Homes & Communities Agency

SECTOR RISK PROFILE 2016

September 2016

Sector Risk Profile 2016

EXECUTIVE SUMMARY

1. In recent years, registered providers of social housing have enjoyed a generally benign economic climate but now face an increasingly complex operating environment as the sector diversifies into a wider range of different markets. Every organisation will face its own unique combination of issues, and it is vital that boards understand and can manage the risks particular to their own businesses. However, the regulator has identified a number of key risks that are increasingly important to a large proportion of the sector.

   - The sector has materially increased its involvement in development of new properties for sale, both for shared ownership (supported by the announcement of increased capital funding at the 2015 Spending Review) and also for outright market sale. It will be important that providers can manage this increase in sales risk and ensure that business plans are resilient to any shortfall in receipts.

   - Registered providers are planning to deliver greater per-unit reductions in operating costs than the sector has achieved in the past. Boards will need to assure themselves that these savings are deliverable.

   - The sector continues to diversify into a range of new commercial ventures and relationships, through unregulated subsidiaries, joint ventures and special purpose vehicles. It is important that board skills and governance structures continue to evolve to match this increasing complexity and mitigate the potential risks associated with the financing and funding structures that support its non-social housing activities.

   - Universal Credit, and with it the payment of housing costs directly to tenants, is now beginning to roll out at greater scale. Further welfare reforms such as the reduction in the household benefit cap are also due to come into effect this financial year. It will be important that boards monitor and manage the impact on their income collection.

2. In addition to the continuation of these long-term trends, providers are currently taking stock following the result of the referendum on membership of the European Union (EU). Boards will want to monitor any developing impact on the financial and property markets and the implications for their businesses.

3. Finally, when they commence, the de-regulation measures in the Housing and Planning Act 2016 will create new freedoms and responsibilities for registered providers of social housing, but also strengthen the need for boards to ensure that they have a grip on decisions around constitutional changes and disposals and are fully informed so that they can manage the reputational, legal, and financial risks.

4. The regulator will continue to seek assurance that boards understand and have effective strategies in place to mitigate the full range of risks to their businesses and will reflect its level of assurance in providers' published Governance and Viability judgements.

INTRODUCTION

5. This is the fifth edition of the social housing regulator's Sector Risk Profile (SRP). While the risks that face each registered provider of social housing will be unique, and boards need to understand and manage the risks particular to their own organisation, there are a range of challenges that face different segments of the sector. This publication is intended to provide a summary of these common strategic and operational risks, for the benefit of boards and other interested stakeholders.

6. In response to the increasingly complex operating environment, boards are making fundamental strategic decisions about the markets that their businesses operate in. It is important that where boards are making significant changes to their strategies, that they fully consider their objectives and relationships with key partners such as lenders and local authorities, and any potential reputational implications for the individual landlord, and the sector as a whole.

7. In common with previous editions, the core focus of this publication is on financial risks that could affect individual organisations' ability to meet the viability aspects of the Governance and Financial Viability standard. However, this year we have also broadened our scope to include a range of other strategic risks that could threaten compliance with other aspects of the regulatory framework.

8. This wider scope recognises some of the important changes that have taken place in the English social housing sector in the year since the SRP was last published. In October 2015 the Office of National Statistics (ONS) announced that it had reclassified private registered providers as public non-financial corporations. Whilst this is a purely statistical change, with no direct effect on registered providers' operations, subsequent policy measures introduced by the Housing and Planning Act 2016, once enacted, will make a number of changes to the role of the regulator, in particular removing the requirement for registered providers to seek consent for constitutional changes such as mergers, or to dispose of social housing property. At the time of writing, the commencement date for these provisions has not been confirmed and the regulator's current requirements for disposal and constitutional consents remain in place for the time being.

9. Our remit – to regulate a sector that is viable, efficient, well-governed and able to deliver homes to meet a range of needs – is unchanged, and we have the powers

necessary to meet this objective. The new freedoms will bring new responsibilities and risks with them for providers. We expect boards to have strong and appropriate oversight of decisions around constitutional changes and disposals and to manage the reputational, legal and financial risks. We have therefore set out some of the common issues that can arise in these areas, drawing on the regulator's experience of handling consent applications in the past.

10. Against this background, it is more important than ever that registered providers and their boards continue to have a grip on those risks that are within their direct control and have a robust approach to stress testing. This should take account of a wide range of scenarios and different risks (both those in their direct control, and those which are not, but will require mitigation) that could take effect in combination for both its social and non-social housing activities.

11. The remainder of this publication considers some of the most important risks in more detail, but there will also be a range of other risks particular to the circumstances of individual organisations and it is important that boards also take these into account.

12. The SRP is divided into four main sections, each identifying a number of the key risks that are likely to be common to the majority of registered providers: the ways in which these risks could affect compliance with the economic standards; the mitigating actions which effective boards are likely to undertake; and the assurance that the regulator will seek. These key risks are summarised in **table 1**.

13. The regulator will continue to seek assurance on registered providers' risk management through its programme of In Depth Assessments (IDAs), annual stability checks and reviews of quarterly surveys, and will reflect its level of assurance through its published judgements.

Table 1

Chapter	Key risks
1- Operational risks – Existing Housing Stock	• Rents and rental market exposures • Welfare reform • Supported housing • Cost efficiencies • Inflation • Asset sales.
2- Operational risks – New Supply	• New development • Market sales (including shared ownership sales) and development.
3- Financial and Treasury Management risks	• Existing debt • New debt • Interest rates • Hedging strategies • Pensions • Counter-party risks.
4- Strategic risks	• Consolidation and constitutional change • Decision making on use of resources and assets • Diversification • De-regulation • Consumer regulation.

1. OPERATIONAL RISKS – EXISTING HOUSING STOCK

1.1 It is important that boards understand the financial risks from day-to-day operations. For the majority of registered providers, these risks will relate to the effective management and maintenance of their existing housing stock, and the associated income and expenditure. This chapter will therefore focus on some of the key changes to the sector's operating environment, and the risks they could pose for registered providers' ongoing financial viability. The regulator will seek assurance that boards understand the potential impact of these risks upon the viability of the business, have stress tested the potential implications of a range of such risks in combination with each other, and have robust strategies in place to manage them.

Rents and rental market exposures

1.2 The Welfare Reform and Work Act 2016 (the Act) requires rents to be reduced on the majority of registered providers' rented properties by 1% per annum from 2016-17 to 2019-20. For the period that the rent under a tenancy of a registered provider's social housing is to be governed by the Act, the rent for that tenancy is not covered by the Rent Standard.

1.3 For most providers the rent cuts will mean a reduction in income, with potential implications for the funding available for investment in services and new development, as well as the headroom to interest cover covenants. The regulator will seek assurance that registered providers have a comprehensive understanding of the cumulative impact of the rent regime over the next four years and have factored the required rent reductions into their business plans. This includes any impact on the valuation of their properties, both from an accounting perspective and for loan security purposes.

1.4 Although registered providers can apply for an exemption from the application of the rent cuts, this can only be granted with approval by the Secretary of State. An explanatory note on exemption applications has been published by the regulator and is available on its website.

1.5 Some providers have diversified into the Private Rented Sector (PRS). Whilst this can provide additional income, PRS stock has the potential to increase cashflow volatility as rent levels can fluctuate as the market does. Boards will need to understand and ensure that the impact of changes in market rents can be mitigated

in existing stock. They should also understand different regional and product markets they operate in before making investment commitments and ensure that they stress test against a variety of market outcomes.

Welfare reform

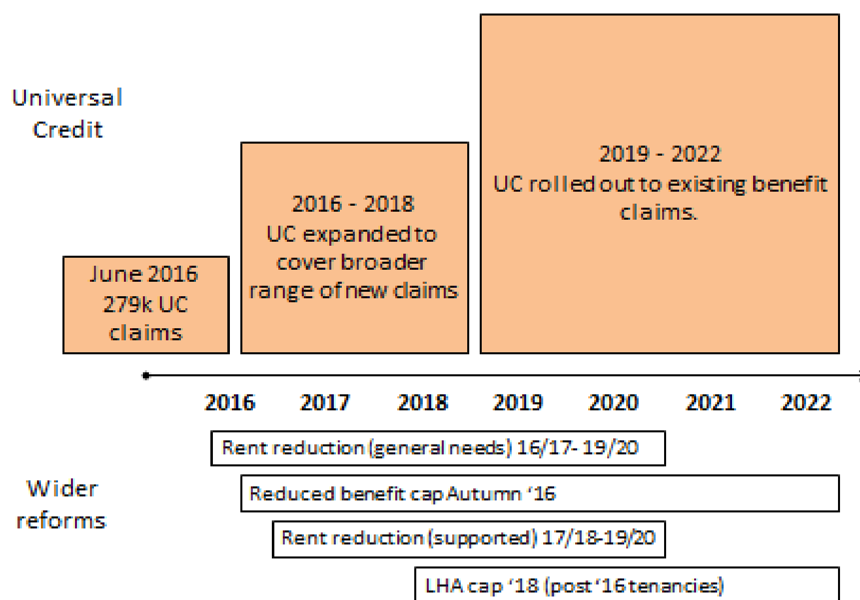
1.6 Since many registered providers' tenants receive housing benefits, existing welfare reform measures, such as the roll-out of Universal Credit and the removal of the Spare Room Subsidy (RSRS), will need careful management in order to protect social rental income. Registered providers have already 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.

1.7 The latest quarterly survey shows that 93% of registered providers are within business plan projections for rent arrears, rent collection and rent lost due to vacant properties. While most registered providers have invested and prepared for the roll out of Universal Credit since its announcement, it must be recognised that plans may not yet be fully tested.

1.8 During 2015, further welfare reforms were announced that will potentially affect registered providers and their tenants. From Autumn 2016, the cap on benefits for an out-of-work working-age family will be reduced to £23,000 in London and £20,000 elsewhere; working-age benefits are to be frozen for four years from April 2016, while changes to tax credits and the removal of automatic entitlement to housing benefit for those aged 18 to 21 are to be introduced from April 2017. Housing benefit is also set to be restricted to the Local Housing Allowance (LHA) rate for each household from 2018. This could have a particular impact on under-35s who will only be eligible for a Shared Accommodation Rate and registered providers operating in areas where social rents for some properties may be close to market rents. The Department for Work and Pensions (DWP) has recently announced that supported housing will be exempted from the application of the LHA cap until 2019-20, pending the introduction of a new longer-term funding model (see Supported Housing section below).

1.9 Universal Credit, in particular, direct payment of housing costs to tenants, remains the reform with the greatest potential risk for most registered providers. To date, roll-out of direct payment has been relatively limited. Only 279,000 live Universal Credit claims were activated up to June 2016 across all tenures, compared to a total potential pool of over five million claims. However, in July 2016, DWP announced that

roll-out will accelerate from October 2017 and should be completed by 2022[1]. The diagram below sets out the key welfare reform timelines over the next six years.



1.10 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.[2] The extent of any risk will depend on the exposure of each provider, the effectiveness of their rent collection and the implementation of government measures such as alternative payment arrangements for tenants. As well as potential cashflow implications the DPDPs also generated anecdotal evidence that Universal Credit could put upward pressure on registered providers' management costs, for example through increased resources required for rent and arrears collection. It will be important that boards monitor the impact on their income collection, and if necessary refine the preparations that most providers have been making in advance of these reforms.

1.11 Registered providers should continuously stress test the implications of the full range of welfare reform measures using realistic assumptions. In addition, they should also ensure that cashflow performance is regularly reviewed in order to mitigate against liquidity risks.

[1] https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Lords/2016-07-20/HLWS98/
[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/388565/rr890-direct-payment-demonstration-projects-key-findings-of-the-programme-evaluation.pdf

1.12 The regulator will seek 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. We will continue to engage with registered 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.

Supported Housing

1.13 Supported housing has typically been a relatively low-margin activity for registered providers; pressures on local authority funding, social rent reductions, and the introduction of the National Living Wage from April 2016 may mean that many face further reductions in net 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. Pressure on local authority budgets means that SP contracts may continue to become increasingly competitive. Whilst the introduction of the rent cuts was deferred for a year for supported housing, social rents for most supported housing properties are currently set to be reduced by 1% per annum from 2017/18.

1.14 The 2015 Spending Review announced that Local Housing Allowance (LHA) caps would be extended to the social housing sector; however the application of the caps has now been deferred for supported housing. Supported housing tenants will be exempted from the application of the LHA until 2019-20. From then onwards a new funding system for supported housing will be introduced intended to ensure that the sector continues to be funded at current levels (taking into account the policy to reduce social rents by 1% per annum). The core rent and service charges will continue to be funded through Housing Benefit or Universal Credit up to the level of the LHA. The Shared Accommodation Rate will not apply to people living in supported housing. For costs above the level of the LHA, the Government has announced the creation of a new funding stream to be devolved to local authorities, and ring-fenced to ensure that it continues to support vulnerable people. The Government has announced its intention to consult on the details of these proposals, and as further details emerge, it is important that registered providers with significant supported housing operations understand the implications of the new funding model for their businesses.

Cost efficiencies

1.15 Many registered providers are looking to make significant cost savings in order to offset the loss of rental income. The October 2015 forecasts saw a sharp reduction in providers' forecast cost base over the period 2016-2010. The sector is planning to make significant cost reductions between 2016 and 2020. Mean major repairs' cost per unit is forecast to decrease by 10% from £1,032 in 2016 to £928 in 2020, equivalent to a 16% reduction in real terms. Over the same time period, planned management and service cost per unit decreases by 5% from £1,721 to £1,629, a 12% real-term reduction.

1.16 Where registered providers are relying on ambitious cost savings, it is important that clear plans are in place to deliver these savings, and further mitigations are in place if they cannot be delivered in practice. These forecast cost savings make it even more important that registered providers understand the key drivers of their costs and boards actively monitor progress. The regulator recently published analysis on unit costs to help boards understand the identifiable factors that drive costs, and, importantly, to allow boards to challenge their own organisation's cost data. Where registered providers' costs appear unusually high, the regulator will challenge boards as part of IDAs. However, we will also seek to understand the assumptions within business plans where there are significant reductions in maintenance and repair expenditure, to gain assurance that this is not a sign of a registered provider failing to maintain its stock or a simple balancing figure in which significant capital investment programmes are being pushed to future years.

Inflation

1.17 Given that social rents are no longer index-linked to Consumer Price Inflation (CPI), any increase in underlying inflation has the potential to erode registered providers' net income and hinder the achievement of savings forecast in business plans.

1.18 CPI was 0.2% in the 12 months to December 2015 – which to the extent that cost inflation is linked to CPI, is likely to soften the potential net impact of rent reduction. However, at the time of writing this review, the latest inflation forecast figures announced by the Bank of England show it rising to 2% by the end of 2017. The potential impact of a rise to inflation combined with a fall in the value of sterling could

place greater upward pressure on input costs than the sector has seen in recent years. The implementation of the National Living Wage for all workers aged 25 and over from April 2016 will increase costs in the social care sector where wages form a large proportion of business costs. Growth in average earnings, which has been historically low since 2008, is projected to exceed 3% per annum by 2017. This may increase pressure on costs, directly through salary costs, or indirectly for example through construction costs. Effective boards should ensure that stress testing takes into account a range of different outcomes for different categories to inflation, including pensions and depreciation, and understand the implications that it may have on covenant compliance.

Asset sales

1.19 Once enacted, the end of the requirement to seek consent for disposals of property, and the adoption of the voluntary Right to Buy deal potentially open new avenues for registered providers to actively manage their existing asset base. Whilst this potentially creates opportunities for some registered providers to generate increased receipts for investment in new and existing stock, it will be increasingly important that registered providers take into account the potential volatility of income from such sources, and have mitigations in place should forecast income from the sale of fixed assets fail to materialise.

1.20 These risks will apply also to those registered providers that are planning to adopt the Right to Buy once detailed guidance and an implementation date for the voluntary policy is available.

1.21 Those registered providers that are not proposing to offer the Right to Buy to their tenants should have regard to the Housing and Planning Act 2016 provision for the Secretary of State to issue homeownership criteria. Registered providers that are not adopting the Right to Buy will need to consider how they will meet homeownership criteria, when it is issued by the Secretary of State, and provide their tenants with opportunities to access homeownership.

1.22 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.

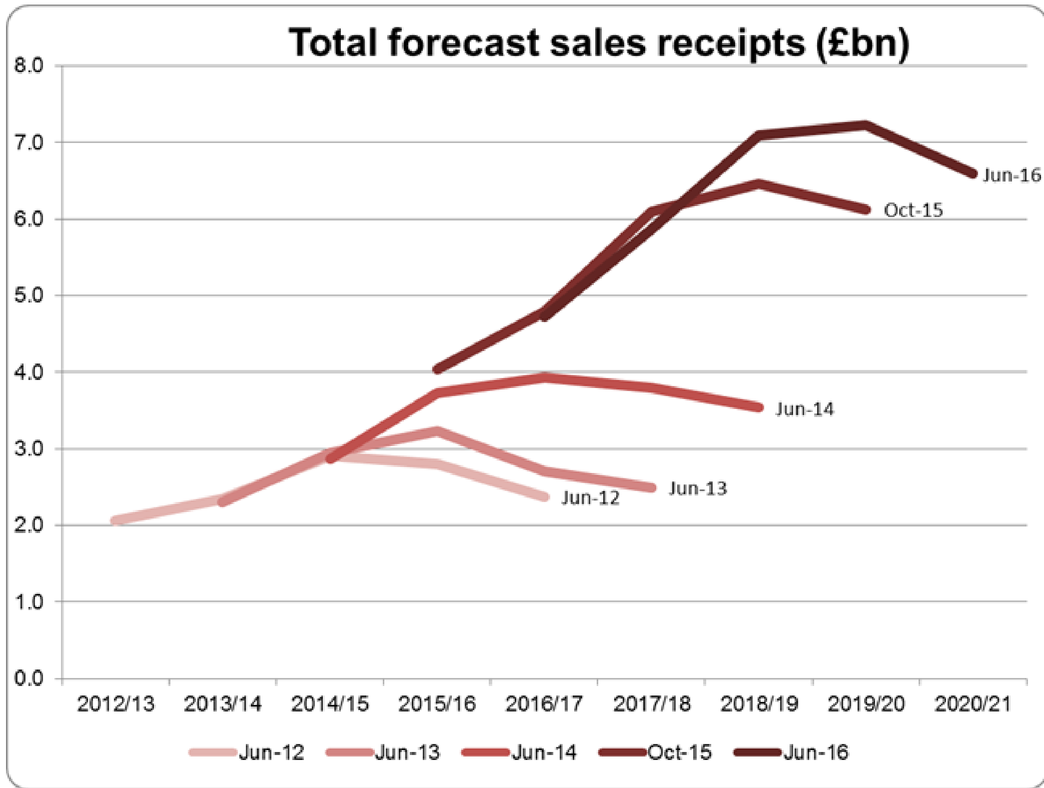
2. OPERATIONAL RISKS – NEW SUPPLY

New development

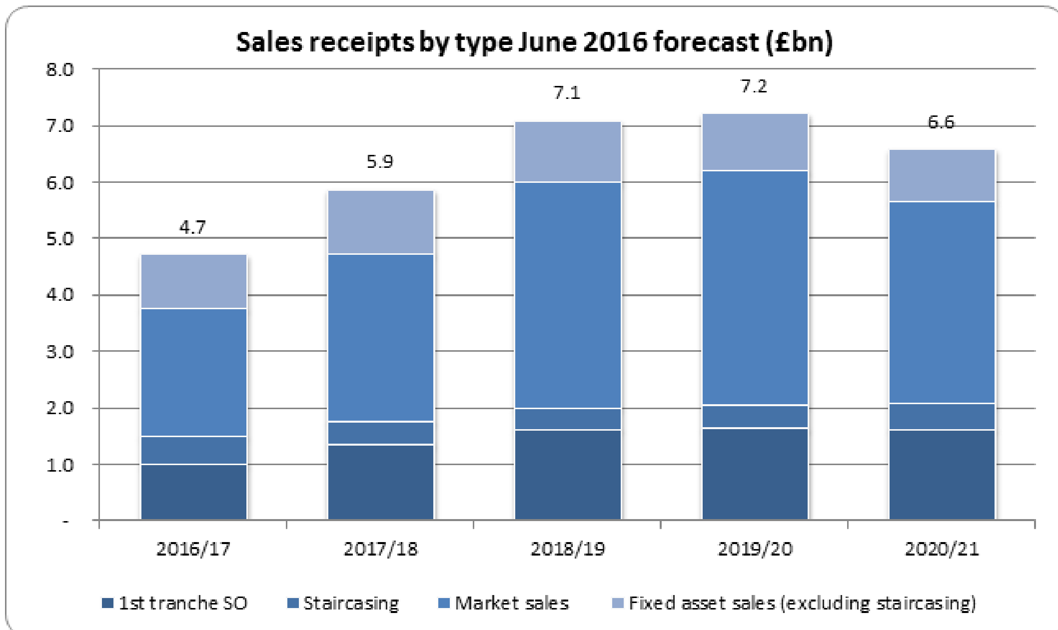
2.1 Early indications from registered providers' 2016 business plans suggest that they continue to plan a major programme of investment in new homes over the next five years. In part, landlords forecast sustaining this investment through greater reliance on sales revenues to offset the loss of rental income following the 1% rent cut introduced in April 2016. It has always been important that registered providers carefully manage the risks associated with financing and delivering a development programme. However, the increased focus on sales income, both from shared ownership and outright market sale, make it increasingly important that registered providers understand the sales markets in which they operate and have the appropriate skills to manage a programme of market facing developments, as opposed to one predominantly for rent.

Market sales and development

2.2 Income from housing sales is an increasingly significant source of income for the sector. Sales forecasts have steadily increased in recent years. However, there was a steep increase in the sector's forecasts following the rent cut announced in 2015. This shift has continued in the sector's latest forecasts received in June 2016.



2.3 Initial analysis from the June 2016 Financial Forecast Returns (FFRs), indicate that in the 2016-17 financial year, total sales of new and fixed assets are expected to generate almost £5bn. This is expected to reach over £7bn per year in 2018/19 and 2019/20, a figure equivalent to 30% of the sector's total income and much more for some providers.



2.4 Housing developed for open market sale is the most significant source of sales revenue. In the current financial year, registered providers forecast that market sales are expected to reach £2.3bn - an increase of over 300% on 2012/13. Around two-thirds of registered providers are not active in this sales market, whereas the top 10% of registered providers now generate 81% of all such revenues. While activity remains concentrated in a small, but growing, number of registered providers, it is for those boards to recognise the extent of the specific risks associated with market sale activity including the market cycle and ensure that they can effectively mitigate the risks of a slowdown in sales or reduction in market prices.

2.5 Traditionally the sector has been more active in developing homes for shared ownership than for outright sale. As shared ownership has usually been developed with grant funding as a social housing tenure, it generally fits with the charitable objectives of most registered providers. In 2016-17 around 70% of registered providers (greater than 1,000 units), are forecasting income from first tranche shared ownership sales.

2.6 First tranche sales remain a significant source of revenue – peaking at £1.6bn per year in the latest forecasts from 2018/19 onwards, up from around £1bn per year at present. The HCA's latest grant funded programme, the Shared Ownership and Affordable Homes Programme 2016 to 2021, plans to fund 135,000 homes for the Help to Buy: Shared Ownership tenure. It is currently at the bid assessment stage.

2.7 Registered providers should recognise the more specialised nature of shared ownership as a product, as compared to open market sale and other products available to the target client group. Registered providers should have a clear understanding of who is likely to buy their properties and how purchasers will access low-cost home ownership (LCHO) mortgages when assessing demand in their areas of operation.

2.8 Sales of existing fixed-asset housing stock make up the remaining proportion of sales revenue. The latest forecasts are for sales of about £1.5bn per year.

2.9 Future house prices are inherently uncertain and evidence from previous downturns demonstrates that higher-value regions, including London, are not impervious to shocks. During the last financial housing downturn, average house prices fell by 17% in England and 18% in London (measured by ONS House Price Index, all houses seasonally adjusted, peak-to-trough from November 2007 to April 2009). 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. Sales activity can fall more sharply than prices in a housing market downturn. Stress testing should therefore consider the cashflow implications of delays in sales volumes. As with any large cash receipts of uncertain timing, it is essential that registered providers have contingency plans in place to ensure adequate access to liquidity should planned sales receipts not materialise.

2.10 Registered providers also need to be clear about what alternative options are available if sales and staircasing are not delivered in line with its plan, and should have fully considered their exit strategies and impact on its cashflows. During previous downturns, most registered providers were at similar stages of their asset-sale cycle and this should be appreciated when working up their exit strategies, which could be similar to their counterparts. Where registered providers are reliant on sales and LCHO income to deliver their business plans, and particularly where they are reliant on sales income to meet interest cover covenants, the regulator will seek assurance on the adequacy of robust stress testing and mitigation strategies. Registered providers who are involved in buying land for future development should also be aware of the risks associated, including the possibility of impairment charges during economic downturns, which could have an impact on financial covenants.

3. FINANCIAL AND TREASURY MANAGEMENT RISKS

Overview

3.1 The macro-economic climate and conditions in financial markets have generally been beneficial for the social housing sector in recent years. Historically low borrowing costs have reduced the sector's overall effective interest rate (which has fallen from 5.9% in 2009 to 4.7% in 2015) and recent bond issues, since the reduction in gilt rates following the European referendum, have reached all-in borrowing costs never previously seen. However, it is important that registered providers plan for a range of alternative scenarios and take into account the potential for increased market volatility driven by economic and political uncertainty in the short to medium term. Effective treasury management has become increasingly important due to significant changes in the finance markets and the different relationships that providers have with a wide range of funders. Boards should ensure that clear parameters are set that manage liquidity and ensure access to sufficient debt and to adequate security when it is required.

Existing Debt

3.2 The latest quarterly survey findings show that the sector remains financially strong with access to sufficient finance. The sector currently has £14.5bn of undrawn facilities in place while it raised £1.2bn of new finance in the quarter from banks and capital markets.

3.3 The sector also has cash balances of £5.6bn but this is forecast to reduce in the next 12 months to £3.9bn as a result of capital expenditure and repayment of loans. It is important therefore for boards to ensure that appropriate cash, treasury management and investment discipline is maintained to ensure cash is protected and available for investment and operating costs when required. The regulator continues to collect data through the quarterly survey on availability of finance and will actively engage with registered providers where there are concerns over existing debt facilities and on-going liquidity.

3.4 As a result of the introduction of the Financial Reporting Standard 102 (FRS 102) many of the disclosures will be new or have been amended and the financial reporting will be very different in many parts. The requirement to annually value standalone and some embedded derivatives at ‘fair value’ remains; this will potentially increase year-on-year volatility and carry a cost implication for some registered providers. Any potential volatility to financial results or balance-sheet position as a result, may impact on a provider’s ability to meet its income and expenditure or balance-sheet based financial covenants.

3.5 While some registered providers continue to take advantage of low interest rates on older debt, others are negotiating revisions to existing loan agreements with their lenders. These may offer opportunities to improve cost of capital and debt but may also result in re-pricing or restructuring of existing debt on less favourable terms, for example reducing the term or seeking repayment of variable rate debt. Boards and executives should take an active interest in those treasury activities, as well as the products in which the treasury deal to ensure that they manage any risk that might hinder the registered providers’ continued compliance with both loan covenants and the regulator’s Governance and Financial Viability standard, including understanding how debt restructuring affects their refinancing profile.

New debt

3.6 New debt is available from three main sources:

a) Bank Debt;

b) Bonds – both through public and private placement;

c) More complex products, including off-balance-sheet structures.

3.7 Registered providers should ensure all the documentation and associated risks are well understood before facilities are entered into, and where necessary, seek independent specialist advice. Registered providers should also consider whether they need independent specialist external advice before processing or engaging in any complex funding structures. Where specialist advice is obtained, we expect that it is understood by registered providers. All financial structures carry risks which may be exacerbated by their duration or by the nature of the structure that has been agreed. Where the interest cost basis is linked to inflation, registered providers should ensure that the associated net income can be generated into the longer term or appropriate hedging is in place.

Interest rates

3.8 The LIBOR reference rate for provider debt, which closely follows the Bank Rate, has been at historic lows since 2009. While this had been widely expected to rise during 2016, economic uncertainty following the EU referendum result prompted a further reduction in the Bank Rate to 0.25% in August 2016, an extension of quantitative easing. This increased uncertainty over the likely timescale for future rate increases. Notwithstanding this, registered providers should understand the potential impact of changes in interest rates on business plans.

3.9 The Annual Quarterly Survey to March 2016 showed that 69% of the sector's total drawn debt is on fixed interest rates. This gives registered providers a degree of certainty on forecasting the cost of borrowing but may result in a higher than necessary price being paid for debt, if not actively managed. The remaining 31% 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 £20.3bn is subject to fluctuating and less certain rates. Although at present the sector continues to benefit from low

floating rates, it is important that registered providers continue to review their exposure to interest rates against a range of scenarios.

Hedging strategies

3.10 Whilst the majority of the sector's debt is fixed, achieved through fixed loan terms or embedded derivatives, some registered providers have taken alternative options by drawing debt on variable rates and then purchasing a standalone derivative – typically an interest SWAP – either from the same or another funder. The advantage of this policy is not only that it provides a fixed rate of interest, but also that it allows the debt to be potentially portable between lenders and can increase debt pricing transparency at the same time. However, the downside risk for this strategy is that the agreement will require the borrower to provide cash (or other collateral) if rates drop significantly below the original level, as has happened in recent years on long-term contracts taken on when rates were substantially higher. Such mark-to-market (MTM) calculations are typically made quarterly with the borrower only having a matter of days in which to obtain the cash. Registered providers should be clear on the potential risks associated with their hedging and ensure that cash and security are in place to accommodate even unlikely security calls.

3.11 The use of free-standing derivatives can be an appropriate mitigation against interest rate risk and other exposures; they can also be used speculatively or to create overly complex or expensive structures. Boards should ensure that they are aware of how derivatives are being used in providers and that appropriate advice is taken. The markets provide a range of financing opportunities but also expose registered providers to different risks. Registered providers should be clear on the relative risks of alternate funding options and ensure that cash and security are in place to accommodate even unlikely security calls.

Pensions

3.12 Pension provision is potentially a significant risk for providers, and arises from a variety of sources including: projected returns on assets, liability valuations, scheme membership, type of scheme and potential termination costs. Registered providers need to take a view on the balance between cost, recruitment and retention, and pensions' provision for staff should be regularly reviewed to ensure it remains fit for purpose. Fluctuations can also arise in respect of pension liabilities, which could give

rise to significant increases in payments. Boards need to understand how pension fund liabilities arise and the potential impact on the provider's business and consider options and mitigation strategies, taking advice where appropriate.

Counter party risks

3.13 All counterparties whether funders, insurers, pension providers and all kinds of contractors carry a risk – the potential to run into financial difficulty can be costly to providers. Registered providers could face losses in terms of money paid without the service delivered or the difficulty of finding a suitable counterparty to complete a contract already started. While the events that cause failure might be sudden, registered providers should ensure that risk monitoring and review is undertaken on a regular basis and on a risk-weighted basis.

3.13 Registered providers also need to fully understand the potential circumstances in which they or the counter party has an option to vary or break a contract, and put in place mitigations to manage the risk in the event this happens.

4. STRATEGIC RISKS

4.1 Boards of registered providers are ultimately responsible for setting the strategic direction of their organisations, effective management of risks to the delivery of those strategies, and for assuring themselves of their compliance with regulatory standards. Ensuring that Board strategic decisions are informed by relevant evidence, and based on a robust understanding of risk, is fundamental to the achievement of the organisation's objectives and to its long-term viability. Gaining assurance that governance structures are fit for purpose remains a fundamental objective of the regulator's engagement with registered providers and their boards.

4.2 More and more boards are making fundamental strategic decisions about the markets that their businesses operate in, diversifying their activities in response to the increasingly complex operating environment. It is important that governance structures evolve to match this increasing complexity and boards should ensure that their skills and risk management evolve appropriately to match the changing nature of the business. It is also important that where boards are making significant changes to their strategies, they should consider the implications for compliance with charitable vires, relationships with key partners such as local authorities, and the reputational implications for the individual landlord, and the sector as a whole.

Consolidation and constitutional change

4.3 Given the challenging environment in the sector, more registered providers may be considering mergers to strengthen or develop their capacity, and, once the provisions of the Housing and Planning Act 2016 are enacted, will no longer require consent from the social housing regulator to do so. A merger may bring a range of benefits but given this change to the consent regime, and the increasing size and complexity of some of the propositions, it is more important than ever that boards fully understand the drivers for such change and ensure that the risks and rewards are clearly quantified. Early consideration of the potential mitigation strategies and mechanisms to drive through the delivery of the anticipated business benefit and value for money are key to success, and effective due diligence will be important in supporting strategic decisions.

4.4 Clear shared and agreed views of corporate cultures and business synergies of the merging organisations can be important to the chances of a successful merger. Boards should also fully consider the opportunity cost attached to a merger and balance these to ensure that sufficient focus remains on day-to-day business activities and these are not neglected prior to the legally merged group being established.

4.5 Effective boards will actively examine the key drivers for a merger, to ensure that it makes strategic and financial sense and that, where they might exist, cultural differences can be resolved early in the process. The boards of the merging organisations are each also responsible for protecting the interests of their tenants and their publicly-funded social housing assets. They should be in overall control of the process and their members and have a general duty to exercise skill and care to ensure that the process is managed with consideration of the reputational and market risks of failure.

4.6 Managing the process of change requires particular skills, and consideration needs to be given to recruitment of boards and executives with the skills to manage this and to run a large, merged body. Boards will need to consider the reputational implications surrounding remuneration packages awarded to out-going executive members of staff and consider their charitable objectives when making decisions on discretionary payments.

Diversification

4.7 As registered providers face new pressures, boards have increasingly taken the strategic decision to diversify and look for new and innovative ways to meet housing demand and deliver more efficient services. The 2015 Global Accounts data set demonstrated that registered providers continue to introduce new services that are supplementary to their core role of providing social housing. The surplus reported on non-social housing activities was £172m in 2015 (2014: £117m), although in aggregate some providers also generated losses. Whilst diversification can present attractive opportunities to generate additional income to subsidise the core provision of social housing, the appraisal and management of the new and existing risks arising from this diversification is crucial.

4.8 Effective boards will consider the balance of risks and rewards before deciding to undertake new activities or to continue with existing ones. The majority of large registered providers' organisational structures now include unregistered entities, and some also have Special Purpose Vehicles (SPVs) and Joint Ventures (JVs). Registered providers should understand the interdependencies and have control mechanisms in place to safeguard social assets. In order that registered providers manage diverse activities, including complex and differing finance sources and business structures, boards should have a range of skills to ensure that they are making well-informed and considered decisions. Registered providers should be able to understand and demonstrate a continuing ability to meet existing commitments, including those to existing lenders, as well as new commitments arising from diverse activities. It also remains important that registered providers should understand, and have strategies in place to manage any risks that diverse activity might pose to the regulated entity and the existing social housing stock through, for example, guarantees or intra-group lending, equity investments and covenants that could be impacted by impairment.

4.9 However, these risks are not just financial. Particularly where registered providers intend to move into non-social housing activity at more than a de minimis scale, it is important to consider whether this is consistent with an organisation's objectives, and where necessary providers should seek assurance about consistency with charitable vires and investment policies. As part of the Governance and Financial Viability standard, registered providers must have a comprehensive, accurate and up-to-date asset and liabilities register and fully understand any intra group liabilities, whether registered or unregistered. In addition, we expect registered providers to have relevant skills and experience among board and senior staff that are applied across its diverse activities.

Decision making on use of resources and assets

4.10 In the current constrained fiscal context, it is more important than ever that the strategic decisions made by boards take into account Value for Money, and boards are informed by a robust understanding of how the organisation can most effectively harness its resources and assets to deliver its own objectives. In the current

environment, a failure to make the most effective use of a provider's own capacity can be one of the most significant risks to the achievement of the organisation's objectives.

4.11 It is the responsibility of boards of registered providers, as independent organisations, to decide what the most appropriate strategy to pursue is, and how to deploy its assets and resources to achieve those goals. To grow and be sustainable, registered providers need to recognise the complexities of doing business in a new and challenging environment that may require them to alter their business strategies accordingly. It is not the role of the regulator to seek to shape such objectives. However, the regulator does expect that governance arrangements are adequate to ensure that those objectives are delivered in an effective, transparent and accountable manner. The regulator will therefore continue to seek assurance through IDAs and stability checks that governance arrangements are sufficiently robust to ensure compliance with both the Governance and Financial Viability, and Value for Money standards.

De-regulation measures

4.12 Following the passage of the Housing and Planning Act 2016, the context in which boards make these decisions will change, and it is important that they understand the forthcoming changes to the regulator's consent powers and their implications for board responsibilities. The deregulatory measures, once enacted, will remove:

- the constitutional consents
- disposal regime
- disposal proceeds fund (DPF).

4.13 Registered providers will no longer need consent from the regulator to dispose of their stock or charge their stock for security, nor will they need permission from the regulator before they merge or change their corporate status. However, boards will remain responsible for meeting all legal and regulatory obligations and will need to balance competing considerations, such as the position of tenants. It is important that boards are clear about the considerations relevant for each activity and their reasons for giving precedence to particular considerations and that they seek specialist advice where assurance is required.

4.14 Registered providers will however be expected to notify the regulator about the activities outlined above. The regulator's fundamental objectives and standards have not changed and it will hold registered providers to account if they are in breach of the regulatory standards.

4.15 Boards will need to consider their governing rules when making strategic decisions, especially where they are charitable, and where applicable, ensure that they notify other regulators about changes to their corporate structure.

4.16 Registered providers who consider tenanted disposals outside of the regulated sector, including to non-registered subsidiaries, should ensure that they understand any impact on their tenants' rights and other regulatory protections and ensure that these are clearly explained to tenants in the consultation process. Boards should have assurance that tenant consultations are open, balanced and meaningful and that concerns raised by tenants are carefully considered when the decision on disposal is made. Failure to address these issues at an early stage and deal transparently with the consultation process on tenanted disposals out of the sector represent a potential for significant reputational risks both to individual registered providers and the sector as a whole.

4.17 The Governance and Financial Viability standard expects registered providers to have governance arrangements that ensure that providers safeguard the reputation of the sector. In addition to this, retaining the confidence of key stakeholders including tenants, lenders and local authority partners is essential if registered providers are to be able to achieve their own goals. As organisations with a social purpose, and often charitable status, registered providers will often be held to higher standards by stakeholders than other bodies might be. In a dynamic and rapidly evolving sector, it is important that boards recognise such expectations, both in exercising new freedoms and delivering their existing responsibilities to tenants under the consumer standards.

Consumer Regulation

4.18 The regulator can take action, as we have a number of times in recent years, where there is a breach of consumer standards that gives rise to potential or actual serious detriment to tenants. However, at a strategic level, the reputational implications can also be significant, and potentially more long-lasting. Our recently published

Consumer Regulation Review reiterates the importance for registered providers to have the systems and processes in place to provide assurance to the board that the consumer standards are being met.

Boards are responsible for meeting the consumer standards. Although the Regulator regulates the consumer standards reactively, that does not lessen the obligation on registered providers to comply. If we find that a private registered provider has breached the consumer standard and there has been a risk of, or actual serious harm to tenants, we also consider whether that failure would change our view of the registered provider's compliance with the Governance and Financial Viability standard.

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The Homes and Communities Agency is committed to providing accessible information where possible and we will consider providing information in alternative formats such as large print, audio and Braille upon request.

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