Homes & Communities Agency

SECTOR RISK PROFILE 2015

September 2015

Sector Risk Profile 2015

Executive summary

This is the 4th edition of the Sector Risk Profile undertaken by the Homes and Communities Agency on behalf of the Regulation Committee. Its aims are:

(i) to highlight the key risks registered providers[1] need to consider that could affect their ability to meet their objectives and achieve their operational strategies
(ii) to help registered providers better evaluate financial risks
(iii) to promote debate and challenge at board level and highlight particular areas of regulatory focus

The Sector Risk Profile is intended to help registered providers across the sector to strengthen their continued financial resilience. Many providers will already be actively considering the range of risks described in this publication, and the actions they plan to mitigate the impact of those risks. For other providers and their boards, this publication may alert them to risks they will need to factor into their considerations. The Sector Risk Profile will also be of interest to lenders and investors as well as to other stakeholders engaged in working with the sector.

The July Budget included a number of measures which will have a direct impact on registered providers; including the announcement of a bill to reduce social housing rents by 1% per annum for 4 years from April 2016. Registered providers will need to review their business plans in the light of policy announcements in the July Budget and decide how they will adapt their business model to determine the best way of meeting their objectives. It is important that boards plan for a wide range of possible scenarios and are able to respond to changes in the operating environment. As that operating environment becomes more challenging, it is possible that some registered providers may conclude that an independent future is no longer possible and seek a merger partner.

The range of risks faced will vary from one registered provider to another. The regulator's new governance and financial viability (G&FV) standard requires registered providers to carry out detailed and robust stress testing against a wide range of identified risks and combinations of risks across a variety of scenarios and to put appropriate mitigation strategies in place as a result. This reflects our regulatory approach set out in the publication Regulating the Standards.

Diversification into non-social housing activities and more complex financing arrangements are likely to continue to grow and may give rise to increased and potentially unforeseen risks. It is therefore essential that registered providers ensure that they have the requisite skills and experience to manage those activities and risks in place at both board and executive levels.

The recent publication of With the benefit of hindsight - Learning from Problem Cases Volume 4 concludes that effective governance arrangements are paramount to the management of day to day as well as unforeseen risks. The report highlights the importance of effective systems for the identification of risk and the exercise of proper controls.

[1] The term "registered providers" refers to private registered providers.

The G&FV standard requires registered providers to inform the regulator when they become aware of potential material non-compliance with the regulatory standards. Where the regulator is unable to gain sufficient assurance that a registered provider will be able to manage its business risks effectively, it will actively engage with that provider to explore options and appropriate solutions. Reflecting our commitment to transparency, where required, the regulator will report ineffective governance and poor financial decision making in its published judgements.

1. Introduction

1.1 The primary focus of the Sector Risk Profile is to outline the key financial risks which, if not properly or adequately managed, may cause a registered provider to fail our economic standards, in particular the viability element of the G&FV standard.

1.2 This publication draws out those risks that are likely to affect the majority of registered providers. It also recognises the broader environment in which registered providers operate. Registered providers must assure themselves that they understand the specific, unique risks to their own businesses.

1.3 Although we have maintained a similar structure to previous editions, this publication particularly highlights changes to the operating environment that will result from the July Budget. These include reductions in rental income, the extension of Pay to Stay and further welfare reform changes. Along with the planned extension of Right to Buy, these changes are likely to have financial implications for registered providers' business plans.

1.4 Whilst this document focuses principally on financial risk, there are a range of other risks that face registered providers. In addition to those that could directly impact a registered provider's continued financial viability, boards must also ensure they understand issues relating to all of the regulatory standards, including the consumer standards.

1.5 During the year the regulator published 6 findings of serious detriment arising from a breach of the home standard. In 4 of those cases, registered providers had failed to meet their statutory obligation with regard to gas servicing. In the other 2 cases we found serious detriment as a consequence of a structural failure of a building, and a widespread, persistent failure of an emergency repairs service.

1.6 Our recently published Consumer Regulation Review highlights the importance of meeting health and safety obligations. The cases where a finding of serious detriment were made are detailed in the regulatory notices available on our website.

2. Operating context

<u>Operating context</u>

2.1 The need for effective risk management remains key for registered providers. Changes in the operating environment in recent years, including the diversification of the sector and changes in the sector's sources of funding, have continued, alongside changes in government policy.

2.2 Issues of housing supply, affordability and fiscal constraint, including through welfare reform, remain high on the political agenda. Registered providers need to understand and articulate their risk appetite within the wider operating context and regularly review how their activities will meet their overall objectives. Analysis of the economic operating environment can be found in the HCA monthly housing market bulletin.

2.3 A focus on value for money (VfM) and efficiency will be an even more important part of boards' risk management strategies in future years. In the view of the regulator, VfM is not a separate issue from focusing on compliance with the G&FV standard. Across the sector as a whole, the regulator took a greater degree of assurance from registered providers, following its review of the 2014 VfM self-assessments, than it had done previously. However, we still found 11 registered providers had not provided sufficient assurance of their compliance with the value for money (VfM) standard. Just over half of the registered providers who were found to be non-compliant with the VfM standard also had wider governance issues.

2.4 The VfM standard remains important under the new Regulatory Framework and value for money will continue to be a high priority for the regulator. In the light of rent reductions in the coming years, we are aware that registered providers are revisiting their plans to focus even more sharply on the control of costs in their business, and will need to drive increasing efficiency across their operations. It is anticipated that revised business plans will be predicated on further efficiency savings and boards should assure themselves that these are deliverable. Where providers may find the rent reductions and other changes especially challenging, their boards should ensure that they are able to confirm assurance over the deliverability of efficiencies and savings before entering into significant capital commitments.

3. Key financial risks

3.1 This section sets out the financial risks that the regulator is most concerned about, which will need to be considered by the majority of boards. The Regulatory Framework is set against the continuing backdrop of an increasingly complex sector and a higher level of associated risks. Therefore, the G&FV standard remains our primary focus.

3.2 The G&FV standard requires registered providers to understand the business environment they operate in and associated risks, and to have in place a fully considered business plan and robust risk and control framework. Registered providers are required to assess, manage, and where appropriate address risks to ensure the long term viability of their organisation. Central to this approach is a combination of robust business planning assumptions combined with sensitivity testing. This should include multi-variate analysis to test the business plan across the whole organisation to demonstrate the extent to which registered providers can cope with a number of changing factors.

A Income

(i) Rents

Social rents

3.3 The majority of the sector’s income continues to come from social rents, notwithstanding diversification into market rent and sales and other commercial activities in recent years. Traditionally, the sector has had a high degree of certainty over this income stream, due to the existence of an index-linked formula and the direct payment of housing benefit to many registered providers. The on-going roll out of Universal Credit means that registered providers will need to work harder to ensure they collect their rental income.

3.4 At the July 2015 Budget, government announced that providers would have to cut social rents by 1% per annum for 4 years, starting from April 2016. This policy replaces the previous rental policy which would have permitted rents to increase by CPI +1% in each of those years.

3.5 This new rental policy is to be introduced through primary legislation subject to parliamentary approval. At the time of writing the Welfare Reform and Work Bill had not yet received Royal Assent, so registered providers must ensure that they keep up to date with the final form of the legislation. As of September 2015, the bill makes clear that the reductions will apply to rented properties, including Affordable Rent, but not to shared ownership.

3.6 Registered providers are already working to factor the change in rent policy into their business plans to ensure in advance that they can comply with it in time for the implementation of the policy in April 2016. Registered providers will need to understand the implications of the rent cut for their overall income and stress test the new base case to demonstrate continued resilience in order to understand any trade-offs that might need to be made as a result.

3.7 Registered providers should also consider whether the reduction in rental income will have any impact on the valuation of their properties, both for accounting purposes and for loan security. The sector’s main valuers have indicated that they anticipate reduced rental income leading to a 20-30% reduction in EUV-SH balance sheet valuations. Registered providers should make sure they understand the implications for any potential impairment of their existing properties. In the longer term, valuers have also indicated that EUV-SH security valuations may also fall. Registered providers will therefore also need to understand the implications for security for existing or planned loans, particularly where they have limited unencumbered assets available.

3.8 The regulator cannot grant a waiver from the new rent policy as the legislation has not yet passed. The bill makes clear that in future, waivers will be at the discretion of the Secretary of State. As the bill passes through parliament, we will develop guidance with DCLG on the conditions that will need to be met before a waiver can be granted. However, it is clear that waivers will only be considered for registered providers who face viability or solvency issues and have considered all mitigating actions, including taking all possible costs out of their business and looking at the possibility of a merger partner.

3.9 The effect of a 1% nominal cut in rents for 4 years will be to set a lower starting rent for business modelling from 2019. The cumulative effect on business plans of the reduction in income, together with the risk of inflationary cost increases over the same period, should be modelled by all registered providers.

<u>Pay to Stay</u>

3.10 In the Budget, Government also announced its intention to extend the policy of Pay to Stay for high income social tenants. Charging affected tenants a higher rent will be mandatory. Landlords will be required to charge a market rent, or near market rent, for tenants with a household income above £30,000 per annum, or £40,000 per annum in London. Government has committed to consulting on the detail of this reform in due course.

3.11 Private registered providers will be able to retain any additional rental income. For registered providers with a significant number of tenants in the relevant income bands, this will potentially provide a source of additional income to offset reductions in rent from other tenants. However, the extent of this additional income will vary from one registered provider to another, and the number of tenants for whom the higher rent is applicable is likely to vary between different parts of the country. The response of tenants to rent increases is inevitably uncertain at this stage, and individual high income tenants may seek to move or exercise the Right to Buy rather than pay the higher rent on their existing property.

3.12 It will be important that landlords understand the range of possible impacts of the final policy on their business plans and stress tests, including any implications for arrears and voids and the costs associated with collecting the higher rents.

<u>Welfare reform</u>

3.13 At the July 2015 Budget, government announced further changes to the welfare system that will affect registered providers and their tenants. At the time of writing, the Welfare Reform and Work Bill is currently before parliament. From 2016/17, the cap on benefits for an out-of-work working-age family will be reduced to £23,000 in London and £20,000 elsewhere. From April 2017, those aged 18 to 21 will no longer be automatically entitled to housing benefits. A range of further planned measures, including the freezing of working-age benefits for 4 years from 2016/17 and changes to tax credits are likely to exert downward pressure on tenants' real incomes.

3.14 The Welfare Reform Act (March 2012) confirmed a number of changes to the benefits system to take place between 2013 and 2018. These include the introduction of Universal Credit and the removal of the Spare Room Subsidy (RSRS). The latter is now in place. Registered providers have already undertaken significant work to understand the impact that these changes will have on their business plans and to prepare for the introduction of the reforms. As Universal Credit is rolled out alongside further welfare reforms announced in the July 2015 Budget the combined impact could potentially increase.

3.15 Registered providers have taken steps to date to manage risks from welfare reform, including measures to mitigate RSRS, increasing business plan tolerances and strengthening rent collection processes. At June 2015, HCA quarterly survey data shows that, to date, arrears, rent collection and rent lost due to vacant properties are within business plan projections for the majority (91%) of registered providers.

However, this largely reflects more cautious business plan assumptions made by registered providers ahead of the roll-out of Universal Credit, and does not capture any increased management costs associated with welfare reforms.

3.16 Universal Credit, in particular direct payment of housing costs to tenants, remains the reform with the greatest potential impact for most registered providers. Roll-out has been limited to date, with Department for Work and Pensions (DWP) data showing 90,000 live Universal Credit claims by July 2015 across all tenures compared to a total potential pool of over 7 million. However DWP (Universal Credit: progress update, October 2014) projects a step-change in the pace of roll-out during 2015/16, concentrated in the North West of England where a substantial minority of tenants could be receiving direct payments by March 2016.

3.17 Evidence from the Direct Payment Demonstration Projects (DPDPs) run by DWP suggests there is a risk of an increase in arrears in the short term during the initial transition to the new system. The precise scale of the impact is hard to predict and will depend on the exposure of each registered provider, the effectiveness of their strategy to manage welfare reform and the evolving implementation of government measures to mitigate impacts on registered providers such as alternative payment arrangements for tenants. The DPDPs also generated anecdotal evidence that Universal Credit is likely to put upward pressure on registered providers' management costs, for example through increased resources required for rent and arrears collection.

3.18 Reductions in tenant benefit income set out in the July 2015 Budget may increase the risk of arrears for households on direct payment. Stress testing and planning of mitigations by registered providers and their boards are important to ensure cash flow and covenant compliance can be sustained for a range of possible scenarios.

3.19 Further reductions in the benefit cap announced in the budget will affect an increased number of households. DWP data from May 2015 shows the current benefit cap of £26,000 affects around 5,000 registered provider tenants, concentrated among households with 5 or more children and more widely in London. From 2016/17, the reduction in the benefit cap for out-of-work families to £23,000 in London and £20,000 elsewhere will increase the number of tenants affected.

3.20 The regulator will want to have assurance on the quality and effectiveness of strategies to manage the impact of welfare reform measures on rent collection, including evidence that demonstrates how these feed into business plans and financial forecasts. The regulator will continue to engage with registered providers where there is a material exposure, particularly where our information and analysis suggests the actual impact on a register provider is proving to be greater in reality than anticipated in forecasts. The regulator will continue to use quarterly survey data as a means to closely monitor emerging issues at individual registered provider level.

(ii) Supported housing

3.21 Supported housing has typically been a low margin activity for registered providers and pressures on local authority funding means that many are dealing with further reductions in income. Local authority funding for housing-related support services – commonly known as Supporting People (SP) funding, plays a role in financing supported housing and wider support activities in the sector. Most large registered providers access some SP funding, but for many specialist supported housing providers, financial reliance on SP funding will account for a greater proportion of their income.

3.22 The removal of local ring-fencing of SP funding, set alongside reductions in local authority budgets since 2011, means that local authority funding is now a less certain income source for registered providers and SP contracts may be increasingly competitive. Some registered providers have already seen falls in support contract income in recent years and, with further fiscal consolidation, downward pressure on funding is likely to continue.

3.23 All providers, and supported housing providers in particular, will need to ensure that they understand the impact of the national living wage and the final form of the legislation introducing the reduction in social rents, in order to assess the implications for their business. The impact of the removal of automatic Housing Benefit entitlement for those aged 18 to 21 may also vary depending on the nature of any exemptions, which are yet to be determined for supported housing. In considering the impact of the range of changes, some registered providers may have to consider the need to have exit strategies in place in the event that services need to be reduced or de-commissioned, especially if they rely on a small number of contracts or contracting bodies.

B Costs

3.24 In light of the risks to registered providers' future income, particularly the introduction of rent reductions from April 2016, most registered providers are in the process of reworking their business plans. Effective boards will ensure that they have a robust understanding of the costs of running their businesses, and a clear strategy for controlling future cost pressures by making efficiencies and/or by reducing discretionary expenditure.

3.25 The VfM standard sets clear expectations that registered providers should understand the absolute and comparative costs of running their services, and seek to make on-going improvements and efficiencies. The regulator will continue to seek assurance that registered providers have a robust and strategic approach to managing their costs.

3.26 The introduction of rent reductions from April 2016 creates an imperative for registered providers and boards to understand likely inflationary pressures as part of a robust approach for managing costs. The macroeconomic climate since 2008 has in many ways been relatively stable for registered providers, with average earnings growth, construction and maintenance cost inflation as well as interest rates, all at low levels compared to other periods. Average earnings growth (amplified by the National Living Wage), is projected to continue to pick up towards long term averages, exceeding 4% per annum by 2019 according to Office of Budgetary Responsibility projections (July 2015), therefore registered providers will need to respond to rent reductions and other risks such as welfare reform at a time when inflationary pressures are likely to be growing.

Differential inflation rates

3.27 To date, registered providers have allowed for a degree of flexibility in their business plans, including development scheme appraisals, recognising the likely differences in cost and revenue inflation, which reflects good business planning. The regulator will continue to seek assurance that flexibilities are built into business plans to ensure that registered providers have the ability to meet any unexpected costs.

3.28 The differentials between cost and revenue inflation will vary over time and cannot be wholly predictable. Stress testing and mitigation strategies are critical to ensure that business plans are robust to a range of outcomes such as cost inflationary pressures exceeding rent growth by more than central projections.

3.29 A focus on differential inflation rates is likely to be particularly important for registered providers with existing liabilities that will remain linked to RPI (for example, existing index linked debt or lease and leaseback arrangements).

Pension costs

3.30 Pension costs and administration are recognised as an area of risk for many organisations, although the precise issues will be unique to each registered provider. The financial uncertainties for registered providers created by Defined Benefit (DB) schemes, such as The Social Housing Pension Scheme (SHPS) and The Local Government Pension Scheme (LGPS), remain significant – even if many are now closed to new entrants. Closed schemes still need to be managed to ensure the future pension commitments are paid to members.

3.31 With the introduction of FRS 102, SHPS DB deficits will appear on balance sheets for the first time and increases in contributions will need to be included in income and expenditure accounts. The financial implications of pension provision will therefore become an increasingly integral part of a registered provider’s risk management and stress testing processes.

3.32 The projected funding gap in SHPS (at March 2014, it had a deficit £1.3 billion), will have to be recovered and registered providers are likely to have to make increased payments to the pension fund over a period of time.

3.33 Whilst the financial implications of Defined Contribution (DC) schemes may be more certain for employers, these are not without risk and registered providers will want to ensure such schemes meet organisational objectives and provide appropriate value. Within this context, employers will need to manage matters of external regulatory compliance and internal employee-related issues (such as information on investment options, individual fund values, and fund access) effectively.

3.34 Registered providers should therefore keep pension schemes under review to determine if their existing schemes are fit for purpose, affordable and whether or not alternative provision should be considered. They should also identify the risks of, and to, their pensions provision, and develop effective mitigation strategies, taking advice where appropriate.

C Assets

Right to Buy

3.35 The Government has announced its intention to extend the Right to Buy to tenants of registered providers who do not currently have the preserved Right to Buy. At the time of writing, the details of the policy and its operation have not yet been fully finalised. For registered providers such as LSVTs, there is already experience of the impact of tenants exercising their preserved Right to Buy. For other registered providers, extending the Right to Buy will be a more significant change to their business plans.

3.36 Registered providers will need to model a range of scenarios that show the impact of key assumptions such as the possible volume of sales and anticipated sales prices. In particular, they will need to ensure that they are in a position to put alternative properties into charge promptly should properties currently used as security on existing loans be sold under the Right to Buy. It will be important that registered providers assess any impact that a significant increase in sales might have on covenant compliance. They will also need to consider how they will manage transaction costs, the administration of replacing the loan security of charged properties that are sold under the Right to Buy, and on-going costs (for example a share of fixed management costs and the carrying cost of debt) in the period between sale and replacement of the property.

3.37 Right to Buy sales may provide landlords with an injection of cash through increased sales revenues, although levels and timing of receipts may be unpredictable and there will be losses of rental income until units can be replaced. Registered providers will need to consider how they can replace homes sold through Right to Buy and the timescales for doing so. Plans for replacement and modelling of possible sales volumes will need to be taken into account by providers as they update their business plans and asset management strategies.

New development

3.38 A fundamental objective of a significant proportion of registered providers is to increase new supply, and those providers will be considering how best to adapt their business plans to continue to do so in light of recent changes in the operating environment. Relevant factors the regulator will wish to see taken into account as business plans are updated are set out below.

3.39 A key part of the effective management of a development programme in terms of debt requirements is the careful monitoring of cash flows, early years' cash deficits, income from sales receipts, grant payments and the timing of conversions. The potential volatility of these cash flows means that there are risks associated with development activity which providers will need to have strategies in place to manage.

3.40 Social Housing Grant contributes to a relatively small proportion of the cost of financing new homes. The majority of the costs now comes from debt, as well as cross-subsidy from a registered provider's other resources. This further highlights the importance of effective treasury and cash flow management especially at a time when income could become more volatile.

3.41 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 are increases in costs related to labour or supplies, the cost of acquiring land, and the risk of that cost being inflated when there is competition from a number of developers, which may give rise to the potential for impairment as a result. It is therefore important that registered providers undertake robust due diligence of planned investments, taking into consideration the impact that changes such as reductions in social rent will have on the viability of new schemes. In addition, because balance sheet capacity can be quickly expended when development is predominantly funded through debt, registered providers should ensure they have considered how their appetite for development is reflected in any cushion on their tightest covenant or covenants.

3.42 Many new developments include a mix of tenures; targeting different customer groups increases the importance of registered providers understanding the market they are developing in and the demand for the range of products being developed.

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

Diversification

3.44 Diversification can be an important way in which registered providers generate income to cross subsidise their main social housing purposes and support new supply. It can also offer the opportunity to deliver wider social or charitable objectives such as regeneration or the provision of care services. However, such activities may also expose registered providers to additional risks, including heightened reputational risk.

3.45 Registered providers that enter into increasingly complex commercial activities and financing arrangements such as sale and leaseback, must appraise the potential costs and benefits associated with entering into those agreements and understand the financing and funding structure which supports its non-social housing activities.

3.46 Boards should be satisfied that any new non-social housing activities entered into are within the organisation’s governing instruments. They should appraise and fully understand the risks each area of activity can generate, and ensure that they have the capability and skills to challenge business decisions, where necessary seeking external advice. They should also understand the financing and funding structure which supports its non-social housing activities.

3.47 The governance and financial viability standard emphasises the importance of a good understanding of the interdependencies between all parts of the organisation including where there are guarantees or cross default clauses between a registered entity and non-registered elements which may give rise to recourse to social housing assets and/or where on-lending or equity stakes create an impairment risk.

3.48 The regulator will take assurance where there are clear mitigating actions, break clauses or exit strategies in place to manage the risks to social housing assets. Registered providers may also wish to 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 a non-social housing entity's failure.

3.49 The regulator will seek assurance that registered providers fully understand the range of risks that involvement in a range of diverse activities exposes their organisations to. We will also need to understand how these activities contribute to and subsidise the core objectives and aims and seek assurance that registered providers understand the importance of these activities making a surplus, or, where they are undertaken to meet wider social objectives, that they appreciate the opportunity cost of undertaking the activity.

Housing market sales exposure

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

3.51 Each of these markets may operate differently and expose registered providers to different risks. Operating effectively in one market does not necessarily mean that a registered provider will automatically do so in another. The regulator takes the greatest assurance where boards 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.

3.52 A review of registered providers' financial forecasts[2] suggests rising expectations of current asset sales:

- LCHO: £875 million in 2014/2015 and currently forecast to peak to £1.1 billion by 2016
- market sales: £835 million in 2014/15 and expected to rise to £2.4 billion in 2017

3.53 This step change in expectations of sales income, both from market and shared ownership sales, means that some registered providers' business models are now more pro-cyclical than they have been in the past. This makes it more important that registered providers consider the market cycle and ensure that they can effectively mitigate the risks of a slowdown in sales, or reduction in market prices. Changes to key assumptions in development plans such as likely volumes, prices, time taken to sell and costs of any delays, can all have an impact on covenant compliance.

[2] Registered providers >1,000 units

3.54 While most forecasters project house price growth to continue, downward house price adjustment is a possibility, especially if interest rates rise. Historic experience demonstrates that, although prices have tended to rise over the long term, there have been periods of downward price adjustment causing delays in sales and falls in income per sale.

3.55 Evidence from previous downturns shows that higher-value regions, including London, are not impervious to shocks. Average house prices in England fell by 9% between 2007 and 2009 (8% in London) as measured by the ONS, or by 21% in the UK (26% in London) as measured by the Halifax. Reductions in residential land values were sharper because they are based on residual development values. Many registered providers experienced delays in sales and falling income per sale, including those operating in higher value London boroughs.

3.56 This experience highlights the importance of understanding different regional and product markets and considering what alternative options are available if sales are not delivered in line with business plans including, ultimately, what exit strategies would need to be if sales fail to materialise.

3.57 The 2014 Global Accounts show surpluses from all sales, and at £815 million make up around one third of total surpluses. The regulator takes assurance from the fact that most registered providers are not dependent upon sales revenue to meet the day to day running costs of their core social housing business.

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

<u>Existing stock</u>

3.59 Management of existing stock relies on robust management information systems, together with planning, budgeting and control systems that allow sound business decisions to be taken. In particular, asset management strategies should help inform the levels of current and future investment required in order that all current stock can be maintained to a Decent Homes Standard.

3.60 Currently, the primary focus for registered providers is the revision of business plans to reflect the impact of the rent reductions against projected operating costs. For some providers, there is a need to balance the risks between short term efficiency gains and the impact and cost of deferring current investment plans for existing stock. Expenditure on repairs and maintenance continues to form part of our annual viability assessment through the stability check. We will discuss with registered providers the underlying assumptions within their business plans where there are significant reductions in maintenance and repair expenditure or where expenditure appears to be below the sector norms, to understand the reason for this and to gain assurance that this is not a sign of a registered provider failing to maintain its stock.

Liabilities

3.61 The changes to the regulatory framework are designed to enable the sector to make the best use of its resources whilst at the same time manage its business risk. Registered providers are now required to maintain a thorough, accurate and up to date record of their assets and liabilities, particularly those that may have recourse to social housing assets. The primary purpose of this requirement is to ensure that registered providers understand their housing assets and security position and have access to this information in decision making and risk management.

3.62 Most economic forecasters expect Bank of England base rate, and hence LIBOR, to rise from 2016 onwards. Other key changes such as the recent action by the credit ratings agency, Moody's, which has placed the English housing association sector on negative watch along with Basel III banking regulations, could lead to an increase in lending margins. Registered providers should therefore consider the risk that higher margins on new debt has on their business plans and take into account a range of potential interest rates as part of their stress testing.

3.63 Effective debt and cash management is essential to maintain liquidity and ensure obligations are met as they fall due. The regulator has consistently encouraged registered providers to have funds available to meet obligations greater than 18 months. While funding may remain available to providers who have shorter periods before needing funds, the cost of this debt may be higher and the covenants more demanding, as funders price in a higher level of perceived risk.

<u>Counter party risks</u>

3.64 Regardless of size, all registered providers are exposed to some degree of counter party risk. There may be risks that a party to a transaction or a contract (including but not limited to, developers, lenders, maintenance contractors and sub-contractors, pension and insurance companies) will be unable or unwilling to fulfil its contractual obligations. Such risks should be included within risk management strategies.

3.65 When evaluating counterparty risk to the overall business, registered providers should understand and evaluate the impact of any third party exposures (arising from, for example, systemic risk in other economic sectors and the financial and operating position of counterparties) and consider the effect of clauses that a counterparty may build into contractual agreements. For example, new lending agreements with lenders can stipulate that a covenant breach with one lender can trigger cross-defaults across the whole loan portfolio.

3.66 Registered providers need to have a thorough understanding of the impact that counterparty risk exposes their business to, build those into their stress tests where appropriate, and ensure that mitigations are in place in the event of a default.

<u>Liquidity</u>

3.67 In recent years, the sector has continued to access funding from both banks and capital markets. Effective debt and cash management is essential to maintain liquidity and ensure obligations are met as they fall due.

3.68 Registered providers seeking new funding have potential access to a wide variety of complex products. Registered providers therefore need to understand the nature of the transactions that they enter into, especially where the debt is accounted for off balance sheet and the exposure of the wider business may not be clear. Robust registered providers will already have both an effective treasury management function and strategy in place.

3.69 Effective boards are also able to identify when and where there are skills gaps and ensure they have an appropriate strategy in place to access the relevant treasury 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. The regulator will therefore seek sufficient assurance that registered providers and their boards understand and are rigorously challenging investment decisions entered into.

Existing debt

3.70 While bond or aggregated finance have become the typical source of long term finance for registered providers, some registered providers still hold substantial amounts of bank provided finance with margins as low as 15 basis points. It is unlikely that these margins will be repeated. A key risk to registered providers is that funders will seek ways to reduce their losses as a result of these low borrowing margins. In some cases this will be through mutual agreement where the registered provider is seeking consent for a revision or waiver to their loan agreement. However, reaching the point where a waiver is required limits the scope for meaningful negotiation.

3.71 Active monitoring of financial covenants is an integral part of a registered provider's good treasury management. Reviewing annual budgets and business plans should alert registered providers to potential pinch points, and this process should be further reinforced through stress testing. Stress testing should illustrate the extent of covenant compliance and cushions across all scenarios, examine the factors that might in combination break the business and hence highlight areas where appropriate alternate strategies and plans need to be prepared.

3.72 The increasing use of bullet debt repayments either through maturity of a long term debt or a revolving credit facility requires registered providers to put in place strategies for dealing with a potential need to replace these facilities, which may not always be via the existing funder. This may equally apply to LOBO (Lender Option, Borrower Option) type loans where refinancing may be required within a short period.

3.73 Data regarding future debt repayment obligations and the availability of undrawn facilities is collated from the regulatory returns provided by registered providers to the regulator. Given the lead times for putting new facilities in place, the regulator expects registered providers to have sufficient funds in place to meet planned obligations over at least the next 18 month period. The regulator will actively engage with registered providers who have not achieved this, with a greater degree of assurance sought where this has been a frequent occurrence.

New debt

3.74 Registered providers seeking new finance are faced with 3 broad choices:

i. bank debt – term finance of between 5 and 10 years duration is now available from the traditional banking market to existing and new clients, but with some making available more limited amounts for periods up 25 years
ii. bonds – whether through a public placement, private placement or aggregator this form of finance has become predominant for long term debt including fixed and index linked rates
iii. complex products such as off balance sheet structures, including leasebacks, have attracted interest from some, especially in the support of non-social housing provision

3.75 Registered providers proposing to use structures such as those outlined at iii above must understand clearly the decisions and obligations being entered into. In some cases a direct link can be made in the contract between inflation and rents over the long term, over which registered providers are likely to have little or no control. In the worst case, these factors could be controlled by events that would in other circumstances be classified as 'force majeure'. Providers should consider what mitigations can be built into contracts or hedging strategies to mitigate exposure to such macroeconomic and political risks.

Index linked finance

3.76 A focus on differential inflation rates is likely to be particularly important for registered providers with liabilities that will remain linked to RPI (for example, existing index linked debt or lease and leaseback arrangements).

3.77 In line with the new Regulatory Framework, registered providers are now required to seek consent from the regulator when considering index linked funding structures. This reflects the regulator's concern with the different risks associated with index-linked finance and its interest in scrutinising such arrangements prior to them being entered into.

Hedging strategies

3.78 Most bank funding to registered providers is structured as variable rate loans, with fixed rate funding being mainly achieved through embedding a derivative contract in the loan package, especially where the term of the debt exceeds 10 years. In order to avoid losses through early debt repayment, banks have included indemnities in their loan agreements so that the borrower would be obligated to pay breakage costs.

3.79 An alternative approach to mitigating interest rate exposures is for the borrower to take the variable rate debt, but buy a standalone derivative (most often an interest rate SWAP) which could be either from the same or another funder. The advantages of this strategy would be to allow the debt to be easily portable between lenders and increase debt pricing transparency. But, the down side would be potential security calls following mark-to-market (MTM) calculations. While funders would normally accept the risk of embedded fixed rate loan break costs, they cannot ignore the potential exposure from a standalone derivative.

3.80 The use of free standing derivatives can be an appropriate mitigation against interest rate exposures. The capital markets provide a range of financing opportunities but also expose registered providers to different risks. Registered providers must seek to understand the relative risks of alternate funding options and ensure that cash and security are in place to accommodate unlikely security calls.

Accounting issues

3.81 For the majority of registered providers, the accounts for 31 March 2016 will be the first published under Financial Reporting Standard 102 (FRS102) and Statement of Recommended Practice 2014 (SORP 2014). FRS102 is itself a simplified implementation, for medium sized enterprises in the UK, of the International Financial Reporting Standards (IFRS), which seeks to ensure reporting is of an internationally recognised level of comparability.

3.82 FRS102/SORP2014 introduces a number of changes that fundamentally change the presentation of accounts and for most registered providers there will be a need to negotiate refreshed financial covenants. This process may potentially be simplified by 'frozen GAAP' clauses that have become increasingly popular in loan agreements, which continue to calculate covenants according to previous accounting bases but require providers to maintain 2 sets of books. Nevertheless, registered providers should:-

a) satisfy themselves either through advice from their own appropriately qualified staff or from appropriate advisors that they can comply with any new financial covenants in a range of scenarios at least into the medium term

b) recognise that running parallel accounting with financial covenants still tested against restated post FRS102/SORP2014 accounts under a 'frozen GAAP' clause will become increasingly difficult and may no longer be feasible after 3 years

3.83 In a small number of cases, registered providers may opt to report under the full requirements of IFRS, but these are likely to be concentrated to larger registered providers with complex financing structures. By adopting this approach, these registered providers are presenting their results in a directly comparable way to major UK and international organisations rather than the simplified form of FRS102/SORP2014.

3.84 Work towards a further SORP (2016) has already started and is focused on the gradual issuance of FRS9 which uprates the reporting of financial instruments to current levels of best practice. The accounting approach contained in FRS9 is a considerable step up compared to that included within FRS102. It is left to the discretion of RPs whether to opt for early adoption of FRS9.

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