Homes &
Communities
Agency

SECTOR RISK PROFILE 2014

September 2014

Homes and Communities Agency

Sector Risk Profile 2014

Executive Summary

This is the third sector risk profile published by the Homes and Communities Agency Regulation Committee (the Regulator). Once again, we intend to raise awareness of the key risks facing the sector, promote debate and challenge at board level and highlight particular areas of regulatory focus.

We have recently finished consulting on changes to our Regulatory Framework, including changes that enhance the focus on risk management and mitigation, including a requirement for providers to have undertaken robust stress testing of their business plans and to have a comprehensive register of their assets and liabilities.

Although the likely changes will amplify the current expectations around risk management we remain firmly committed to a co-regulatory approach. Boards are responsible for managing their organisations, including understanding all the risks they face, ensuring they have the appropriate skills and gaining assurance the risks are being managed effectively. Therefore a key message remains that good governance and effective risk management support each other in well run organisations

Poor governance within an organisation is often a forward indicator of future problems. If a board does not fully understand the implications of, and risks associated with, the decisions it makes it is often unable to act quickly to resolve issues when they arise in the future. The independent review of the Cosmopolitan Housing Group, commissioned by the Homes and Communities Agency and Sanctuary Housing Group and conducted by Altair[1] contains a number of recommendations for board members and is a timely reminder that boards must retain sufficient control and have the required skills in order to manage risk effectively.

Boards of Registered Providers are also responsible for ensuring their organisations comply with all of the Regulator's standards, and continue to do so into the future. The consumer standards apply to Local Authorities, and councillors are similarly responsible for ensuring their organisations comply with the requirements of these. Even though the Regulator does not proactively regulate the consumer standards this does not lessen the need to comply and we will intervene where we conclude that there is a breach of the consumer standards that leads to actual or potential serious harm to tenants.

The Regulator has, and will continue to, reflect ineffective governance and poor decision making in its published judgements in order to maintain the confidence of lenders and other key stakeholders, and to protect social housing assets.

[1] Cosmopolitan Housing Group Lessons Learned

1. Introduction

1.1. In the year ahead, the HCA will implement a new Regulatory Framework effective from 1 April 2015 and we are currently considering the responses to the consultation exercise on the proposals. Effective risk management remains central to the proposals and the enhanced requirements will help providers have a better grasp of the risks that they face and a more thorough understanding of how these may crystallise. We believe that these requirements are necessary to maintain the security of social housing assets in an increasingly diverse sector.

1.2. The principal driver for the proposed changes is the increased risk and complexity in providers' operating environment flagged in our Sector Risk Profiles. The primary focus of this document continues to be the financial risks that may cause a provider to fail our economic standards, in particular the viability element of the Governance and Financial Viability (G&FV) Standard. As with previous editions we group the risks under headings of the assets, liabilities, income and cost base of providers.

1.3. However, since the last publication we have dealt with a number of cases where, even though the financial loss or risk to social housing assets was minimal, there was nevertheless a breach of the standards. In response we have changed the section on operating context and included a set of strategic risks.

1.4. We hope this publication will form part of the sector's approach to managing risk effectively and is a useful tool in assisting boards and other key stakeholders to have a better grasp of the risks their organisations face in an increasingly complex and diverse sector.

2. Operating context

Operating Context

2.1. Providers face a range of risks in delivering their objectives and managing their businesses. This publication draws out those risks that are of particular concern to the regulator but recognises the broader environment in which providers operate. It does not seek to identify every risk that could potentially affect an individual provider. It is essential that providers should understand the particular set of risks and issues that confront their business.

2.2. We expect boards to clearly understand and articulate their risk appetite and regularly review how their activities fit in with their overall objectives. The Regulator seeks to understand how boards of providers gain their assurance that they are aware of the risks their organisation faces and are managing them effectively. Providers should expect challenge from the Regulator where it is unable to gain sufficient assurance that the impacts are fully understood and effectively managed.

2.3. The issues of housing supply and affordability are very high on the political agenda. Boards should consider the extent to which their strategies and business plans could cope with changes in housing policy and related areas including welfare, health and social care. Factoring in the impact of potential policy changes into the scenarios used for stress testing is likely to be helpful to achieve this.

2.4. Another impact of the increased profile of the sector is likely to be a corresponding increase in the level of public scrutiny and interest in housing providers. Social media has increased the likelihood that an issue within an organisation has the potential to escalate more rapidly, and spread more widely, than has been the case in the past. Many boards are already taking an increased interest in managing reputational risk through the identification of particular risks that could impact on their strategy, the markets they operate in or the services they offer. Boards need to ensure they consider risk in the round and are able to monitor risks in combination so that they can act in time to head off an issue before it can impact on their reputation or that of the sector.

Strategic risks

2.5. The main part of this document highlights in more detail some of the key operating financial risks for providers. However, the range of risks providers need to be aware of is broader than only financial ones, particularly as the sector increases in complexity. Over the past year the Regulator has dealt with an increasing number of issues, including cases that have led to breaches of economic or consumer standards, and that had the potential to harm tenants and the reputation of particular providers or the wider sector in general.

2.6. Registered providers face a wide range of operational challenges, and this document does not seek to identify the full range of issues that could cause non- compliance with the Regulatory Standards. However, our engagement with the sector over the past year illustrates the breadth of the risks that could cause a breach of the economic or consumer standards.

2.7. In the past year, a number of providers did not give sufficient assurance that they were compliant with the Value for Money (VFM) standard, publishing self-assessments that did not provide an independent stakeholder with sufficient evidence to be able to take an informed view about the provider's performance. Furthermore, whilst the regulator does not set standards on providers' remuneration policies, we have also seen a number of cases where severance or redundancy settlements have been handled poorly, with weaknesses in processes or a failure to regularly check for overly generous terms and conditions. These have suggested weaknesses in governance more generally.

2.8. During 2013/14, we published three findings of serious detriment. In each of these cases we found that providers had breached the Home Standard, in particular, that they had failed to meet their statutory obligations with regard to gas servicing and that as a consequence, there was potential for serious detriment to tenants.

2.9. Our recently published Consumer Regulation Review highlights the importance of health and safety obligations. These are not only restricted to gas servicing but also include issues such as fire safety, information security, disease outbreak and working on construction sites.

2.10. Boards are responsible for ensuring that providers comply with all the standards, both economic and consumer. The fact we regulate consumer standards reactively does not lessen the obligation to comply but does make the risk of non-compliance significant, as interventions in the event of failure are likely to be noteworthy and public. Where a registered provider fails to meet the consumer standards we will consider what implications that failure has on our judgement of governance within the provider.

Counter party risk

2.11. The issue of counter party risk is not new but as financial and non-financial transactions increase in complexity the potential for organisations to be exposed to counter party risk increases both in terms of likelihood and impact. However, it is not only new transactions where counter party risk needs to be understood. Many providers will have existing contracts – with lenders; suppliers; development partners or insurance companies for example – which expose them to varying levels of counter party risk.

2.12. Boards should understand the terms and conditions of their existing and future contracts or agreements and ensure they identify the potential liabilities and risks associated with each. This needs to be in the widest context rather than assuming the relationship is simply on a one to one basis; a development contractor for example may sub contract elements of its work to a third party and boards need to understand what, if any, counter party risk this exposes their organisation to. Boards also need to fully understand the potential circumstances in which they or the counter party has an option to vary or break a contract, and put in place mitigations to manage the risk in the event this happens.

3. Key financial risks

3.1. As noted in the introduction the Regulator needs to understand the breadth of issues that may cause a provider to fail the economic standards. But those risks that may lead to a failure of the viability standard remain our primary focus. Although the requirements of the G&FV Standard are likely to change during the lifetime of this publication we believe the effective management of the highlighted risks, along with good governance and the financial strength to withstand adverse changes, remain essential components of well-run organisations.

Assets

3.2. Social housing is primarily an asset based business. The 2013 Global Accounts revealed that the largest 340 registered providers owned housing properties with a combined gross book value of £126 billion. At March 2013 the sector had invested approximately 82% of its accumulated revenue reserves in the acquisition, development of, and improvement in, fixed assets.

3.3. Therefore a key focus of boards must be the effective management of existing stock as well as adding to it through the development and purchase of homes.

Managing a housing development programme

3.4. One of the main aims of many providers is to increase new supply. A key part of the effective management of a development programme in terms of debt requirements is the careful monitoring of cash flows, early year's cash deficits, income from sales receipts, grant payments and the timing of conversions. Given the potential volatility of these cash flows there is always risk associated with this activity.

3.5. In July 2014, initial grant funding allocations were made for the Affordable Homes Programme 2015-18 and The Mayor's Housing Covenant 2015-18. Circa £1.3billion has so far been allocated to deliver around 62,000 new homes. Whilst grant will contribute to the cost of financing these homes, most of the funding will come from debt. This further highlights the importance of effective treasury and cash flow management especially at a time when income could become more volatile due to the potential risks to income outlined in this publication.

3.6. As well as the cash flow implications of managing a development programme, boards should understand a range of other risk exposures and their impact on delivery of their development programme. Examples of these are increases in costs related to labour or supplies, the cost of acquiring land – which can often be inflated when there is competition from a number of developers – and the potential for impairment as a result. It is therefore important that providers should undertake thorough due diligence of planned investments. In addition, because balance sheet capacity can be quickly expended when developing with little or no grant, boards should understand how their risk appetite is reflected in any cushion on their tightest covenant or covenants.

3.7. The Regulator will seek assurance that a provider is effectively managing its development programmes and that the board gains assurance on both the risks associated with individual schemes and also the cumulative impact of the whole programme. It will seek to understand what early warning systems, triggers for exit and other mitigation plans providers have in place should there be adverse variations from delivery plans or adverse variations elsewhere in the business that affects its development capacity. The regulator will wish to understand how deliverable such mitigations might be in practice, and whether there are any financial or contractual constraints on a provider's ability to exit a development if necessary.

Diversification

3.8. The 2013 Sector Risk Profile highlighted that providers' diversification into other activities was an increasingly complex area where the nature and scale of risks was evolving particularly rapidly. We were clear then, as we are now, that we have no desire to stifle innovation in the sector and recognise the need for providers to identify additional income streams within an increasingly challenging operating environment.

3.9. Diversification can be an important way in which registered providers cross subsidise their main social housing purposes and support new supply. In addition, in a world of lower public subsidy and increased volatility in traditional income streams, diversification may be a way of mitigating some of these risks. It can also offer providers the opportunity to deliver wider social or charitable objectives such as regeneration or the provision of care services.

3.10. However, the Regulator also recognises that commercial activities, new and more complex financing arrangements and new business structures expose providers to an increasingly wide range of risks. Boards need to ensure that they have the required capability and skills, internally, from external professional advice, or a combination of the two, to understand and manage these.

3.11. Boards should have access to adequate information on the potential cost benefits and risks of undertaking a wider range of diverse activities. They should be clear how entering in to new markets or activities fits into their overall strategy and helps them meet their core objectives. Increased diversification often leads to increasingly complex organisational structures, made up of a wide range of companies that sometimes have very different aims, legal requirements and financing structures. Therefore the board should retain adequate oversight of all the activities and companies within their groups while ensuring the fundamental objectives of their organisation do not get neglected in favour of new areas of business.

3.12. It is important for boards to understand the different types and timeframes over which risks need to be managed. Some of the activities will expose providers to shorter term revenue risks. There may be other activities where the cyclical nature of a sales programme, for example, is the key risk; and finally there are other activities that will expose providers to liabilities over a longer term. Boards should understand the implications and impact of the different types of risk, both individually and in aggregate, and have appropriate mitigations in place to manage these.

3.13. Boards need to ensure they understand the interdependencies between all the parts of their organisation including where there are any guarantees or cross default clauses between the registered entity and non-registered elements which may give rise to recourse to social housing assets; and have appropriate arrangements in place to mitigate these risks. In addition boards need to be clear that any mitigating actions, break clauses or exit strategies in place to manage the risks they identify are actionable and possible in practice as well as on paper. Boards should also consider whether, even where they have comfort over the legal recourse to the social housing assets, they could bear the financial, reputational and other implications of the entity's failure.

3.14. The Regulator will seek sufficient assurance that boards fully understand the range of risks that involvement in a range of diverse activities exposes their organisations to. We will need to understand how the activities contribute to and subsidise the core objectives and aims of the provider. We will seek assurance that boards understand the importance of these activities making a surplus, or, where they are done to meet wider social objectives, that boards appreciate the opportunity cost of undertaking the activity.

Housing market sales exposure

3.15. Development of homes for sale remains a key activity for many providers and exposes them to a range of housing markets. Some of these are products where many providers have experience, such as shared ownership, but increasingly providers are turning to outright sale as a method of cross subsidising social housing build programmes.

3.16. Each of these markets operates differently and exposes providers to different risks. Boards should not assume that because they operate effectively in one market they will automatically do so in another. They need to ensure that they have the right range of skills and take, understand and critically appraise, the appropriate legal and technical advice before they enter into any new market.

3.17. Providers' financial forecasts suggest rising expectations of current asset sales:

- LCHO: £750 million in 2013 and 2014 and expected to rise to £1 billion in 2015
- Market sales: £650 million up to £1.7 billion in 2016.

3.18. This increased expectation of sales income, both from market and shared ownership sales, means that some providers' business models are now more pro-cyclical than they have been in the past. This makes it even more important that providers manage their sales programmes with care and ensure that they can effectively mitigate the risks of a slowdown in sales, or reduction in market prices.

3.19. While most forecasters project house price growth to continue, significant downward house price adjustment is a possibility especially as interest rates rise. History suggests, although prices have tended to rise over the long term, there have been periods of downward price adjustment causing significant delays in sales and falls in income per sale.

3.20. The HCA quarterly surveys show significant volume of Right to Buy sales being made; around £300 million in 2013/14. While these sales may provide an injection of cash to the sector, the longer term risks associated with the replacement, or potential loss, of this stock need to be managed.

3.21. The latest Global Accounts show surpluses from all sales, at £640 million, make up around one third of total surpluses. The Regulator takes assurance in the fact that most providers are not dependent upon sales revenue to meet the day to day running costs of their core social housing business.

3.22. Providers should model a range of scenarios that demonstrate the impact of changes to key assumptions around delivery of their development plans such as likely volumes, prices, time taken to sell and costs of any delays, and assess the impact these changes have on covenant compliance.

3.23. Boards should understand the impact of these changes as well as understanding the different regional and product markets they operate in. We will also expect providers to be clear about what alternative options are available if sales are not delivered in line with their plans and ultimately what their exit strategies will be if the sales fail to materialise.

3.24. The Regulator will take a particular interest in those providers who are reliant on sales to meet their interest payments or running costs or where the failure to achieve sales would mean new debt is needed more quickly than planned.

Existing stock

3.25. The sector has largely met the challenge to bring its stock to the Decent Homes Standard, with only a small proportion of stock remaining below standard; owned by those providers with extensions to the deadline for compliance.

3.26. A key challenge for the sector will be to ensure that the stock remains at the level required to continue to meet the Decent Homes Standard, in an operating environment where boards need to balance their ambition for growth against the need to invest in existing stock. This is dependent on boards ensuring they have high quality, up to date stock condition data and an appropriate long term investment strategy. Many asset management strategies allow for a degree of flexibility in the profiling of repairs and maintenance expenditure, allowing it to be adjusted when other capital commitments, such as new development, take precedence. But boards should ensure it doesn’t simply become the balancing figure in their business plans which will store up significant maintenance requirements that need to be met in the future.

3.27. Expenditure on repairs and maintenance forms part of our annual viability assessment. We will challenge providers where there are significant reductions in expenditure or where expenditure appears to be below the sector norms, to understand the reasons for this and to gain assurance this is not a sign of a provider failing to maintain its stock. In addition we will seek assurance that long term business plans demonstrate that the income streams are sufficient to maintain the stock in a condition that complies with the Decent Homes Standard.

3.28. A number of providers are also involved in significant regeneration projects. The regulator will seek assurance that boards have consciously made the decisions around long term sustainability of these regeneration projects, on the basis of a full cost-benefit analysis, especially where this is a loss making activity that, whilst consistent with a provider’s social objectives, may also have wider implications for future viability.

Liabilities

3.29. In order to meet their objectives and growth ambitions providers are reliant on debt funding. As at 30 June 2014 the sector reported facilities of £73 billion, of which £60 billion was drawn, leaving undrawn facilities of £13 billion. Cash available to the sector was reported to be £4 billion.

3.30. Effective debt and cash management is essential to maintain liquidity and ensure obligations are met as they fall due. This requires providers to have a sound treasury management strategy in place. This allows boards to ensure that clear parameters are set that manage liquidity, ensure access to sufficient debt and adequate security when it is required and ensure interest rate risk is managed.

3.31. Effective treasury management has become increasingly important due to significant changes in the finance markets, the greater variety of products available and the different relationships providers have with an increasingly wide range of funders. Providers should also understand the impact of different accounting treatments for the various sources of finance, particularly those which appear off balance sheet. In these instances we would expect boards to receive information that reports variances in cash flow against budgets to fully appreciate the real impact on the business plan.

3.32. These changes also heighten the need for boards to ensure they have the skills and knowledge to understand the diverse range of risks their organisations will be exposed to as a result of the increasingly complex nature of the transactions they enter into. Boards must be able to identify when and where there are skills gaps and ensure they have an appropriate strategy in place to access the relevant expertise. However, in seeking expert advice from third parties boards need to retain sufficient control and understanding to be able to constructively challenge where they believe the advice is not truly independent or in the best interest of their organisation.

3.33. The following sections highlight some of the key risks providers need to manage in relation to their existing and future debt requirements as well as some changes in accounting practice that will impact on the way liabilities are treated.

Existing debt

3.34. By 2016 the sector's rate of refinancing, compared to 2013/14 levels, will double to £2 billion of debt per annum. This exposes providers to a growing refinancing risk especially given much of the money being repaid is likely to be at historic low loan margins, typically 30-50 basis points above LIBOR.

3.35. The operating environment is also likely to remain challenging. The base rate is widely predicted to rise and this could reduce providers' financial capacity, and decrease the head room in their business plans. Providers should ensure, through effective liquidity management and covenant compliance monitoring, that they have sufficient cash to meet their obligations as they fall due.

3.36. The Regulator regards the careful monitoring of loan covenants, both financial and non-financial, as an essential part of an effective treasury management strategy. The majority of providers do this on a regular basis, either within the organisation or by using external treasury management specialists. However, the proposed changes to the G&FV Standard will make it a requirement that providers stress test their business plans against a range of scenarios including understanding 'what could bring the business down'. Although in many cases breaching a loan covenant may not in itself break a business plan, it may significantly weaken a provider's financial position. It may remove the control from the organisation over its loan portfolio and impair its ability to negotiate with its funders. This could result in funders triggering a re-pricing or even lead to demand to repay the loan. We are likely to view such failures as a material breach of the G&FV Standard requiring regulatory action.

3.37. Providers and their boards should ensure they fully understand the detailed terms and conditions of their loan agreements such as cross default clauses and counter party risk. They should also be clear where there are break clauses or points when a lender can re-price, such as with LOBOs or callable swaps, which mean treating these loans as long term finance may mask a potential refinancing risk. Providers should also model the impact of any bullet repayments on their business plans including a range of interest rates that may prevail at the time of the repayment.

3.38. We continue to collect data through our quarterly survey on availability of finance and will actively engage with providers where existing debt facilities cover less than 18 months' worth of obligations, particularly where this has been a frequent occurrence. In addition, through our viability assessment we seek assurance that treasury management arrangements are effective. This includes gaining evidence that boards understand the risks when making investment decisions and have sought independent external advice where appropriate. Where we conclude this indicates deficient treasury management we will reflect this in our regulatory judgement of that provider.

New debt

3.39. The June 2014 quarterly survey of private registered providers found that new facilities of £1 billion had been arranged in the quarter, with 62% of this new debt being raised through the capital markets.

3.40. To meet long term financing needs, providers have primarily looked to the bond market to supplement bank debt. Other more complex sources of funding are becoming available, such as index linked finance (ILF) embedded in sale and leaseback or lease and leaseback structures. A number of providers have entered into these deals, as well as index-linked loans, attracted by the lower initial start costs, and lower asset cover requirements.

3.41. However, ILF arrangements may potentially lead to higher costs overall. They also pose different risks from the more traditional funding that providers are used to. Boards should take care to ensure that they understand the real, long term cost of such arrangements, and take into account the change from RPI to CPI linked rental income. Leases are commonly for 40 years or more and this is a long period within which to assume that the main income streams will keep pace with inflation.

3.42. Raising new finance, regardless of its source or type, is always going to carry a degree of risk. Boards should understand implications and obligations associated with any new debt arrangements they choose to enter into and the risks should be understood by the full board to avoid placing an over reliance on one or two key board members, executives, or advisors.

Mark to market issues and bond finance

3.43. As at 30 June 2014, 48 providers reported they made use of derivative instruments in order to manage their interest rate exposure. The notional value of the instruments is circa £9 billion and the average term is 14 years.

3.44. The use of free standing derivatives can be an appropriate mitigation against interest rate exposure and to date engagement indicates providers have managed the exposure effectively. However, the impact of tying up circa £2 billion of social housing security is a material one. Further security may be needed as new derivative instruments are taken out to move fixed rate debt to floating, which means regardless of the way interest rates move, providers will always need to give collateral to a counterparty.

3.45. The capital markets provide a range of financing opportunities, but also expose providers to different risks. Public markets have specific legal requirements, they demand much greater transparency and disclosure and the investors generally have different expectations and needs. The level of counter party risk is also greater given that once bonds are issued a provider has very little control over who purchases them, including subsequently through the secondary market. Capital market issues can also mean that providers hold larger cash balances and will need to carefully manage the counter party risk associated with investing these balances.

3.46. Boards need to appreciate the on-going relationship with these institutional investors will be of a very different nature to the relationships with funders they are traditionally used to. Increasingly, as new products enter the market, boards will need to ensure they have the skills, either within their organisation or from expert external advice, to understand the wider implications of raising funds through this route.

Accounting Issues

3.47. As well as managing the liabilities themselves and their associated risks, providers must also ensure that they comply with the reporting requirements and present their financial statements in the required format. Although changes to accounting standards are subject to consultation the final outcome is often beyond the control of providers and they must adhere to the requirements. Therefore it is important that they have discussions with their auditors and advisors at an early stage to ensure they understand the implications of any proposed or in-coming changes.

3.48. Providers should be planning for the introduction of Financial Reporting Standard 102 (FRS 102) which was issued in March 2013 and comes into effect for accounting periods beginning 1 January 2015. Many of the disclosures are new or have been amended and the financial reporting will be very different in many parts. The greater use of fair values and the general principle of no netting off assets and liabilities is likely to have a significant impact on the way providers' accounts look, and give the appearance of increased volatility in income and expenditure when year-on-year comparisons are made, even if the underlying financial strength of the business is unaltered.

3.49. The Statement of Recommended Practice (SORP) offers guidance and went through the final Financial Reporting Council approval in September 2014. As previously drafted, the SORP had the potential to increase the amount of impairment providers needed to consider. It now introduces a new valuation methodology – Value in Use-Service Potential – that recognises the way new development occurs in the sector and that social housing units are not just held for their income generating capability but for social benefit. The change also only requires impairment to be considered where there are 'impairment indicators', which are generally material changes to schemes or development programmes such as the discovery of contamination that increases costs, change of use of some or all of the properties, significant falls in property values or demand that weren't anticipated when the development was planned.

3.50. However, the requirement to annually value standalone and embedded derivatives and some types of finance leases at 'fair value' remains, which will potentially increase year on year volatility and carry a cost implication for some providers. Any potential volatility to financial results or balance sheet position as a result may impact on a provider's ability to meet its income and expenditure or balance sheet based financial covenants.

3.51. In the transition period boards will be able to significantly influence the appearance of their results and net assets depending on the accounting policy choices they make. When making these decisions boards should consider the longer term implications of their chosen policies which may have an impact on covenant compliance or the appearance of the accounts in future years.

3.52. Where covenants need to be renegotiated with funders following the introduction of FRS 102 boards should obtain appropriate independent expert advice to ensure that they understand the implications of the revised covenants and to assure themselves that they have secured the best deal for their organisation in the current economic climate.

3.53. As part of its on-going financial monitoring and assessment of viability the Regulator will seek assurance that boards understand the implications of FRS 102 and are effectively managing the transition to maintain current and future covenant compliance.

Income

3.54. Traditionally the sector has had a high degree of certainty over its main income stream (social housing rents) as price has been set by an RPI linked formula and the direct payment of Housing Benefit has meant that the timing of the receipt of a large proportion of the rental stream has been reasonably certain. The level of certainty on rent increases has been maintained by the Government's rent policy that they will be linked to CPI for a period of ten years from 2015/16. However, the introduction of the Affordable Rent product and the impact of welfare reforms have introduced volatility into the cash flow that providers will have to carefully manage in the current operating environment.

Rental market exposure

3.55. The Regulator's Rent Standard, effective 1st April 2015, stipulates that increases in social rents will be limited to CPI +1% p.a. for ten years from 2015/16. This will replace the current rent restructuring policy which restricts annual increases in target rent to RPI +0.5%. Under the rent restructuring regime providers were permitted to increase rents by up to an additional £2 per week above the guideline limit where rents were below targets. This is no longer allowed. The regulator can issue waivers from the new rent standard, but will only do so in exceptional circumstances where compliance with the standard would risk non-compliance with other regulatory standards, particularly where there would be a risk to the provider's on-going viability.

3.56. Providers should now have factored the change in rent policy into their business plans. Where providers' business plans were predicated on the assumption that upwards convergence on target rent would continue beyond 2015, they should have assessed the implications for their rental income and understood the trade-offs that might need to be made. Any providers with concerns about potential impact on their on-going compliance with the G&FV standard should have contacted the Regulator.

3.57. The introduction of Affordable Rent and other products which link rents to market levels have the potential to increase cash flow volatility because they fluctuate as the market rent does. The Regulator's Statistical Data Return reported that there were 80,000 Affordable Rent homes as at March 2014, compared to 40,000 the previous year.

3.58. In addition to Affordable Rent a number of providers are either diversifying into, or increasing their portfolio of, market rent properties which also exposes them to fluctuations in the rental market. The increase in market linked rental products highlights the need for providers to understand the new markets and manage the different risk profile including levels of voids and arrears associated with market linked tenures.

3.59. The Regulator will seek assurance that providers understand the different markets they operate in and the associated risks with each. We will also expect providers to have an understanding of the impact of a downturn in the market and to have appropriate mitigations in place to withstand any fluctuations.

Welfare reform

3.60. The Welfare Reform Act (March 2012) confirmed a number of changes to the benefits system to take place between 2013 and 2017. The effects of the changes are well documented and impact of these changes will vary from provider to provider, but they represent a change in the operating environment and potentially introduce several risks to net income that will need to be managed effectively.

3.61. Since the welfare reform changes were confirmed in March 2012, providers should now have an understanding of the numbers of tenants affected by the most important reforms and have modelled a range of potential financial impacts on their business that arise as a result. Based on their findings, they should have developed plans to more actively manage income collection, and targeted their resources on working with potentially affected tenants to minimise the impact on their income cash flows.

3.62. The impact of welfare reform is already being felt by many providers and is having a significant influence on their business plans. This is likely to increase as Universal Credit is rolled out, combined with other reforms, including any potential further reductions in benefits. Providers have taken steps to manage risks from welfare reform, including increasing business plan tolerances and strengthening rent collection processes. HCA quarterly survey data from June 2014 shows that arrears, rent collection and rent lost due to vacant properties are within business plan projections for the majority (91%) of providers.

3.63. Evidence from the Direct Payment Demonstration Projects run jointly by the Department for Work and Pensions and the Department for Communities and Local Government suggests there is a risk of an increase in arrears in the short term during the initial transition to the new system. The scale of any impact is hard to predict as design and implementation of policy measures to mitigate any impact on providers continue to be developed.

3.64. Providers and their boards should closely monitor the financial impacts of welfare reform and revise their approach as new evidence emerges to ensure they reflect the impact in future forecasts and continue to mitigate the risks effectively. In particular the risks from direct payment, such as the risk of spikes in arrears as people are moved on to the new system affecting liquidity and covenant compliance, need to be carefully understood. Robust stress testing and agreeing appropriate mitigation strategies will be critical. For most providers, the key period will be the national roll-out of Universal Credit to existing claimants scheduled in 2016 or 2017. Some providers may see some effects before then, with staged roll-out to all new benefit claimants in the North West scheduled to be complete by the end of 2015.

3.65. The regulatory interest in welfare reform will include seeking assurance on the quality and effectiveness of strategies to manage welfare reform, including evidence that demonstrates how these feed into business plans and financial forecasts. Looking ahead, we will wish to get assurance that the potential effects of direct payment in particular inform adequate stress testing. The Regulator will continue to engage with providers where there is a material exposure, particularly where our information and analysis suggests the actual impact on a provider is greater than anticipated, and will continue to use quarterly survey data as a means to closely monitor emerging issues at a provider level.

Supported housing

3.66. Supported housing has always been a low margin activity for providers and pressures on Supporting People (SP) contracts mean that many are dealing with further reductions in income. While the total SP accessed by the sector has fallen over recent years, SP still plays a critical role in financing supported housing and wider support activities in the sector. Most large providers access some SP funding, but for many specialist supported housing providers financial reliance is much greater than average.

3.67. The removal of local ring-fencing of SP funding, set alongside increasing pressure on local authority budgets and reductions in SP allocation for many local authorities, means that SP funding is now a less reliable income source for providers and contracts are increasingly competitive. Some providers have already seen sharp falls in SP income during the last three years and, with local authority budgets projected to be reduced until at least 2015/16, the income is unlikely to increase in the near future.

3.68. Providers with significant SP funding or a dependence on one or two contracting authorities need to plan for what happens in the event of reduction or loss of the contracts. In particular providers need to have a good understanding of how readily they can make necessary cost reductions, or source alternative income, if their SP funding falls.

3.69. The Regulator will continue to engage with those, mainly specialist, providers where the loss of a contract or contracts would have a material impact on their viability and will expect to see these risks appropriately reflected in provider's stress testing.

Costs

3.70. With increased focus on diversified activity, welfare reform, new funding streams, income volatility and Affordable Rent, it is important providers continue to control their cost base. Delivering efficiency savings or providing enhanced services for the same money will be increasingly challenging for the sector, especially as it comes under greater scrutiny. The Regulator will expect providers to be clear about the cost of delivering key services, and communicate this transparently to stakeholders as part of their VFM self-assessment.

Pension costs

3.71. Pension costs remain an issue with liabilities varying as a result of investment returns and actuarial assumptions. A new valuation for the Social Housing Pension Scheme (SHPS) is due in 2015; at its last valuation date it had a deficit of over £1 billion. The Local Government Pension Scheme (LGPS) also remains in deficit the amounts of which vary across each administering authority.

3.72. FRS 102 requires that schemes that currently enjoy multi-employer exemption, such as the SHPS, are now recognised in the financial statements which bring the accounting treatment closer in line with the LGPS and other schemes. Boards need to plan carefully so that they mitigate their exposure to rising pension costs and account for them correctly in their audited accounts.

3.73. Given the fact that pension costs are likely to continue to increase boards need to evaluate whether the schemes they are in remain fit for purpose. Providers will also need to consider any potential impact from the introduction of auto-enrolment. They should understand the longer term cost of remaining in the scheme and undertake some form of cost benefit analysis covering a range of options they could introduce to mitigate the impact of rising costs.

Differential inflation rates

3.74. The latest Global Accounts 2013 show management and maintenance costs increasing at a higher rate than the previous year. The increase was below the inflation rate applicable to rent increases in that year and management and maintenance costs actually reduced as a percentage of turnover. With a shift from an RPI linked rental income to a rent policy linked to CPI from 2015, providers should take care to understand how the relationship between their cost base and income stream might change in future. This will be particularly important where providers have existing liabilities that will remain linked to RPI (for example, existing index linked debt or lease and leaseback arrangements).

3.75. Providers should also plan, and allow flexibility in their financial forecasts, for fluctuations in their running costs which may be linked to cyclical changes. For example, a stepped increase in development activity may inflate build costs more rapidly as materials and skills become increasingly in demand.

Other business costs

3.76. As providers increasingly diversify into other areas boards need to understand the differing cost bases of their activities and factor them into their financial forecasts. As well as realistic assumptions around the differential cost of various activities, there should also be an appreciation of the fact that start-up costs for a new business can be high – as they are potentially very resource and debt hungry – and this is likely to be different to their longer term cost once the business is established and anticipated scale is achieved.

3.77. Providers should regularly review all of the contracts they enter into. Boards should understand the impact that changes in the economy can have on costs at both an individual contract level and also cumulatively. Boards should also be mindful of the counter party risk associated with each contractor and have mitigating strategies in place to deal with a range of scenarios including what action they would take in the event of a failure of a major contractor.

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Publication date: September 2014