Homes & Communities Agency

SECTOR RISK PROFILE 2013

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Executive Summary

This is the second sector risk profile published by the Homes and Communities Agency Regulation Committee (the Regulator). It focuses on the financial risks that may cause a provider to fail to comply with our economic standards, in particular the viability element of the Governance and Financial Viability standard.

There is a key message running through this document related to the role and responsibility of boards in ensuring effective governance and risk management is at the heart of their business. We highlight in several places the importance of boards and executives in the co-regulatory settlement in that they are responsible for running their organisations. The Regulator’s role is to look for assurance that they have identified the risks to their business and they are being managed effectively.

This means boards and executive teams need to regularly appraise their mix of expertise and assure themselves that they have appropriate skills to manage their business. Even if the aims and objectives of a provider do not alter, the sector and policy environment is changing rapidly so boards must ensure they are fit for purpose by refreshing and renewing skills regularly.

Boards also need to understand the interaction between the various risks and their overall ‘portfolio’ impact. An approach to risk that considers issues and their mitigation in isolation is unlikely to be effective in the current operating environment.

Where providers identify skills gaps they need to ensure they have an appropriate strategy in place to ensure they have access to the expertise, either in house or from external consultants or advisors, to constructively challenge and make sound business decisions. This is particularly true where they are entering a new market, with different risks to the activities they are currently managing.

The Regulator has dealt with a number of cases where poor governance, often coupled with weak internal controls frameworks, has led to ineffective risk management. In many cases this has resulted in boards receiving poor quality, incomplete or incorrect information when making key business decisions. They did not have sufficient skills to challenge or did not recognise the need for specialist or professional advice. Therefore, some of the risks associated with the decisions were missed or the implications of others were not fully understood. Even where the financial loss is minimal there can be significant reputational damage either to the individual provider or the sector as a whole and boards need to be mindful of this risk when making decisions that affect their organisations.

We have published regulatory judgements that reflect sub optimal risk management or poor quality decision making by boards of providers. Where we conclude an organisation is mismanaging risk or making poor decisions, we will continue to reflect this in our published governance and financial viability judgements. Where we believe this may put social housing assets at risk or damage the reputation of the sector, we will take the necessary action to prevent this happening.

1. Introduction

1.1. The Regulator published its first sector risk profile in June 2012. The purpose of the publication was to raise awareness of the key risks facing the sector, to promote debate about them, including the response from boards and to give an insight into how they inform our regulatory activity.

1.2. We acknowledged in the 2012 publication that the model of social housing that existed for approximately 25 years was changing after the credit crunch. Before then providers could base their plans on substantial levels of government grant for new development, housing benefit underwriting rental income for claimants, and banks providing long term debt on low margins. These pre credit crunch conditions have changed and it is clear that their return is not likely in the foreseeable future. In this environment, boards need to be completely focused on the risks and choices they face in order to meet their objectives.

1.3. As set out in our publication *'Regulating the Standards',* we adopt a risk and assurance based regulatory approach. Our main focus is to seek assurance from providers that they are meeting our economic standards (Governance & Financial Viability, Value for Money and Rent) in the round, but the level of assurance we seek varies depending on the nature and scale of risk faced by particular providers.

1.4. We remain firmly committed to a co-regulatory approach, where boards and providers are responsible for managing their own businesses. This means they must fully understand the risks they face and be appropriately skilled to manage them. One of the key messages in this document is that strong governance and effective risk management support each other in well run organisations.

1.5. Where the Regulator is unable to gain sufficient assurance that an organisation understands the risks to its business or there is evidence that, through poor quality decision making, it is mismanaging them we have and will continue to reflect this in our published regulatory judgements on governance and financial viability. And we will, where necessary, take action.

1.6. The broad structure of the sector risk profile remains the same as the 2012 publication as we believe the full range of risks identified previously still apply. The operating context and strategic risks sections reflect the fact that there are a number of key risks the sector has always had to manage, including exposure to housing and financing markets. However, there are two areas where the scale and nature of the risk facing the sector are evolving particularly rapidly- the potential impact of welfare reform and the different risk profile of diverse activities. Although some details of the new Government policies announced in the 2013 Spending Round remain subject to consultation, we have reflected the potential impacts upon the sector where we can in this document.

2. Operating context and strategic risks

<u>Operating context</u>

2.1. The Regulator monitors the financial position of providers through data collected in its financial forecast returns, quarterly surveys and annual accounts. The 2012 Global Accounts demonstrate that the sector remains financially robust and is in general responding well to the current economic climate. However, uncertainty remains in the housing and financial markets so the next few years will still be challenging.

2.2. As well as the traditional housing and finance market business risks, providers are also managing on-going changes in capital and revenue cash flows as the Government's Affordable Rent model and welfare reforms change the timing and quantum of state funding. In the light of these changes, as well as being a response to opportunities within the wider economy, many providers are increasingly looking to non-core activities to generate cash flow and/or provide subsidy for the social housing business. These activities are most commonly related to the core business of social housing, but the change in strategic focus and the different disciplines required means that boards and executives need to ensure they are able to meet the new challenges whilst continuing to deliver the traditional social housing service as well.

2.3. Looking to the future, providers will also need to understand the implications for their businesses of the Government's 2013 Spending Round policy announcements, which will shape key aspects of the sector's operating environment until 2025. In particular, the Spending Round confirmed that social rents would be permitted to rise by up to CPI +1% per annum for ten years from 2015/16, with the intention that this would give providers the certainty that they need for long term business planning. The current RPI +0.5% formula will remain in place until 2015. Providers will need to assess the potential impact of this change on their business plans and financial forecasts.

2.4. We expect boards to clearly articulate their risk appetite in light of the continued challenging operating environment and regularly review how their activities fit in with their overall objectives. The Regulator will seek to understand how boards of providers gain their own assurance that they are aware of the risks their organisation faces and are managing them effectively. The risks identified in this publication form one part of that approach and providers should expect challenge from the Regulator where it has evidence the impacts are not fully understood or managed.

<u>Strategic risks</u>

2.5. The main part of this document highlights in more detail some of the key operating risks for providers, but given their significant nature it is worth highlighting four strategic risks that all providers have to manage:

<u>(i) Welfare reform</u>

2.6. The variety of changes brought in by welfare reform over the period 2013 – 2017 will potentially increase the volatility of providers' income cash flows. The launch of the under occupancy reform in April 2013 means that changes have now started to take effect. Rather than simply being aware of the proposals and modelling their potential impact on their businesses, providers should now be putting their plans into action to manage or mitigate the actual impact on their financial position.

2.7. Through our regulation to date we know that the majority of providers have already allowed for increases in arrears and bad debts. They are putting plans in place to more actively manage income collection and are targeting their resources on working with potentially affected tenants to minimise the impact on their income cash flows.

2.8. Our regulatory interest in welfare reform has also moved from gaining assurance that providers are formulating plans, to seeking assurance on the quality and effectiveness of those strategies and how these feed into business plans and financial forecasts. We will continue to engage with providers as the welfare reform policies are implemented, particularly where our information and analysis suggests the actual impact on a provider is greater than anticipated.

(ii) Diversification

2.9. Although the sector has always had diverse activities within it, these are increasingly common as providers face choices about how to continue to fund their core business in a world of lower public subsidy and less certainty about private finance.

2.10. The Regulator recently published a discussion document *'Protecting social housing assets in a more diverse sector'.* This set out a number of ideas on how providers could potentially manage increased diversification, while providing enough assurance that social housing assets were not put at risk, the public value within them was protected and the sector continues to attract private finance.

2.11. The document was clear that it is not the Regulator's intention to stifle innovation in the sector or reduce providers' flexibility to plan, structure and develop their business in the most effective way. The case for finding additional income streams to cross subsidise core operations is recognised in an increasingly challenging operating environment. This will lead to a formal consultation on changes to the Regulatory Framework later this year, which will address any statutory consultation requirements that arise from proposed amendments to the framework.

2.12. While this diversification brings new opportunities, it also introduces additional risks and we need assurance that providers are sighted on these. This publication therefore expands upon the issues that boards of providers seeking to diversify into non-social housing activity should understand, in order to mitigate the risk to existing social housing assets.

(iii) Housing market risk

2.13. Exposure to the rental market has increased as providers move away from the traditional social housing rental model into a wider range of products. As well as offering Affordable Rent through their development of new units, some providers are increasingly involved in market rent or other private sector rental activity. The risk profile of Affordable Rent is different to traditional social rent as rent levels are both higher and linked to market levels. Market rent properties will clearly be even more exposed to fluctuations in the private rental market. Boards must have the right skills to understand these markets, understand the different risk profile of each and make appropriate decisions based on good quality information.

2.14. The sector continues to have a significant sales programme including shared ownership, social housing sales and market sales. The credit crunch resulted in a restricted supply of mortgage finance, especially for first time buyers, which dampened the housing market in many areas. In spite of a variable market picture providers have continued to deliver planned sales performance. However, future sales are forecast to increase and a number of providers are reliant on sales to support their business plans, deliver their growth ambitions and meet interest costs. Therefore, exposure to the housing market remains a key risk for the sector to manage.

2.15. Growth through the development of new affordable homes continues to be a key objective for many providers. However, grant rates to support the delivery of these programmes remain lower than they have been in the past, placing a greater reliance on debt, at a time when the traditional sources of funding offered by the banks have also changed. This makes it even more important that providers effectively manage development cash flow.

(iv) Finance market risks

2.16. The sector benefits from a significant portion of its debt being at historically low interest rates. Whilst it is uncertain when rates are likely to increase, providers need to ensure that business plans are stress tested against a range of scenarios to demonstrate the robustness of their financial position, including regular reports on covenant compliance and headroom, to help them formulate contingency plans.

2.17. The low interest rate environment also impacts on the mark-to-market position of free standing interest rate derivatives, with a fall in the reference swap rate over the last few years. Providers exposed to mark-to-market calls, of which there are circa 50 in the sector, have continued to manage their exposure. However, this has required both cash and fixed asset collateral to be tied up and, with continuing uncertainty, remains a long term risk exposure.

2.18. New loans tend to be at higher margins than the sector has historically enjoyed and for shorter terms. To meet long term financing needs, providers have looked to the bond market and other sources of funding, such as index linked finance which is often embedded in sale and leaseback structures. These sources of finance offer an opportunity for providers to meet their growth ambitions, but also pose different risks than the more traditional funding they are used to. Boards need to make sure they fully understand these new funding streams, including how they are different to more traditional sources of debt, and gain sufficient assurance that the organisation’s treasury management function is managing them effectively.

3. Specific risks

3.1. To regulate effectively, and in a proportionate and risk based manner, the Regulator needs to understand the issues that may cause a provider to fail the economic standards. In particular, the Regulator is keen to establish those risks that might cause a failure of the viability standard and therefore the following analysis of risks examines the issues that relate to the assets, liabilities, income and cost base of providers. However, we are clear that effective risk management, strong governance and financial strength to withstand adverse changes are essential components of well run organisations.

Assets

3.2. Social housing is largely an asset based business. The 2012 Global Accounts revealed that the total grants, Social Housing Grant and other capital grants, reported on balance sheet was £43.8bn. Typically the sector reinvests approximately 80 - 90% of its revenue reserves in the acquisition and development of fixed assets.

3.3. Therefore a key focus of boards remains the effective management of existing stock as well as adding to it through new development and purchase of homes. Given the size of the sector's asset base it can create a significant risk for providers if it is poorly managed.

<u>Managing a housing development programme</u>

3.4. One of the main aims of the sector is to increase new supply. A key part of the effective management of a development programme is the careful monitoring of cash flows, both in terms of debt requirements and income from sales receipts where the continuation of a scheme or schemes is dependent on them. Given this volatility of cash flow there is always a degree of risk associated with this activity.

3.5. The Affordable Rent product has introduced a further level of volatility to development cash flows both in terms of when the grant payments are made and the timing of conversions. A number of schemes are reliant on existing general needs conversions to Affordable Rent to generate additional income to fund new development. Where the timing, location, value or volume of these conversions is not achieved in line with expectations, providers will need contingencies in place to ensure they have sufficient cash flow to meet requirements.

3.6. In the recent Spending Round Government announced a further £3.3bn capital funding to support delivery of 165,000 new affordable homes over three years from 2015/16. However, reductions in grant rates in recent years continue to mean that new development is more debt reliant than it has been in the past. This further highlights the importance of effective treasury and cash flow management especially at a time when income may potentially become more volatile due to welfare reform and the other risks to income outlined in this publication.

3.7. The Regulator will seek assurance that a provider is effectively managing its development programme and that organisations understand the risks associated with individual schemes and also the cumulative impact of a whole programme. It will also seek to understand how much of a development programme is committed expenditure versus aspirational uncommitted expenditure when forming a view on the relative risk of a provider's programme. We will also need to understand what early warning mechanisms, triggers for exit and other mitigating factors providers have in place should schemes take longer than planned to develop or there are other adverse variations from delivery plans.

Diversification into other activities

3.8. For many years providers have undertaken a diverse range of activities in order to meet their objectives and growth aspirations. Where the activity is undertaken within the registered provider, some data is collected through the annual accounts returns and reported in the Global Accounts. However, a large amount of diverse activity is often carried out within an un-registered element of a group and so the true scale of non-social housing activity undertaken by these groups will be greater than that reported in the Global Accounts.

3.9. In the latest set of providers' annual accounts, 162 groups disclosed at least one unregistered subsidiary, Joint Venture (JV) or Special Purpose Vehicle (SPV). Many disclosed more than one within their group meaning in total there were 577 unregistered bodies (although 67 of these were dormant). Almost half of these bodies related to development or funding vehicles of one kind or another. Just over a third related to mainstream or specialist housing activity or community/andwider social objectives. The remainder related to purely commercial activity intended to generate a surplus to be re-invested.

3.10. Providers should not assume because an activity is carried out in an un-registered element of their business the Regulator will not, or has no right to be, interested in it. Understanding the interdependencies and ultimate control mechanisms between the regulated and non-regulated elements remain key areas where we gain assurance to ensure social housing assets are not unduly put at risk.

3.11. We understand undertaking a diverse range of activities does not automatically increase the risk profile of a provider. There are potentially many benefits for the sector in diversifying. These opportunities can be an important way in which providers cross subsidise their social housing purposes. Also, diversification can be a rational response to a range of the risks facing the sector outlined elsewhere in this document. Diversification has the potential to facilitate innovation and development of new homes and to contribute to wider economic and social benefits.

3.12. However, in order to manage diverse activities, often with differing finance sources or business structures, boards require an equally wide range of skills and high quality risk management. If these things are not in place and diversification is mismanaged there is greater potential to put social housing assets at risk.

3.13. Boards need to ensure they have the right mix of appropriate skills to understand the different risks posed from each market they enter. Where boards identify skills gaps they need to ensure they have access to the right specialist and professional advice. The risks also need to be priced correctly so that boards are making informed choices about the activities undertaken and that structures are in place to ensure social housing assets remain protected.

3.14. We have seen a number of cases where providers have entered into diverse activities without understanding all of the implications or the full extent of their obligations to third parties. Sometimes this has been in the form of underwriting debt or the performance of a JV or SPV, where the provider thought their liability was limited at a certain amount only to find it was substantially more when things went wrong.

3.15. We have also seen instances where a provider has entered into some form of lease arrangement and hasn't understood all of the clauses. Again this has led to substantial problems when performance is sub optimal and the provider has found it is unable to get out of the contract, often when this exit strategy was one of the key risk mitigations they thought were in place.

3.16. Another key consideration for many providers before they decide to enter into a new or diverse business area is whether they are legally able to undertake the activity and to what scale or volume. Providers can act only in furtherance of their organisational purposes and charities are also subject to the restrictions of charity law. This may also place a number of restrictions on the interactions and movement of (working) capital etc. between charitable and non-charitable entities within a group. We will need to understand how the provider has gained its own assurance (including relevant legal advice) that it can undertake the activity and that the new business area fits within its charitable objects.

3.17. The Regulator recently published a discussion document *'Protecting social housing assets in a more diverse sector'* which set out a number of ideas on how providers could potentially manage increased diversification, while providing enough assurance that social housing assets were not put at risk, the public value within them was protected and the sector continues to attract private finance. This will lead to a formal consultation on changes to the Regulatory Framework which will address any statutory consultation requirements that arise from proposed amendments to the framework.

3.18. While we review our approach to protecting social housing assets in a more diverse sector we will continue to regulate in line with the current expectations as set out in the Regulatory Framework. The Governance and Financial Viability standard clearly sets out the expectation that boards of registered providers need to be sighted on the risk exposures their organisation faces and have effective strategic planning and a control framework in place to manage and mitigate them.

3.19. More specifically section 1.4 of the Governance element of the Governance and Financial Viability standard requires that, where a non-regulated element exists, the registered provider is required to put appropriate mechanisms in place to ensure it is not prejudiced from meeting regulatory requirements.

3.20. Therefore, the Regulator will increasingly look for assurance that boards understand the extent of risk arising from diverse activity, fully understand the implications of entering into the activity in both the short and longer term, and are making informed choices based on correct pricing of the risk (including the differential between start up and on-going costs and the opportunity costs of entering into the chosen market).

3.21. Additionally, as well as being aware of the worst case or doomsday scenario, we expect boards to understand all of the circumstances where social housing assets may be put at risk, even if this does not threaten an organisation's viability. We will seek assurance that effective mechanisms and mitigations are in place to safeguard social housing assets, in the event of the risks crystallising.

3.22. The level of assurance boards gain on the risks to social housing assets and the effectiveness of the mechanisms in place to protect them is the main source of our regulatory evidence and assurance. Increasingly providers should expect challenge from the Regulator where social housing assets or the public value in them appear to be at risk.

<u>Housing market sales exposure</u>

3.23. 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 their social housing build programmes.

3.24. Each of these markets operates differently and exposes providers to different risks so boards should not assume that because they effectively operate in one market this automatically translates to another. They need to ensure they have the right range of skills and take the appropriate legal and technical advice before they enter into any new market.

3.25. The 2012 Global Accounts reported that the surplus from sales of fixed assets increased by £196m (61%) to £516m. This is significantly higher than the level of sales experienced in the last few years and is more consistent with the surplus recorded pre credit crunch in 2008 of £577m. Sales of current assets (first tranche affordable home ownership and properties developed for outright sale) are forecast to increase from £1.2bn in 2013 to £2.2bn in 2015 and 2016, mainly due to increases of first tranche sales forecast in the current Affordable Homes Programme. As the surplus on sales of assets becomes a larger proportion of forecast income, it is even more important for providers to fully understand and manage sales risk exposure.

3.26. The HCA quarterly surveys show significant volume of Right to Buy sales being made, typically upwards of £50m each quarter. 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.

3.27. Where there is evidence of a significant sales risk, the Regulator will seek assurance that providers are making reasonable assumptions about likely volumes, price and understand 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 the plan and ultimately what their exit strategies are should the sales fail to materialise.

3.28. Many providers have sensible programmes for sales, and the latest Global Accounts show that delivery of these sales is being made. Most providers are not dependent upon sales revenue to meet the day to day running costs of the core social housing business. However, 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. This is especially critical where business plans are predicated on optimistic assumptions about likely volumes or prices achieved in order to make them stack up.

Existing stock

3.29. The sector has successfully met the challenge to bring its stock to the Decent Homes Standard, with only a small proportion of stock remaining below standard as those providers with extensions to the deadline for compliance complete the required works.

3.30. 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 also dependent on boards ensuring they have high quality, up to date, stock condition data and an appropriate long term investment strategy.

3.31. Providers are responsible for ensuring they maintain compliance with all the regulatory standards even where the Regulator does not proactively monitor this. We do not carry out a separate activity to monitor Decent Homes compliance, however, expenditure on repairs and maintenance forms part of our viability assessment. We will challenge providers where there are significant reductions in expenditure based on the financial information we receive each year to understand the reasons for this and to gain assurance this is not a sign of a provider failing to maintain its stock.

3.32. A number of providers are also involved in significant regeneration projects in often challenging areas of the country. The Regulator will seek assurance that boards have consciously made the decisions around long term sustainability of these regeneration projects, especially where this is a loss making activity that may have wider implications for future viability.

Liabilities

3.33. In order to meet their objectives and growth ambitions providers are reliant on debt funding. As at 30 June 2013, the sector reported facilities of £68.9bn, of which £57.3bn was drawn leaving undrawn facilities of £11.6bn. Cash available to the sector was reported to be £3.5bn.

3.34. Debt and cash management have always relied on a provider having a sound treasury management strategy in place. This allows executives and 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.

3.35. Effective treasury management has become increasingly important in the current economic climate 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.

3.36. 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.

<u>Existing debt</u>

3.37. Providers' existing loans continue to benefit from traditionally low loan margins, typically 30-50 basis points above LIBOR on 30 year terms. It is estimated that a significant amount of this finance is 'underwater' i.e. it is costing banks more to borrow the cash than they receive from lending. As banks now lend at higher loan margins and shorter terms, the opportunity for lenders to re-price existing debt remains attractive.

3.38. This has meant that as well as monitoring financial covenants providers must continue to monitor all the conditions of their loan agreements. There may be circumstances where providers are able to negotiate revisions to existing loan agreements with their lenders on mutually beneficial terms, but providers should be careful to ensure their lenders are not inadvertently given the opportunity to re-price or reduce the term of the loan in ways that could hinder the provider's continued compliance with the Viability standard. Rather than being a short term change in response to the financial crisis of 2008, the changing attitude of lenders as a result of the increased capital requirement and regulation of banks is one of the fundamental changes within the sector. Providers should continue to factor in the changed relationship with the banks as part of their treasury strategy.

3.39. Currently circa 65% of the sector's total drawn debt is on fixed interest rates and this gives providers a degree of certainty on forecasting the cost of borrowing. However, the remaining 35% of debt is subject to change either because it is a floating rate, is cancellable by the lender or is inflation linked, and therefore potentially £20bn is subject to fluctuating and less certain rates. Providers have benefited from low floating rates in recent years, but it is important they continue to review their exposure to interest rates against a range of scenarios.

3.40. The levels of cash held in the sector are significantly higher than have traditionally been the case, generally to provide certainty in light of the changes highlighted in paragraph 3.35. While it is sensible to ensure there is enough liquidity within organisations to meet obligations as they become due, providers must actively manage this as part of an effective treasury management policy. Investments are now in a range of counterparties and different structures, boards must clearly understand the nature of these arrangements and their associated risks before making the decision to invest. Conversely, boards need to understand the associated risks where all of the cash is invested in a single institution.

3.41. We 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. 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 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

3.42. Providers continue to need access to new debt to finance their business plans. However, as the traditional financing model has evolved, so providers have begun to look at new funding strategies. In many cases this has meant looking to the capital market, either through own name bond issues or aggregating vehicles, but it has also meant looking at other forms of finance including private placements, sale and leaseback schemes and retail bonds. In addition, the banks continue to be a source of short term lending which can provide valuable working capital.

3.43. The 2012/13 Q4 quarterly survey confirmed that the move towards capital market funding continued in 2012/13, with £3.8bn (2011/12 £1.5bn) being raised through public bond markets and private placements. This represented 70% of the new funding raised in the year. Although this does represent a significant shift in sources of new funding, traditional bank lending continues to represent 83% of the total agreed facilities. As more PRPs access the capital markets and seek alternative sources of funding, it is important that they understand and manage the risks inherent in different forms of debt.

3.44. The capital markets do provide a range of financing opportunities, but providers must be aware of the wider implications of raising funds through this route. Public markets have specific legal requirements, they demand much greater transparency and disclosure and the investors generally have different expectations and needs. Boards need to understand 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.

3.45. A number of providers have entered into index-linked finance (ILF) deals including sale and leaseback and lease and leaseback, as well as index-linked loans. The main attraction of these arrangements is that the lease payments are index linked and provide a low start financing option. ILF arrangements can also require a significantly lower asset cover which is especially useful where the RP has limited free security and this can help overcome restrictions on existing debts. However, providers should take care to ensure that they understand the real, long- term cost of such arrangements, and in particular take into account the change from RPI to CPI linked rental income.

3.46. Refinancing risk and the need to have adequate security in place in plenty of time is also a key issue that boards need to consider and monitor closely. The sector is due to repay £1bn of debt in 2013/14, by 2016 this increases to £2bn of debt per annum to be refinanced. Although the sector's aggregate free security is more than enough to cover this several times over, at an individual provider level it may be inadequate to cover new debt requirements. In addition, the time taken to arrange new finance and put adequate security in place has generally increased. Providers should be aware of the complexity, quality requirements and timescales for arranging new finance and charging security.

3.47. 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 or executive members.

Mark-to-market issues

3.48. The Regulator continues to use its quarterly survey to monitor the exposure of providers to the mark-to-market position on free standing interest rate derivatives. The number of providers reporting that they make use of these derivative instruments remains stable at 49. As at 30 June 2013, the nominal value of the instruments was £9.5bn and they had an average term of 15 years. Continued interest rate volatility means that collateral requirements will remain a long term exposure for to providers to manage.

3.49. The reported level of mark-to-market exposure has fallen slightly. Current exposure net of unsecured thresholds is reported at £1.2bn, compared to £1.6bn in March 2013. Collateral in the form of property and cash of £1.5bn has been given against this exposure. However, banks will now often require security to cover the mark-to-market on fixed rate debt before allowing the release of security.

3.50. The use of free standing derivatives can be an appropriate mitigation against interest rate exposure, data received from the quarterly surveys and our engagement indicate providers have so far managed the exposure effectively. However, the impact of tying up nearly £1.5billion of social housing security as a result is a material one. This further highlights the need for boards to understand the products they buy and make informed decisions about their funding arrangements including their longer term implications. They should be mindful of the security implications of their free standing derivatives as and when interest rates rise.

Accounting issues – new accounting standards

3.51. As well as managing the liabilities themselves, 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 statutory 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.

3.52. One of the key changes to accounting standards issued in March 2013 was the introduction of Financial Reporting Standard 102 (FRS 102) which comes into effect for accounting periods beginning 1 January 2015. Whilst much of its requirements are familiar, there are some areas of significant change which may have an effect on the reported results of some providers.

3.53. Some significant areas of difference in FRS102 include:

- Accounting for government grant - the current practice of netting grant off against cost will no longer be acceptable. Whilst different options are available, grant will need to be recognised in the income statement.
- Financial instruments - some types of embedded and standalone derivatives may need to be valued annually and resulting changes reflected in the income statement. Additionally some finance leases may also require similar treatment. This 'fair value' assessment could introduce volatility to the financial results.
- Leases – currently the classification of a lease as either a financial or operating lease is based on whether the risk and reward of ownership has transferred. A finance lease exists where lease payments equate to 90% of the fair value. The 90% test is not a requirement of FRS102 and so the classification of leases is more subjective, which may lead to the reclassification of some existing operating leases as finance. This reclassification requires an on-going fair value to be recognised in the accounts which may, presentationally, introduce further volatility in the statements.
- Pensions accounting – schemes that currently enjoy multi-employer exemption, such as the Social Housing Pension Scheme, will now require recognition in the financial statements.

3.54. Changes to accounting standards may not always affect the underlying structure of a business but as outlined above, they may alter the way certain transactions, products or instruments are treated and presented in the financial statements. Where these changes require gains /losses to be recognised at an earlier stage, revaluations to be made more frequently or changes to what is reported off or on balance sheet, this may imply a provider has a weakened or more volatile financial position than is the case in reality.

3.55. There may also be a knock on effect to the way covenants are calculated or impact on a provider's ability to meet them. 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.

3.56. The Regulator seeks assurance that providers are complying, and will continue to comply, with their covenants. Where we identify, through our on-going financial monitoring, that there is likely to be a material impact on a provider or group of providers as a result of the changes we will seek assurance that they are effectively managing this to maintain covenant compliance.

Income

3.57. 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 increases to rent levels is likely to be maintained by the Spending Round announcement 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.

<u>Rental market exposure</u>

3.58. As a part of the Spending Round it was announced that increases in social rents will be at 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%. Although the Government has announced that it intends to consult on the details of future rent policy, it has also indicated that it is not minded to permit rents to increase by up to an additional £2 above the annual target rent change.

3.59. For providers the announcement provides a degree of certainty that can be built into financial plans. Providers should understand the potential implications of the new rent policy for their rental income, although the precise impact of the policy change upon providers' business plans compared to previous forecasts will clearly depend on the future relative paths of RPI and CPI inflation. Where providers' business plans are predicated on the assumption that upwards convergence on target rent would continue beyond 2015, they should assess the implications for their rental income streams and understand the trade-offs that might need to be made. especially around development aspirations and other discretionary expenditure, if efficiencies cannot be made elsewhere to make up the shortfall. Any providers with concerns about potential impact on their on-going compliance with the Governance and Financial Viability standard should contact the Regulator.

3.60. The new Affordable Rent product was introduced in 2011 under the HCA Affordable Homes Programme 2011/15. Affordable Rent tenancies will generally be shorter and for fixed terms, with rents at levels above social rent up to a maximum of 80% of local market rent. The Statistical Data Return (SDR) reported that 284 providers owned circa 39,600 Affordable Rent homes as at 31 March 2013; 95% of which were general needs with the remainder made up of supported housing and housing for older people. This includes homes newly built and conversions from existing social rented homes to Affordable Rent homes.

3.61. 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. This highlights the need for providers to understand these new markets and manage the different risk profile including levels of voids and arrears associated with market linked tenures.

<u>Welfare reform</u>

3.62. The Welfare Reform Act (March 2012) confirmed a number of changes to the benefits system to take place between 2013 and 2017. Together they spell a significant reduction in housing-related and other benefits for many social housing tenants, which could impact on their ability to pay rents. Welfare reform will also mean a switch from payment of housing-related benefits to landlords to direct payment to working age tenants.

3.63. The first elements of these changes have now come into effect. The under-occupation reform (launched in April 2013), the introduction of the Benefit Cap, changes in up-rating of non-dependent deductions and Council Tax Benefit reforms have all now come into effect. These changes will continue to be implemented between now and 2017 by which point direct payment under Universal Credit will be rolled out to all tenants who are not considered to need an alternative payment arrangement.

3.64. The Department for Work and Pensions is undertaking Direct Payment Demonstration Projects to test the mechanisms by which payment to tenants will work. The conclusions from these projects may inform changes to the reforms as they are rolled out and therefore current measures in place to manage the impact may need to change in the future.

3.65. Welfare reform represents a change in the operating environment for providers and potentially introduces several risks to their net income that will need to be managed effectively. These include potential increases in the amount of arrears and bad debts, increased rent collection times and an additional length of time to fill void properties where the under occupation reform may impact.

3.66. Since the welfare reform changes were confirmed in March 2012, providers have been focused on developing their understanding of their potential exposure. Providers should now have a better appreciation of the numbers of tenants likely to be 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.

3.67. Now the changes have started to be rolled out, providers should have moved from the planning stage outlined above to one of implementation. Their focus should now be on monitoring the financial impact of changes and the inclusion of realistic assumptions based on the actual impact within their forecasts. Boards should be monitoring the effect of the measures they have put in place to manage their organisation's response to the reforms and be changing or refining them where they do not mitigate the risks as effectively as they were intended to.

3.68. This shift within providers means that our regulatory interest in welfare reform has also changed from simply gaining assurance that providers are formulating plans to seeking assurance on the quality and effectiveness of those strategies including evidence that demonstrates how these feed into business plans and financial forecasts.

3.69. As more of the key welfare reforms come into force, and in particular the roll-out of direct payment gets closer, the regulator will expect to see evidence that providers are actively managing the impact of welfare reform changes. However we 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.

<u>Supported housing</u>

3.70. Supported housing has always been a low margin activity for providers and pressures on Supporting People (SP) contracts means 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. Providers collectively received over £350m in SP funding in 2011/12, equivalent to more than 2.5% of total sector turnover. Most large providers access some SP funding, but for many specialist supported housing providers financial reliance is much greater than average.

3.71. 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 much less reliable income source for PRPs and contracts are increasingly competitive. Providers that have 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.

3.72. For many providers, the impact of a loss in SP funding is not material. However, 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.

Costs

3.73. 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.

<u>Pension costs</u>

3.74. This continues to be an area of cost that needs careful consideration. The Social Housing Pension Scheme (SHPS) had, at its last valuation date, a deficit of over £1bn. The Local Government Pension Scheme (LGPS) triennial valuations are due as at 31 March 2013 and the on-going deficits are expected to be high.

3.75. Both SHPS and LGPS are taking steps to revise their schemes with the costs being shared between employers and staff. Government is keen to ensure that more employees are included within pension schemes, so that they are provided for in old age, and are rolling out pension auto-enrolment across all organisations which is likely to increase costs as well. Boards need to plan carefully so that they mitigate their exposure to rising pension costs, whilst ensuring they maintain employment packages that enable them to recruit and retain high quality staff.

<u>Differential inflation rates</u>

3.76. The latest Global Accounts 2012 show a slight increase in maintenance and management costs for the first time in three years. However, this was marginal and management and maintenance costs actually reduced as a percentage of turnover. In the main, providers also kept costs below the increase in RPI, albeit compared to a historically high rate of RPI (5.6%). 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.

3.77. 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.

3.78. 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, as noted earlier in the document many providers are forecasting an increase in development activity in the period 2015 – 2017 in a return to the levels seen pre credit crunch. A stepped increase in activity may inflate build costs more rapidly as materials and skills become increasingly in demand.

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