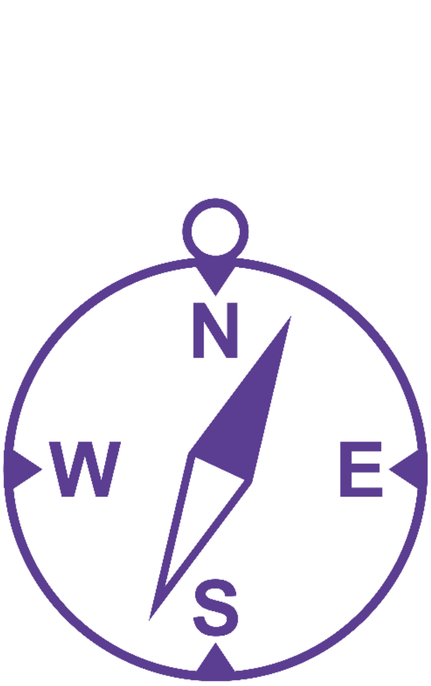
Regulator of Social Housing

Sector risk profile 2021

October 2021



Contents

Executive summary

The Sector Risk Profile sets out our view of the most significant sources of risk to providers' ongoing compliance with our regulatory standards. This publication is aimed primarily at Boards of private registered providers and focuses in particular on risks to compliance with our economic standards, though some issues will also be relevant to local authority registered providers. It remains the responsibility of Board members and councillors to meet regulatory standards and to determine how this is done.

Much of providers' focus over the past year was inevitably dedicated to the COVID-19 pandemic. Providers responded well to the unprecedented challenges they faced, reacting quickly to change operating models and develop new ways of working. However, the public health and economic outlook remains unclear, and providers continue to operate in an intensely uncertain environment.

The economic recovery to date remains fragile, with significant ongoing disruption to supply chains and the labour market resulting in high-cost inflation and ongoing shortages of materials and skills. Weaker operating margins and increased spending on existing stock due to remedial safety works, catch up on repairs, and energy efficiency improvements have seen the sector's interest cover deteriorate in latest forecasts. Providers will need to maintain a close watch on these sources of risk. Ultimately, Boards are custodians of people's homes and failure to maintain compliance with our economic standards can threaten a provider's existence and harm to its tenants.

Providers face increased scrutiny as they respond to the government's Social Housing White Paper[1] and the government looks to the sector to deliver against evolving requirements from its zero-carbon commitments. Navigating sometimes competing demands for providers' resources will require some difficult trade-offs, and these will need to be communicated transparently and sensitively to a range of stakeholders. It is crucial that Boards have a strategic approach to these trade-offs; those who fail to achieve this, risk being overwhelmed, either financially, operationally, or reputationally.

[1] The charter for social housing residents: social housing white paper - GOV.UK (www.gov.uk)

The complexity and breadth of the risks Boards must manage and mitigate is substantial. The rest of this document explores considerations for Boards in managing these; from these specific risks emerge the following, more general, themes that are likely to be key areas of focus for Boards and for us as the regulator.

- **Strategic choices:** Boards face a broad range of competing pressures and trade-offs in setting the strategic direction for their organisations and in utilising their limited financial capacity. Providers will need to undertake essential investment to respond to changing building safety and energy efficiency standards and maintain the quality of their existing housing stock. At the same time, providers are investing to develop homes to serve future tenants, including the more than a million households currently on local authority waiting lists. A provider's purpose, how it makes choices, and its performance in delivering its objectives will be scrutinised by multiple stakeholders. Boards must be able to clearly articulate their organisation's purpose and be transparent in communicating performance against this in order to manage the reputational risk inherent to such trade-offs.

- **Macroeconomic risk:** There is substantial ongoing uncertainty as the UK and global economies emerge from the pandemic. Labour market and supply chain disruption are affecting the prices and availability of goods and services, with significant volatility in inflation. Boards must fully understand their cost base and capital requirements, stress testing a range of assumptions and developing mitigation plans. Access to skills is likely to remain a substantial issue for providers' delivery of development programmes, major repairs and maintenance, health and safety compliance, and key services to tenants. Boards will need to ensure emerging and longer-term labour, skills, and materials shortages are monitored and that these don't undermine essential activities.

- **Financing:** Providers are reporting increased reliance on debt to fund strategic objectives such as investment in new and existing housing and this has resulted in weaker projected operating margins and lower interest cover, only partially ameliorated by assumed continued low interest rates. It is crucial that Boards have the skills to understand and challenge the merits and risks of all financial products they employ and that they are right for the organisation in delivering its objectives. Boards must understand how higher than expected borrowing costs could impact providers' financial viability.

- **Stock quality:** Providers are likely to need to undertake substantial investment in existing stock over the next few years. Providers' stock is a long-term asset, and Boards must ensure an effective system for repairs and maintenance is in place to meet minimum standards and the needs of tenants. Boards must ensure they have robust data on the quality of their stock and how this relates to evolving requirements from the review of Decent Homes Standard and the government's decarbonisation agenda.

- **Health and safety:** Ensuring that tenants are safe in their homes is a fundamental responsibility of all social landlords. Boards must have assurance that providers' stock meets all relevant statutory health and safety obligations, irrespective of whether providers are carrying out these checks directly. Boards must understand their duties and responsibilities with regard to fire and building safety under the new regulatory regime introduced by the Fire Safety Act 2021 and future legislation currently reflected in the Building Safety Bill. Providers' ability to meet statutory health and safety requirements relies on holding good quality data about their tenants and their stock.

- **Service delivery and accountability to tenants:** Our consumer regulation casework continues to show the importance of effective and transparent communication with tenants. Demands for transparency will increase following the publication of the White Paper, and providers should take action now to strengthen engagement with tenants and improve the services they receive. Boards' assurance that tenants are being treated with fairness and respect, and that their diverse needs are considered, should be reinforced by decision-making processes supported by robust data. Boards must also ensure that systems are in place to ensure data security to protect tenants from potential harm.

- **New supply and the housing market:** Forecasts for development have now broadly returned to pre-pandemic levels. Both the development and sale of new units carry significant risks that Boards will need to manage, including the potential for impacts to financial viability and the achievement of strategic objectives, as well as providers' reputation with stakeholders. Through stress testing and mitigation planning, Boards must assure themselves that they understand and can mitigate against these risks, including impairments of joint venture investments that could affect registered providers.

1. Introduction

1.1 The 2021 Sector Risk Profile sets out our view of the most significant sources of risk to providers' ongoing compliance with our regulatory standards. This publication draws on submitted regulatory returns and other data provided to us as the regulator where applicable. Detailed analysis of providers' annual accounts (FVA) at a sector level, including analysis of providers' Financial Forecast Returns (FFR), are set out in our annual *Global Accounts* publications.[2]

1.2 Risks are grouped into four sections:

- Strategic risks
- Operational risks – existing stock and service delivery
- Operational risks – development
- Financial and treasury management risks

1.3 These risks have the potential to threaten the successful delivery of providers' strategic objectives, providers' viability, or the safety of tenants. The Sector Risk Profile describes both risks that most providers are likely to face and also those that may only affect a minority of providers. Board members of private registered providers and, where applicable, councillors forming the governing bodies of local authority registered providers (henceforward 'Boards') should be alert to these risks.

1.4 We remain firmly committed to a co-regulatory approach. It is for Boards to ensure that providers are managed effectively and that they meet all regulatory requirements. As part of this, we expect Boards to have an effective risk management and internal controls assurance framework. It is the role of each board to assess its own risks in the round and satisfy itself that appropriate strategies are in place to mitigate these.

1.5 As the regulator, our focus remains to seek assurance from providers that they are meeting its economic and consumer standards. It has set specific expectations of provider risk management in the Governance and Financial Viability Standard and associated Code of Practice.[3] We will continue to challenge individual providers where a risk that has been identified as material through our analytical work, engagement, or referrals is not captured in the provider's risk and control framework.

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[2] Global accounts of private registered providers - GOV.UK (www.gov.uk)

[3] Governance and Financial Viability Standard and Code of Practice - GOV.UK (www.gov.uk)

1.6 Although we regulate the consumer standards reactively, this does not mean that the obligation for registered providers to comply with the standards is lessened. We continue to consider referrals made to us in relation to breaches of the consumer standards, signposting to the Housing Ombudsman where a referral appears to be an individual rather than a systemic failing.[4] Further detail on lessons drawn from our consumer regulation casework is set out in our annual *Consumer Regulation Review* publications.[5] We are undertaking engagement with stakeholders in advance of the implementation of the new regulation regime set out in the government's Social Housing White Paper, which will introduce a more proactive approach to consumer regulation.

[4] Memorandum of Understanding between the Regulator of Social Housing and the Housing Ombudsman - GOV.UK (www.gov.uk)

[5] Consumer regulation review - GOV.UK (www.gov.uk)

2. Strategic risks

Diversification

2.1 Diversification into non-traditional business streams can potentially allow providers to increase their turnover and supplement rental income and grant funding by investing returns back into their core activities. However, diversification introduces additional risks to those from social housing activity. Failure to appropriately manage these can damage a provider's reputation and be detrimental financially, potentially putting social housing at risk.

2.2 Diversification can include market sales, student housing, portfolios of commercial property, and specialist care which may be in line with a provider's core purpose but brings a different profile of risk. 29% of providers' forecast income over the next five years is accounted for by activity other than social housing lettings (FFR 2021). While providers have reduced their reliance on market sales income to cross subsidise other activity compared to previous forecasts – providers are forecasting £13.0bn in outright sale receipts over the next five years (FFR 2021), compared with £17.5bn assumed in 2019 forecasts – they are largely planning to fill the shortfall in planned sales receipts by increasing their reliance on debt funding and exposure to interest rate risk.

2.3 Boards must ensure that they have the required skills, information and advice to appropriately assess any move into a new business stream, and to monitor this on an ongoing basis. Boards must understand the full range of risks diverse activity can expose them to and ensure that such activity has a clear strategic role in meeting their organisation's purpose and objectives. Furthermore, Boards must understand the potential risks associated with the finance and funding structures of non-social housing activities. Boards must have appropriate governance structures and ring-fencing arrangements in place to ensure that social housing assets are not put at risk by, for example, guarantees or impairment relating to non-social assets.

2.4 Charitable providers must also have regard to charity law when undertaking diverse activity. As the regulator, we will seek assurance from providers that non-social housing activity creates rewards commensurate with its associated risks, that this activity makes a clear contribution to the provider's core purpose, and that social housing is not put at undue risk.

Access to labour and skills

2.5 Providers are reliant on access to skilled workers to deliver development programmes, undertake major repairs and maintenance, comply with health and safety requirements (including building safety), and deliver key services to tenants. Ongoing skills shortages, made worse by current disruption to the labour market, may threaten providers' ability to deliver these programmes and services.

2.6 There have been long-running concerns about the availability of key staff and skills in certain industries, including construction, building safety, and care. However, longer-term structural issues have been compounded by the effect of the end of free movement associated with EU exit and the disruption to labour markets created by the pandemic. Current shortfalls of construction workers[6] will become more pressing as providers look to catch up on delayed works, undertake substantial development programmes and invest in stock quality, increasing costs or delaying programmes. The lack of chartered and incorporated fire engineers able to sign-off category B External Wall System (EWS1) forms has resulted in delays to new builds and many thousands of leaseholders unable to sell.

2.7 Shortages of suitably qualified safety professionals may become more acute as implementation of the Fire Safety Act and Building Safety Bill will require a significant increase in demand for qualified fire safety professionals. Providers offering care services are also facing substantial shortages in key staff, with ongoing vacancies in care homes which may be amplified by the requirement for all staff to be vaccinated by 11 November 2021. These roles have frequently been filled by European Economic Area (EEA) nationals, but the post-EU exit points-based immigration system does not allow for direct recruitment from abroad in most adult social care roles.[7]

2.8 Boards must ensure that their business planning, risk management, and control framework is effective and covers all aspects of the business. Boards will need to ensure they fully understand their operating environment and how this impacts the delivery of organisational objectives. Boards will need to ensure that they have robust systems to manage risks from emerging and longer-term labour and skills shortages, establishing effective mitigation strategies to prevent these impacting the delivery of services and strategic objectives.

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[6] State of Trade Survey Q2 2021 – Federation of Master Builders (fmb.org.uk)

[7] International review: immigration routes for social care workers - GOV.UK (www.gov.uk)

Delivering against expectations

2.9 Providers face a range of competing demands from stakeholders. Providers will need to make strategic decisions to navigate these in order to successfully meet their objectives. Failure to consider competing demands at the outset, or failure to communicate these choices effectively once made, can have serious ramifications for a provider's own reputation and that of the sector as a whole. As organisations with a social purpose, many of which have charitable status, providers' actions will inevitably be scrutinised by a range of stakeholders. These include current and future tenants, local communities, councillors and MPs, local and national government, lenders, contractors, other regulators, and the media. Instances of poor quality or performance may reach the public domain very quickly and can be shared widely before providers are able to address them.

2.10 Complaints from tenants to the Housing Ombudsman have seen a marked increase over the past year.[8] Complaints provide rich insight into the performance of services and can act as early indicators of wider issues – it is essential that providers seek to learn from tenant complaints and hear the messages tenants are giving them. There has been recent significant media attention and public concern about poor quality accommodation and delays in repairs. Health and safety non-compliance, poor service quality and issues from outsourced service delivery, poor complaint handling, incorrect rent and service charge setting, conflicts of interest, and executive pay have also all led to recent criticism of providers including from tenants, councillors, and MPs. While these issues may not be widespread in the sector, Boards should be seeking assurance that their organisations are not affected by these and resolving issues where they are found.

2.11 Boards must consider reputational risk as part of their strategic approach and decision making. Boards must be proactive in seeking to understand tenants and other stakeholders, having regard for their expectations and their diverse needs, particularly for vulnerable tenants. It is for Boards to manage the risk of adverse external perceptions and to manage and maintain effective relationships with stakeholders. Boards should ensure that they have timely and effective mitigating strategies in place to manage reputational risks.

[8] Housing Ombudsman Insight Report - Housing Ombudsman (housing-ombudsman.org.uk)

2.12 As the regulator, we do not have a role in resolving individual disputes between tenants and their landlord, but we do look to consider whether there is evidence of a systemic failing by a registered provider and consider the impact (or potential impact) to tenants. Failure to provide good service or to appropriately handle complaints can indicate systemic issues which can also call into question the quality of a provider's governance. There is regular engagement between the Housing Ombudsman and us as the regulator to ensure effective signposting of referrals, including the referral of potential systemic issues to us.[9]

Counterparty risk

2.13 Providers enter into contracts with a wide range of third parties, including funders, insurers, auditors, pension providers, construction and maintenance contractors, care providers and through joint ventures. These can represent effective ways for providers to deliver key services and help deliver value for money. However, entering into contracts with third parties exposes providers to counterparty risks and can reduce the control that providers have over the quality of delivered services. Reliance on a limited number of third parties or sources of finance also exposes providers to concentration and reputational risks.

2.14 Some providers have used outsourcing of landlord services as an option to drive down costs. Lockdowns, ongoing supply chain disruption, and labour market dislocation during the pandemic has resulted in significant financial pressure faced by many maintenance and construction contractors, with heightened risk of failure and consequent effects on delivery of these services.

2.15 It is ultimately Boards that remain accountable to their tenants and stakeholders. Boards must ensure their organisations conform to all relevant policies, standards, and law when outsourcing to third-party organisations. Boards must have assurance that concentration risk is being managed, including monitoring of counterparty robustness and consideration of protections for breaches or termination of contracts. Due diligence should be undertaken to ensure any potential conflicts are identified that could breach policy, regulation, legislation or cause reputational harm.

[9] Memorandum of Understanding between the Regulator of Social Housing and the Housing Ombudsman - GOV.UK (www.gov.uk)

Value for money

2.16 Providers must balance a wide range of competing demands to deliver their strategic objectives. Responding to policy requirements set out in the White Paper and the government's zero-carbon commitments against a backdrop of uncertain economic pressures will require careful consideration. For some providers this will require re-evaluating what their core objectives are, and how they maintain an emphasis on delivering against them.

2.17 It is essential that Boards closely monitor and constructively challenge their organisation's performance to make well informed decisions regarding the effective use of the assets and resources available to them.

2.18 As the regulator, we will continue to seek assurance around the robustness of Boards' decision making to ensure that they have a strategic approach to delivering value for money in meeting the Value for Money Standard.[10]

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[10] Value for Money Standard and Code of Practice - GOV.UK (www.gov.uk)

3. Operational risks – existing stock and service delivery

Existing stock quality

3.1 A provider's stock is most fundamentally a home for its tenants. Failure to ensure the quality of housing stock is maintained at a decent standard or to effectively respond when issues arise can result in significant consequences for tenants, as well as having substantial implications for the trust and confidence that tenants and other stakeholders have in a provider. Failure to invest appropriately can also lead to deterioration of stock, potentially leading to greater expense at a later date.

3.2 There has been a substantial degree of stakeholder and media scrutiny on stock quality issues in the sector in recent months. This has the potential to continue, particularly as increased energy costs for tenants over the winter could heighten fuel poverty and underscore issues of poor thermal efficiency in tenants' homes. The review of the Decent Homes Standard announced in the White Paper and more stringent energy efficiency requirements as part of the government's net zero-carbon commitments are likely to result in requirements for substantial investment in providers' existing stock.

3.3 Providers' latest five-year forecasts show a 12% increase in major repairs and maintenance expenditure when compared with last year's forecasts as providers reprofile delayed expenditure and increase investment to respond to new standards (FFR 2021). At the same time, providers are facing substantial ongoing supply chain disruption, materials inflation, and labour shortages which are likely to increase costs and delay works. Lack of transport capacity and import backlogs have increased delivery times and resulted in severe shortages of materials and components. Scarcity of labour, compounded by EU exit, is likely to put upward pressure on wage costs while skills shortages may mean that some providers are unable to source key staff, contractors, surveyors, or building safety professionals in order to undertake planned works programmes as envisaged.

3.4 Boards must ensure that their organisations provide a repairs and maintenance service to homes and communal areas that represents value for money and which ensures tenants' homes meet minimum standards. Providers' stock is a long-term asset and Boards will need to ensure that it continues to be fit for purpose over its lifetime. As a fundamental initial step, Boards will need robust and up-to-date stock condition data. Boards will need to understand the implications of new requirements, including on the economic performance of provider assets, and identify investment needs in their business plans. In ensuring their stock remains fit for purpose, providers should also consider the resilience of their stock to the effects of climate change, such as the implications of higher temperatures, more extreme weather events, and indoor air quality.

Delivering services to tenants

3.5 The provision of good quality housing services to their tenants is core to the role of a registered provider. As well as breaching consumer standards, failure to deliver these services or to engage effectively with tenants could lead to a breakdown in trust in the relationship providers have with their tenants, as well as seriously damaging the reputation of the provider and sector.

3.6 The publication of the Social Housing White Paper[11] has set out the government's approach to strengthen providers' engagement with tenants and improve the services tenants receive. The White Paper commits to delivering proactive consumer regulation, transparency on landlord performance, building safety, effective handling of complaints, strengthened resident engagement, and good quality homes and neighbourhoods. The impact of the pandemic has meant tenants have spent more time in their homes and this has underlined the importance of the relationship between tenants and their landlord.

3.7 Our recently published *Consumer Regulation Review*[12] identifies key issues and lessons arising from our casework in 2020/21. Our casework continues to demonstrate the importance of effective communication with tenants and learning from tenant complaints. How a provider interacts with its tenants and how it puts things right when they have gone wrong is indicative of an organisation's culture and how its systems and processes operate in practice.

3.8 Boards must ensure that strong governance arrangements are in place to continue to manage effective delivery of services to tenants and maintain compliance with consumer standards. Providers should ensure all decisions and communications with tenants demonstrate transparency and accountability. Board assurance that tenants are being treated with fairness and respect, and that their diverse needs are considered, should be reinforced by decision-making processes supported by robust data and effective internal controls.

[11] The charter for social housing residents: social housing white paper - GOV.UK (www.gov.uk)

[12] Consumer regulation review 2020-21 - GOV.UK (www.gov.uk)

Health and safety

3.9 Ensuring that tenants are safe in their homes is a fundamental responsibility of all landlords. Providers must ensure that they comply with statutory health and safety obligations. These requirements apply to both existing, and to new build properties. Providers also have wider responsibilities such as fulfilling their legal duty of care to their staff.

3.10 The Fire Safety Act 2021 and the Building Safety Bill introduce wide-ranging changes, including the creation of a new Building Safety Regulator with a range of enforcement powers and a new regulatory regime. Our Consumer Regulation Review[13] highlights the extent to which providers' ability to meet statutory health and safety requirements relies on holding good quality, accurate data on their tenants and their stock. It also highlights the importance of being proactive in managing risks and responding promptly to identified issues. Failure to inspect and deliver safety remediations in a timely manner can put tenants at risk and also has a substantial impact on shared owners who can find themselves unable to sell and trapped in homes that no longer suit their needs.

3.11 Boards must ensure that they adequately understand all legislative requirements relating to health and safety compliance, including their duties and responsibilities with regard to fire and building safety under the new regulatory regime. Boards must ensure that they have comprehensive and effective building safety systems and programmes in place to provide assurance that tenants remain safe. This is particularly important when services are provided by third parties such as managing agents or contractors.

3.12 Boards will need assurance that their organisations hold good quality data to enable the accurate assessment and management of risks. Boards must understand the costs associated with remediation works and any implications for other planned major repairs, particularly for large and complex buildings. Where remediation works may take time to implement, taking account of industry capacity and risk, Boards must ensure that their organisations communicate transparently with tenants and stakeholders.

[13] Consumer regulation review 2020-21 - GOV.UK (www.gov.uk)

Supported housing

3.13 The provision of supported housing is a key element of some providers' core purpose. Supported housing accommodation makes up around 15% of the sector's stock, with particular concentrations among small providers.[14] Much supported housing and support services activity, especially where reliant on local authority contract funding, is inherently low-margin and is vulnerable to fluctuating income and costs, or changes in government policy. Failures to provide adequate services can have severe impacts for supported housing tenants, including some of the most vulnerable people housed by providers.

3.14 Many local authorities have seen substantial reductions in income and increased costs as a result of the pandemic, and this may place further downward pressure on support contracts. Pre-existing staffing pressures in supported housing from workforce shortages have been exacerbated by labour market dislocation, immigration restrictions, and the upcoming requirement for staff working in a CQC-registered care or nursing home to be fully vaccinated from November 2021. Providers face increased costs from wage inflation, higher insurance premiums, and as a result of enhanced hygiene measures. Some providers have looked to supplement contract incomes by bidding for support contracts for higher vulnerability tenants.

3.15 Boards of providers with significant supported housing or support contracts must ensure they understand funding risks, including stress testing against increased costs, loss of contracts, and the commissioning of revised or new services. Boards will need to ensure that the delivery of adequate services to tenants is not threatened by lack of staff. Boards of providers tendering for contracts in unfamiliar areas of support need to fully understand the wider risks involved, such as increased safeguarding risks, and have robust systems of oversight and effective mitigation strategies in place.

3.16 The addendum to the 2018 Sector Risk Profile highlighted specific risks around specialised supported housing provided on a leased basis.[15] The risks identified in this addendum continue to be a significant concern. Boards of such providers must ensure that they are able to manage interruption to their cash-flows, including from any possible changes to government policy.

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[14] Private registered provider social housing stock in England - GOV.UK (www.gov.uk)

[15] Lease-based providers of specialised supported housing - GOV.UK (www.gov.uk)

Costs and inflation

3.17 Providers' costs are expected to rise over the next few years, in part due to reprofiling of spending previously delayed by COVID-19 restrictions alongside planned remedial safety works and energy efficiency improvements to existing stock. Failure to manage their cost base effectively could impact on providers' resilience, with reductions in free cash flow, margins, and interest cover.

3.18 There is significant uncertainty about prospects for inflation as the UK and global economy comes out of the pandemic. Inflation is forecast to rise significantly in the short term, with the Bank of England expecting CPI inflation to temporarily reach 4% in Q4 2021 as a result of energy and other goods prices.[16] Labour market and supply chain disruption are likely to continue to affect the prices and availability of goods and services, with costs for specific items rising much faster than this average. Producers of energy-intensive materials such as steel, bricks and cement are facing substantially rising energy costs. Construction input cost inflation in August rose at the second-fastest rate on record as firms face severe shortages of materials and lack of available transport capacity.[17] Staffing costs have increased to fill gaps in capacity created by employee moves, overseas worker availability, and skills shortages.

3.19 Boards will need to fully understand their cost base and capital requirements, ensuring that a range of inflation assumptions, including differential assumptions, are factored into their stress testing. The potential for high CPI inflation in the 12 months to September 2021 may represent a significant increase in providers' maximum permitted rent inflation for 2022/23, and Boards will need to consider a wide range of factors in reaching decisions on rent increases charged to tenants.

[16] Monetary Policy Report August 2021 – Bank of England (bankofengland.co.uk)
[17] UK Construction PMI August 2021 – IHS Markit/ CIPS (markiteconomics.com)

Rent setting

3.20 Both private registered providers and local authority registered providers are required to set rents in line with the government's *Policy Statement on Rents for Social Housing* as set out in the Rent Standard.[18] The Rent Standard requires an annual inflation increase of no more than the Consumer Price Index (CPI) plus one percentage point, over five years from April 2020. Charging the correct rents to tenants is a fundamental aspect of being a social housing provider. Failure to set rents correctly or inappropriately applying exceptions can lead to over-charging tenants and undermine business plans. This can have significant impacts on a provider's reputation with stakeholders and calls into question a provider's system of internal controls and board's assurance on this.

3.21 Overall compliance with rent regulations appears strong for both private registered providers and local authorities, who were required to submit rent data to the regulator for the first time during 2020 (SDR 2020, LADR 2020).[19] Service charges are not governed by the same factors as rent. However, providers are required to comply with the expectations of the *Policy Statement on Rents for Social Housing* which states providers should endeavour to keep increases for service charges within the limit of CPI plus one percentage point to help keep charges affordable for tenants.

3.22 Boards should ensure that they have adequate assurance on the quality of their organisation's internal controls on rents to ensure compliance with all regulatory requirements. Similarly, Boards should ensure that rigorous systems are in place to set and manage service charges and that they adhere to all legal requirements in this regard.

3.23 We have previously published an addendum to the 2019 Sector Risk Profile on setting rents in social housing, highlighting some of the themes that we found in our engagement with providers on rent.[20] Rent compliance will continue to be an area of scrutiny for us as the regulator, and issues with rent setting will continue to be reflected in providers' regulatory judgements or through regulatory notices.

[18] Rent Standard and guidance - GOV.UK (www.gov.uk)
[19] Private registered provider social housing stock in England - GOV.UK (www.gov.uk)
[20] Setting rents for social housing - GOV.UK (www.gov.uk)

Rental income and arrears

3.24 Rental income accounts for the large majority of the sector's income. Frequently this rental income is supported by government benefits such as Housing Benefit or the housing element of Universal Credit. Changes to benefits policy and the administration of benefits can have implications for providers' rent collection. Some providers have also diversified into the private rented sector – this income can fluctuate more than social rental income and introduces additional risks. Failure to appropriately manage rent collection and arrears can ultimately impact providers' financial viability.

3.25 Mean current tenant arrears increased to 4.0% in Q1 2020/21 at the start of the pandemic, but these subsequently have fallen back to pre-pandemic levels. Latest quarterly survey data show average (mean) current tenant arrears at 3.5% in Q1 2021/22, consistent with Q1 2019/20.[21] Notwithstanding this, there is the potential for further pressure on arrears. Reduced benefit incomes, continued benefit cap freeze, the potential for higher tenant unemployment as government support for the economy winds down, and well as increased energy costs may all increase financial pressure on tenants over the coming months.

3.26 Boards will need to continue to ensure rental income risks are appropriately managed. Boards will need to demonstrate that they understand the implications of increased arrears, as well as how each provider's composition of tenures, geography, and stock type will dictate the nature of any potential issues, stress testing against falls in income and establishing mitigations for this. Where providers have diversified into the private rented sector, Boards must understand the commercial risk associated with private sector rents and have assurance that the level of return is commensurate with this and that risks are appropriately balanced.

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[21] Quarterly Survey for Q1 (April to June) 2021 to 2022 - GOV.UK (www.gov.uk) Mean rent collection rates 98.8% in Q1 2021/22

Data integrity

3.27 Accurate, up-to-date, complete, and consistent data are fundamental for Boards to monitor areas such as rent setting, financial management, stock condition, health and safety, and meeting consumer standards. Board oversight, control, and decision making is undermined by failure to maintain data integrity or by data isolated in siloed systems.

3.28 Boards must have assurance that data integrity is appropriately managed, including ensuring adequate quality controls and robust audit trails are in place, identifying critical data and Information Asset Owners, establishing process maps, and implementing appropriate software solutions such as error detection.

3.29 Accurate and timely data underpins our engagement with providers. We consider failure to manage data integrity to be indicative of a poor internal controls assurance framework. Failure to provide accurate and timely data that meet regulatory requirements will be reflected in the judgement of a provider's compliance with regulatory standards.

Data security

3.30 Providers gather many types of data in the course of their activities and have a duty of care to tenants and staff to protect this data against a backdrop of increasing data security risks. Failure to adequately ensure the security of data risks a breach of trust between the provider and its stakeholders, damage to services, potential penalties, and harm to tenants.

3.31 The widespread adoption of remote working and increased online service delivery during the pandemic has allowed more opportunities for phishing, malware, and ransomware attacks. These have included high-profile instances of public sector and not-for-profit organisations falling victim to such attacks in the last year. Remote working has also increased the likelihood of staff having devices lost or stolen when away from the office environment. Many providers have also collected more data on tenants and staff during the pandemic, increasing exposure to data protection risks.

3.32 All providers must comply with the Data Protection Act 2018, and Boards must seek assurance that their IT security function is safe and secure and that security vulnerabilities are appropriately mitigated. Boards must also understand the risks of processing personal data with third parties, including the need to undertake due diligence on third parties' security measures, using standardised contractual clauses where necessary, and documenting where data is located.

4. Operational risks – development

Low-cost home ownership and market sales

4.1 The development of new housing – both social and non-social – remains a key priority for government and providers continue to play an important role in meeting this demand. Some providers develop units for sale to meet their strategic objectives, as well as to generate surpluses to cross subsidise other activity. However, exposure to the housing market brings its own set of risks to manage, including price increases or scarcity in material and labour costs, volatility in market prices or slowdowns in sales volumes, and impairment risks from joint ventures.

4.2 Providers reprofiled development forecasts in response to COVID-19 disruption, planned increases in major repairs expenditure and the new Affordable Homes Programme.[22] Forecasts for development have now broadly returned to pre-pandemic levels, with 378,000 units forecast to be developed over the next 5 years across all tenures (FFR 2021). While the proportion of units developed for sale remains lower than 2019 forecasts, low-cost home ownership and outright market sales continue to make up a significant part of the sector's current development programme, accounting for 39% of units to be developed over the next five years (2019: 43%). Development of units for sale remains concentrated in a relatively small number of providers, with the top ten providers accounting for around a third of the 111,000 low-cost home ownership units and half of the 39,000 market sale units developed by the sector.

4.3 A number of providers undertake further market sale activity through entities in which they hold a non-controlling interest (mainly joint ventures). An additional 27,000 units are forecast to be developed for market sale in this manner, now representing more than 70% of those market sale units sold by sector-controlled entities. Despite a buoyant housing market during recent months, the expected margin on new market sales units over the next five years remains lower than pre-pandemic forecasts (FFR 2021: 24%, FFR 2019: 30%).

4.4 Boards must assure themselves that they understand the implications from the potential for lower than forecast sales income, stress testing against feasible but severe scenarios for house prices and transactions. Boards must understand the extent to which impairments of joint venture investments could affect registered providers, for instance through financial covenant calculations. Boards must understand the risk of default and factor the risk of impairment into their investment decision-making process, stress testing and control framework.

[22] Affordable Homes Programme 2021 to 2026 – GOV.UK (www.gov.uk)

Construction process risks

4.5 The process of development itself can entail significant risks that require effective oversight and management. Ongoing disruption to supply chains and labour markets and increased input costs may risk delays to developments, resulting in potential financial impacts or reputational damage. Failure to satisfy statutory safety and quality requirements and stakeholder expectations could result in reputational damage, or potentially harm to tenants.

4.6 There was significant disruption to construction as a result of the pandemic and leaving the European Single Market and Customs Union. New requirements from the White Paper, Fire Safety Act 2021, and Building Safety Bill with regard to decarbonisation, building safety, and design will increase the expectations for new build homes. The establishment of the New Homes Ombudsman will increase scrutiny and accountability on failings in construction of new homes.

4.7 Boards must have sufficient assurance that new properties meet stakeholder expectations and satisfy all legislation regarding building regulations, health and safety requirements, and regulatory standards. This is the case regardless of whether the development is delivered by the provider itself or acquired from a third-party developer or joint venture. Boards must manage counter party risk for third-party contractor development, considering possible impacts on contractual or planning obligations and establishing appropriate plans to mitigate exposures.

4.8 Boards should also be aware of changing and increasing stakeholder expectations with regard to construction methods as the government looks to drive improvements in decarbonisation, building safety, and design. Where these represent significant differences from providers' current practices, Boards should ensure they have sufficient assurance that new properties will meet statutory requirements and they fully understand the implications of any new development approach. Boards must understand the risks inherent to development, including stress testing against increased costs or delays to programmes.

5. Finance and treasury management

Existing debt

5.1 Debt accounts for the majority of financing in the sector. As at the end of March 2021, providers had agreed facilities of £111bn and £85bn drawn. The proportion of bond finance has grown rapidly since 2008 and today the drawn amount (£45bn) currently exceeds the funding drawn from banks. More than 70 providers now hold published ratings and while many bonds have more-limited covenant suites, providers need to still carefully ensure that these are respected. Failure to manage relationships with lenders or compliance with covenants can threaten financial viability and undermine the achievement of strategic objectives.

5.2 Increased spending on existing stock due to remedial safety works, catch up on repairs, and energy efficiency improvements has seen providers' interest cover deteriorate. The sector's forecast aggregate interest cover over the next five years is 161% (FFR 2021), down from 165% in 2020 and 181% in 2019. Nevertheless, market confidence in the sector remains high. There is evidence that providers have been taking advantage of low fixed rates to refinance existing debt facilities. The proportion of fixed rate debt (greater than one year) is 80% in 2021/22, falling to 75% in 2025/26, although this still leaves a significant volume of debt vulnerable to changes in interest rate.

5.3 The deadline for retirement of London Inter-Bank Offered Rate (Libor) is the end of 2021, and failure to complete Libor updates risks providers losing control of their variable interest costs. New facilities since April 2021 already incorporate the Sterling Overnight Index Average (SONIA) as their basis, and work on updating existing debt instruments was reported either completed or well advanced with most funders by the end of September 2021.

5.4 Boards must ensure appropriate treasury management and governance processes are in place to effectively monitor existing loan covenants to mitigate the risk of breaches. Boards must also stress test against changes in underlying assumptions to understand and mitigate against unforeseen requirements for financing or increases in interest costs. Where Boards are in doubt of any aspect of the changes to Libor they should seek immediate independent advice.

New debt

5.5 Providers' strategic purposes, objectives and risk appetites differ, and therefore suitable funding options also vary. Providers are forecasting greater reliance on debt to deliver increased investment in existing stock and delivering new supply, and this increases exposure to interest rate risks. Failure to maintain investor appetite and manage interest rate exposure would lead to reduced capacity to deliver new developments and capital investment in existing stock.

5.6 Sector debt is forecast to increase from £85bn drawn and repayable in 2020/21 to £114bn in 2025/26, £6bn higher than 2020 forecasts and £12bn higher than 2019 forecasts (FFR 2021). This includes a requirement for £47bn in additional planned facilities to be agreed over the next five years. Providers' credit ratings are currently clustered in the low-single A band, but these are vulnerable to downgrades from weakened operating performance or further falls in the UK sovereign rating. Falls in provider ratings, especially below investment grade, would see decreased investor appetite and upward pressure on costs of capital. Non-investment grade providers are likely to encounter a combination of reduced investor appetite and increasing cost of capital and in such a scenario they may be tempted to use more innovative and/or complex financing products with unfamiliar risks.

5.7 Recently, providers have shown increased consideration of Environmental, Social and Governance (ESG) linked funding and Sustainability Linked Loans, which is reported to have widened the number of interested investors. While such funding can be slightly cheaper, there can be extra costs associated with evidencing delivery against targets.

5.8 Boards should ensure that decisions around which debt funding option is right for their business stems from their activity, rather than the other way round. It is crucial that Boards have the skills and expertise to understand and effectively challenge financial advice, especially when considering innovative and/ or complex funding structures.

5.9 Where providers are agreeing to targets as part of ESG funding Boards will need to ensure that these targets are deliverable and that these do not undermine Board control over the business. Boards will need to manage relationships with investors and lenders and manage counterparty risk, particularly where long-term debt may be sold on to other parties. Boards should ensure they undertake robust stress testing to understand the sensitivity of business plans to decreases in investor appetite and potential changes to the cost and availability of debt.

5.10 As the regulator, we do not favour one funding approach over another, but we do expect to see evidence that a critical assessment has been undertaken with use of independent, specialist external advice as appropriate, and that Boards are able to effectively understand and challenge this.

Alternative funding models

5.11 While debt accounts for the majority of providers' funding, alternative models have become increasingly prevalent in the sector. An increasing number of private investors have looked to invest in social housing products. This investment has been through the establishment of funds providing equity to (usually) for-profit registered providers, by way of lease arrangements, or through direct equity investment in registered providers. These approaches can bring their own risks in addition to those applicable to all providers.

5.12 Private investment has allowed some providers to target rapid growth in units under management, but this funding has the potential to be more expensive than debt. Furthermore, rapid growth can heighten the risk that managerial capacity may not keep pace. A number of for-profit providers have recently been established with tightly defined roles within wider corporate structures, with no staff and most business functions outsourced.

5.13 It is for Boards to assess the risks associated with any new types of funding they take on. Boards must ensure that there are no potential conflicts from the influence of funders over strategic direction and that the board remains appropriately independent. Boards must bear in mind that they cannot outsource their responsibilities and ensure that they own and manage the risks associated with specific business models.

Pensions

5.14 Employer payments towards pension provision are today a standard part of most sector employees' overall remuneration. All schemes have membership and legal obligations. The balance of financial risk will vary depending on many factors including whether schemes are defined contribution or defined benefit.

5.15 Many providers have exposure to defined benefit schemes. The financial obligations are remeasured on a triennial basis, creating risks of increased costs where schemes are found to be in deficit. Long-term reductions in interest rates and ongoing weak gilt yields have resulted in many schemes being under-funded. Changes from 2030 to align the calculation of the Retail Prices Index (RPI) with the Consumer Prices Index including owner-occupiers' housing costs (CPIH) will likely further reduce funding levels for many schemes.

5.16 Boards of providers should understand the potential for changed contribution levels and the implications of this. Although most providers have taken a proactive approach to managing this risk, where appropriate Boards should seek independent advice from relevant professionals to understand their risk exposure.

Fraud

5.17 Providers are exposed to the risk of fraud through their procurement and provision of services. Where fraud occurs, it is reputationally damaging and can have significant implications for providers' financial viability and delivery of strategic objectives, disrupting their services and eroding tenant and stakeholder confidence. Fraud also has the potential for wide-reaching indirect impacts upon other organisations and businesses. Providers are also exposed to the risk of money laundering and terrorist financing risks through their every-day operational activities.

5.18 There has been a substantial increase in attempted fraudulent activity during the pandemic as criminals have looked to take advantage of disruption to normal routines and increased remote working. Substantial increases in online payments fraud, identity theft, location spoofing, call services, and phone number spoofing have all been seen. Widespread changes to working practices may mean that providers' normal systems of internal controls are less robust, while moves to remote working and cloud-based services may introduce new vulnerabilities.

5.19 Boards must ensure that they have robust internal control procedures in place, and seek appropriate professional advice when fraud is identified. Boards should also understand their responsibilities under anti-money laundering legislation.

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RSH regulates private registered providers of social housing to promote a viable, efficient, and well-governed social housing sector able to deliver homes that meet a range of needs.