes detailed in the statutory consultation published May 2014³, primarily changes to the governance and financial viability standard and changes to the disposals regime for profit making registered providers

Option 1: do nothing

The Regulator has a number of fundamental objectives set out in the statute. The Regulatory Framework articulates the regulator’s expectations of registered providers to enable it to fulfil those statutory objectives.

The current Regulatory Framework was written at a time when the sector and the operating environment were different. Although the Housing and Regeneration Act 2008 allowed profit making providers to register as social housing landlords, few had done prior to April 2012, and the regulator had little experience and knowledge to draw on to reflect in the Regulatory Framework.

If the Regulator were to take no action, in spite of the evidence of the need for change, risks to social housing assets would be greater. Social housing may be lost to the sector, tenants risk losing their homes and public investment made in those assets may be lost. Loss of assets would have a knock on impact to the reputation of the sector and may affect pricing and availability of funding.

² http://www.homesandcommunities.co.uk/sites/default/files/our-work/130404_regulatory_framework_discussion.pdf

³ <http://www.homesandcommunities.co.uk/ourwork/consultations>

In the Regulator's view, if the regulatory framework does not provide adequate protection against these risks, it is no longer fit for purpose. Therefore, option one to do nothing has been discounted.

Option 2 – changes detailed in the discussion document published April 2013

In April 2013 the Regulator published a discussion document, "protecting social housing assets in a more diverse sector", to start a conversation with stakeholders in the sector about how the regulator should address the issues and risks facing the sector. The key areas of change proposed in this document were ring fencing, recovery planning and disposal consents.

In the discussion document the Regulator asked stakeholders for specific feedback on the impact of each of the proposals on their businesses. The impact of the proposed changes detailed here includes evidence gained through this process.

Ring fencing

The response analysis document reflected that whilst registered providers seemed to understand the concept of the 'comply or explain' approach, there was less understanding of who it would apply to. A large number of non-profit registered providers responded as if they would have to comply, whereas the explain route would have been available to them. The 'comply' route would only have been required for profit making registered providers and new entrants, not to existing not for profit registered providers. Therefore, the impacts described below would have only applied to a relatively small number of registered providers.

Of prime concern was the disproportionate burden that would be placed on registered providers, with more prescriptive requirements. There was concern that this would have a significant negative impact on the existing non-profit sector, potentially limiting development and new supply. There would potentially be a financial cost of compliance for some providers if they were required to move social housing assets into a separate legal entity, which may also trigger a review of lending agreements and re-pricing of loans.

The ring fencing proposals may bring the benefit of greater protection of social housing assets than the current regime. However, the Regulator has concluded that social housing assets can be protected via a different route for the existing not for profit sector, thus reducing the burden on this group. For this reason, the ring fencing proposals in their current form have been discounted. However, for the profit making sector the Regulator can only regulate in so far as it relates to social housing. For this reason it is reasonable to require some ring fencing for this group. For registered providers whose parent is not registered, actions and decisions made by the parent or other parts of the group may have a negative impact on the social housing assets. For this group the Regulator only has oversight over the registered provider and not the activities of the parent. It is therefore reasonable to require additional mechanisms to ensure that social housing assets are protected where the group is structured so as to have an unregistered parent.

Recovery planning

The proposal in the discussion document was for a three tiered regime, ranging from a light touch register of assets and liabilities to a more extensive contingency planning requirement.

This requirement would drive an improvement in registered providers' asset registers, and in registered providers' understanding of their security position, particularly for those registered providers who have no asset register or where it is scant in detail or poorly maintained. The proposals would have greatest impact on those who do not have accurate records and carry out limited work in this area already.

The proposals were tiered for different registered providers in order that the requirements were proportionate to the complexities of the registered provider. For all registered providers there would be resource requirements to draw up and maintain recovery and where required contingency plans.

As a result of the changes to ring fencing proposals, it is proposed that in order to avoid duplication and reduce the burden on the sector some of the elements of recovery planning are built into the risk management requirements in the Standard. The full proposals will be reviewed and streamlined to reduce burdens wherever possible.

Changes to the disposals regime

The proposals put forward in the discussion document on changes to the disposals regime only apply to profit making registered providers.

There are a number of potential impacts on profit making registered providers of the proposals. The proposals may have a market shaping impact if it deters new profit making providers from entering the sector or discourages them from purchasing stock from non-profit registered providers.

There is also the potential that the additional requirements may affect the financial gains of profit-making providers in such transactions which could in turn result in a lack of investment in the stock, for example in maintenance of existing stock.

In addition to potential generic impacts of changes to the disposals regime, the two alternative approaches also have potential impacts. The REITs model (option 1 in the discussion document) refutes the perception that profit making registered providers' sole objective in engaging with the sector is to asset strip, and could facilitate dealings with local authorities. The second option, based on a formula with a proportion of the proceeds reinvested in social housing assets, is more open to manipulation and therefore public investment being taken out of the sector. It would also require greater skill and resource to manage the more complex process.

Responses to the discussion document showed a preference of option 1. This, alongside the potential loss of historic public investment through manipulation as a result of option 2, means that option 1 is being taken forward and developed for formal consultation.

Option 3 – changes detailed in the statutory consultation

The areas of change proposed in the statutory consultation are to:

- Governance and Financial Viability Standard
- the disposals regime
- registrations
- Rent Standard to reflect the government's latest direction on rents

Changes to the rent standard are not included here as the Department for Communities and Local Government (DCLG) have already consulted on changes to rents and the changes outlined in the statutory consultation document follow the directions issued to us by DCLG.

Changes to the Governance and Financial Viability Standard

When changes to the Governance and Financial Viability standard have been considered, the Regulator has been mindful of the duty to balance our statutory objectives and to minimise interference. The changes are designed to ensure that registered providers better understand the risks they face and have appropriate plans in place to manage them. Many already do this well and there will be little impact on those registered providers. The greatest

impact is on those registered providers who fall short of the expected requirements. Inevitably those registered providers carrying out activities with greater risks will see the greatest impact on their businesses of the proposals. The impacts on those registered providers are described below.

For those registered providers who do not have sufficient skills to manage the activities they undertake or plan to undertake, additional resource and skills will be required in order to fulfil the requirements, for example in providing training or hiring of staff or consultants. Skill and resource will also be required to develop risk frameworks, ensure accurate asset and liability registers, carry out stress testing and using this to inform decision making.

It is the Regulator's expectation that the requirements on entering agreements with third parties will only impact on a small number of registered providers or potential new applicants and will have no impact on those where those agreements are entirely appropriate and proper.

Likewise, for those registered providers who already regularly assess compliance with the standards, the new reporting requirement (to assess and certify compliance with the governance and financial viability standard) creates a minimal additional burden in terms of boards gaining assurance. However, it will have a greater impact on those who do not already evaluate their compliance and will require resource and skill to do so.

There are some additional new requirements being proposed which would apply only to specific types of registered providers.

The requirement for a separate legal entity for profit making registered providers could have a financial and administrative cost where restructure of the business is required. This currently affects a very small number of existing registered providers who are designated as for profit. The requirement ensures that the Regulator can effectively regulate the part of the business that it is required to. However, the cost of doing this is potentially offset by a lower cost of borrowing on social housing as lenders would be able to better price social housing risks and offer reduced loan rates.

The requirement for registered group parents to provide assistance to other registered providers in the group is an enhancement to existing expectations. Whilst it has not been a formal requirement before it has been the expectation of the Regulator and the understanding of the sector. The impact of this requirement will vary from case to case, and will only be required where reasonable.

The requirement for registered providers with unregistered parents to not enter into arrangement which support the activity of the parent or another group member where they may have a material negative impact on the social housing assets will have an impact on the ability of registered providers whose parent isn't registered to use the social housing assets to support other parts of the business. This may have an impact on the growth of those other parts of the business however the regulator is of the view that this impact is reasonable and proportionate in order to continue to meet its fundamental objectives and its aim of protecting social housing assets.

In order to protect social housing assets some additional changes are proposed to the General Consent regime. The proposed change to Category 6 of the General Consent will impact on non-profit registered providers with unregistered parents. This group will now be required to seek specific consent from the regulator. There will be an administrative burden on registered providers in seeking that consent, and inevitably some of those consents may not be granted. However, the regulator is of the view that this is reasonable in order that it continue to meet its fundamental objectives and its aim of protecting social housing assets.

Changes to disposals regime

Changes proposed are only concerned with profit making registered providers when stock is acquired from non-profit registered providers. They place restrictions on the use of proceeds from onward disposal of this stock. This ensures that public investment in social housing stock is retained in the sector.

The potential impacts are similar to those highlighted in the discussion document section previously. There is a risk that due to the restrictions on the proceeds from the sale of this stock that once acquired, profit making registered providers do not invest in social housing stock that they own, for example on repairs and maintenance. This may have a negative impact on the long term value of that stock. The restrictions may also impede new profit making applicants from entering the sector or discourage them from acquiring stock from non-profit registered providers.

The proposed changes to the disposals regime should have a positive impact on perceptions and reputation of profit making registered providers and could for example have a positive effective of facilitating dealings with local authorities.

Changes to the Registration Criteria

Changes in the Governance and Financial Viability standard have consequential changes on the registration criteria. Given that the specific expectations of the Governance and Financial Viability standard have been merged, there is now a requirement that in order to be registered a provider must meet the requirements of the governance and financial viability standard at the point of registration. This means that the Regulator will take a view on whether the arrangements in place are appropriate for the stage of development of the applicant (whether this is a start-up business or an existing business, for example). We do not anticipate that this change will have any material impact on the number of applicants that are judged to meet the registration criteria.

Impact on small businesses

The majority of the proposed changes to the Governance and Financial Viability Standard apply to all registered providers regardless of their size. Any differentiation in requirements is by type of registered provider not size. In reality, profit making registered providers currently tend to be small, but it is likely that this will not always continue to be the case in the future. The regulator has a risk based approach to regulation; in general small registered providers usually have a lower risk profile and as such are subject to a reduced regulatory approach.

For smaller registered providers with low risk profiles, the effect of the proposals will be limited. Whilst they are still required to comply the work involved in complying is likely to be significantly lower than for registered providers with higher risk profiles.

Equality and Diversity

The HCA is mindful of its statutory equality duties under section 149 of the Equality Act 2010. The HCA has published its equalities strategy which sets out 9 equality objectives that we are working to deliver. This includes work to ensure that we pay due regard to equality when undertaking our regulatory functions involving matters of serious detriment. The regulator will take a proportionate approach to its equality obligations and has identified no specific equalities implications for this consultation. However, based on responses to this consultation, the HCA reserves the right to revisit these matters if new information comes to light.