Homes &
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Agency

Sector Risk Profile 2017

July 2017
Homes and Communities Agency

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Executive summary

Registered providers need to ensure they are able to meet new challenges while continuing to deliver their core objectives. The regulator will seek to understand how boards of providers gain their own assurance that they are aware of the risks their organisation faces and are managing them effectively.

Health and safety

- Meeting health and safety obligations is a core responsibility for registered providers. While the outcomes of the range of investigations being undertaken are not yet known, the recent tragic fire at Grenfell Tower re-emphasises the importance of all registered providers, both housing associations and local authorities, having comprehensive and effective systems in place to identify and manage all health and safety requirements which apply to their homes.

Economic risks

- While the finances of the social housing sector have, in general, strengthened over the past five years, much of this has been the result of a favourable economic climate, including buoyant house prices and low interest rates. Parts of the sector have chosen to utilise that strength to take on additional financial risk to deliver strategic goals. In order to manage those risks, it is essential that registered providers ensure that their stress testing fully explores all the risks that they face, both individually and in combination, and that carefully thought through mitigation plans are developed, recorded and, if necessary, implemented.

Risks to rental income

- Boards need to manage risks to core social housing rental income. While the sector has adapted its business plans in response to the rent cuts, inflation is now higher than has been the case in recent years. This makes the effect of the rent cuts more acute, further emphasising the need for registered providers to keep control over their costs. Roll-out of Universal Credit is now beginning to accelerate and registered providers will need to keep their preparations under review to minimise any risk of cash flow problems as their tenants are switched over to the new system.

Supported housing risks

- Supported housing providers need to ensure that they monitor their sources of funding and understand the impact to their business should funding diminish or contracts fail to be renewed. Supported housing providers must consider a range of scenarios and need to have exit strategies in place where there is a material risk that contracts are likely to come to an end. As well as meeting health and safety requirements in relation to the physical building, registered providers that provide supported housing should ensure that they comply with relevant care requirements.

Development risk

- The sector is forecasting a further significant increase in development intended for sale, either for shared ownership or outright market sale. For the first time the majority of the funding for future development will come from sales receipts, rather than grant or debt. It is vital that boards understand the market risks associated with sales revenues, and have plans in place should these revenues fail to be delivered.

Debt

- While the cost of new debt has fallen to further historic lows, the sector needs to raise around £24bn in new debt over the next five years. At the same time, some registered providers still hold substantial amounts of bank finance with margins as low as 20 basis points. Boards must understand the impact of any increase in rates and the effect of new margins negotiated with lenders on their business plans and compliance with loan covenants.

Deregulation

- We noted in last year's Sector Risk Profile[1] (SRP) that the deregulation measures in the Housing and Planning Act 2016 (HPA 2016) would create new freedoms and responsibilities for registered providers but also strengthen the need for boards to ensure that they are in full control of decisions around constitutional changes and disposals. Boards will need to ensure that they are fully informed so that they can manage the reputational, legal, and financial risks and where necessary have access to legal advice.

[1] https://www.gov.uk/government/publications/sector-risk-profile-2016

These measures came into force in April 2017. We have therefore included with this document an annex that reflects the regulator's experience of dealing with consent applications and sets out some issues that boards will need to consider in the changed regulatory landscape. Boards should also note that in July 2017 the regulator revised its Tenant Involvement and Empowerment Standard[2] to clarify expectations on tenant consultation prior to disposals outside the sector.

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

[2] https://www.gov.uk/government/publications/regulatory-standards

1. Introduction

1.1 The SRP sets out the regulator's view of the range of strategic, financial and operational risks that face registered providers of social housing. These risks have evolved over recent years, as the sector has undergone an unprecedented degree of change in response to developments in the economic and policy environment. Registered providers are forecasting that this level of change will continue over the coming years, and indeed that it will accelerate. It is important that boards understand and can manage the new risks posed by increased development activity and diversification into building for sale and other non-social housing activity. While diversified activities can support registered providers' core activities, boards must assure themselves that this is the case and it does not come at the expense of their fundamental role.

1.2 At the time of writing, the full causes of the terrible fire at Grenfell Tower have not yet been determined. Police and Fire investigations are on-going and the government has announced a Public Inquiry. It will be important that governing bodies of registered providers (boards and councillors) respond as necessary to the conclusions of these inquiries. As a priority in the short term, providers should cooperate with the Department for Communities and Local Government and other statutory agencies to identify, and where necessary, undertake remedial work, taking account of on-going advice available from the government's Building Safety Programme.

1.3 Boards and councillors must continue to ensure that they meet the requirements of the regulator's consumer standards, including the obligation under 1.2(b) of the Home Standard[3] to 'meet all applicable statutory requirements that provide for the health and safety of occupants in their homes'.

1.4 Meeting health and safety obligations is a core responsibility for registered providers. Boards and councillors must ensure that they have effective systems in place to identify and comply with all health and safety obligations (including but not limited to gas safety, fire safety, electrical safety, asbestos and legionella).

[3] https://www.gov.uk/government/publications/regulatory-standards

1.5 Boards and councillors must be aware of their on-going obligations when contracting out delivery of services and should not assume because a service is undertaken by a third party that there is no inherent risk to their business. Contracting out delivery does not contract out the responsibility to meet the requirements of legislation or standards. It is incumbent on all who are involved with the negotiation and execution of contracts to understand the risks involved and to employ prudent control strategies to mitigate them.

1.6 Registered providers must understand fully all their obligations in relation to tenants' health and safety. Boards will wish to access professional advice in the event that they are not clear on their statutory obligations. Should any provider identify failings in relation to health and safety which indicate that they are not in compliance with the Home Standard, they must notify the regulator and take action to resolve the issues immediately. As well guidance in its publication Regulating the Standards[4], the regulator publishes each year a Consumer Regulation Review[5] to help governing bodies understand the lessons from the previous year's consumer regulation cases.

1.7 While the sector is more diverse than it ever has been, the primary responsibility of registered providers remains the safe and effective management of the social housing stock. Boards must have assurance that they meet this responsibility, and have the skills, capacity and systems in place to be able to meet all of the regulatory standards.

Strategic risk management

1.8 It is the role and responsibility of boards to assure themselves that they fully understand: the degree of risk that their organisations take and are exposed to; the probability and impact of these risks materialising; and that they have mitigating strategies in place to manage them effectively. The Housing and Planning Act 2016 has created new freedoms for registered providers.

4 https://www.gov.uk/government/publications/social-housing-regulation-regulating-the-standards
5 https://www.gov.uk/government/collections/consumer-regulation-review

1.9 Boards of registered providers are also responsible for the delivery of their strategic objectives. Business plans should identify uncertainties that may impact on the delivery of those strategic objectives and have appropriate risk management measures in place. It is therefore vital that boards obtain sufficient evidence and assurance that their business plans are based on sound assumptions and that the objectives of their organisation can be realistically achieved. Boards must consider their risk appetite as a starting point for agreeing their business plan and ensure there is a measured approach to managing risk as an integral element of business plans being agreed.

1.10 In order to manage risk effectively, it is essential that providers' financial and management data is accurate, consistent and timely, both to permit internal decision-making and to meet regulatory requirements. A number of high profile attacks in the past year have also emphasised the importance of cyber-security. The regulator relies upon providers supplying it with timely and accurate data. This is fundamental to the success of co-regulation. Failure to provide accurate and timely data may be reflected in our judgement of a provider's compliance with the regulatory standards.

1.11 As the sector landscape continues to change, registered providers need to be able to respond to an increasingly uncertain and complex operating environment. The degree of change that the sector has witnessed in recent years is unlikely to abate, and broader issues, including the progress and outcome of Britain's exit from the European Union, may affect individual sectors of the economy, including housing. Over and above the key operational and financial risks outlined in this document there are a range of strategic risks that boards need to consider, as appropriate to their objectives.

1.12 This year, the SRP seeks to highlight the key risks to the sector in their longer-term context, drawing on both outturn data and forecast data to draw out the key trends that are reshaping the sector. It will be important for boards to understand these trends, and to ensure that they continue to have the skills and capacity to respond to them and manage the risks that they could pose to their continued viability.

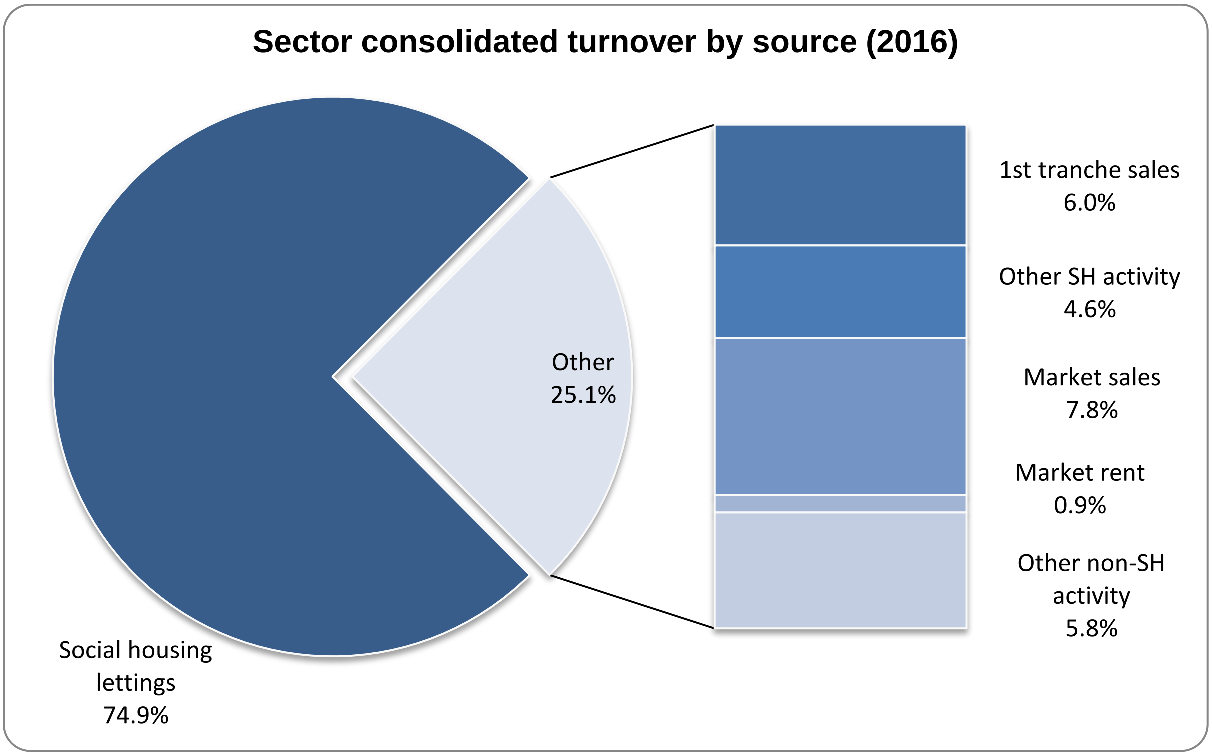
1.13 The regulator will continue to seek assurance on registered providers' risk management through its programme of IDAs, annual stability checks and review of quarterly surveys, and will reflect its level of assurance through its published judgements.

2. Operational risks – existing stock

2.1 It is essential that boards understand and can manage the risks associated with the existing housing stock, both those affecting the management and maintenance of the properties themselves, and risks to the income that rent generates for reinvestment and debt servicing.

2.2 Notwithstanding diversification over recent years, the core of the sector's activity remains social housing management. Around 2.5m of the 2.75m homes that the sector owns are either general needs social housing or supported housing. The sector's forecasts suggest that social housing lettings activity will still be responsible for c.67% of turnover by 2020-21.

Graph 1



Stock management and housing quality

2.3 Boards and councillors are responsible for ensuring that tenants' homes meet the requirements of the Decent Homes Standard or, where relevant, any higher standards of design and quality that applied as a condition of publicly-funded financial assistance when the home was built. They must also meet all applicable statutory requirements that provide for the health and safety of the occupants in their homes and ensure a prudent, planned approach to repairs and maintenance of homes and communal areas.

2.4 Boards are responsible for meeting the Home Standard and other consumer standards. Although we regulate the consumer standards reactively, that does not lessen the obligation on registered providers to comply. Registered providers and local authorities must have robust and effective systems in place to ensure that they meet their legislative and regulatory obligations. The regulator will act where a breach of a consumer standard is found, and that breach causes potential or actual serious harm to tenants, as we have done on a number of occasions, including for breaches of fire and gas safety requirements. The regulator intends to publish a further version of its annual Consumer Regulation Review in the autumn to highlight lessons from its experiences in this area.

2.5 Even where a breach of the consumer standards does not lead to harm to tenants, the reputational damage from getting services to tenants seriously wrong or mishandling complaints can be serious and long-lasting. It can take significant time, effort and resource to recover, to the detriment of achieving a registered provider's other objectives. Boards must manage reputational risk in considering the adequacy of compliance systems and processes, as well as how they are communicating with tenants and other stakeholders.

2.6 Effective planning and delivery of responsive and planned major repairs are also important for continued compliance with the economic standards. A lack of investment in the existing stock can store up long-term problems and incur greater costs in the long term by increasing the need for responsive repairs or by making properties more difficult to let. The regulator seeks assurance through IDAs that registered providers' approach to asset management is well integrated into their overall strategies and based on a good and up to date understanding of stock condition.

Rents and rental market exposure

2.7 Until 2015, the sector had enjoyed a relatively high degree of certainty from its core income steam. However, the sector is now in the second year of the rent cuts required by the Welfare Reform and Work Act 2016[6] (WRWA), which will continue until 2019-20.

2.8 The regulator will seek assurance that registered providers have a comprehensive understanding of the rent regime. The conditions of the rent regime vary for different property types. There are a limited number of exceptions from the rent reductions for certain types and providers (e.g. for Community Land Trusts and Almshouses). There is therefore a risk that providers fail to comply with the terms of the legislation if they do not correctly categorise their stock. If there are uncertainties over the application of the rent reductions to particular properties, providers should seek legal advice to mitigate this risk. As registered providers are required to comply with all relevant law, we expect registered providers to take care to ensure that adherence with the legislative regime for rents has been considered before they certify compliance with the Governance and Financial Viability Standard.

2.9 Where we become aware of any material non-compliance with the legislative rent requirements, we will investigate and determine the appropriate regulatory response.

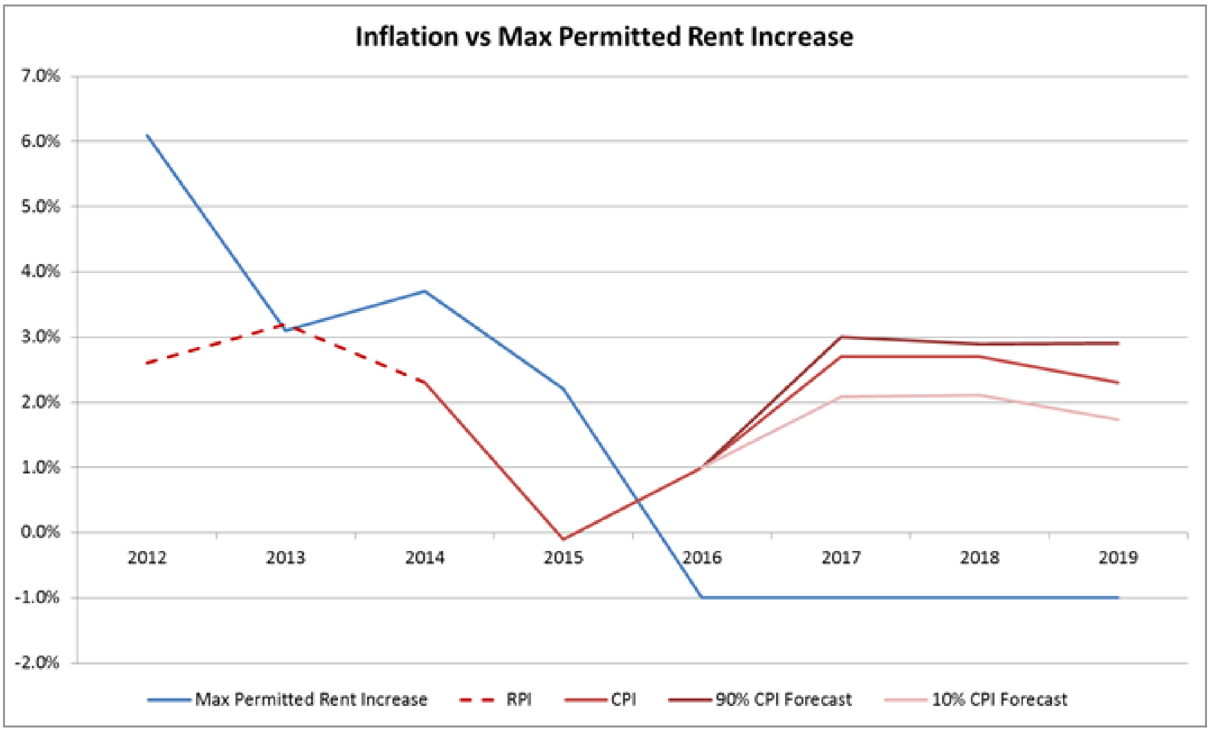
2.10 Some registered providers have diversified into the Private Rented Sector (PRS). While this can provide additional income, PRS stock has the potential to increase cash flow volatility as rent levels can fluctuate as the market does. Boards will need to understand and ensure that the risk of falling market rents and any knock-on effects on Affordable Rents can be mitigated. They must also understand different regional and product markets they operate in and the expectations of different tenants before making investment commitments. The regulator will seek assurance that boards appreciate the opportunity cost and risk of entering into this activity.

[6] http://www.legislation.gov.uk/ukpga/2016/7/contents/enacted

Inflation

2.11 CPI (Consumer Price Index) has risen at its highest rate in four years rising above the Bank of England inflation target[7] of 2%, and reaching 2.6% by June 2017. Notwithstanding an unexpected decrease from 2.9% the previous month, CPI is forecast to continue to rise throughout 2017. Other measures of inflation, of particular importance to registered providers, are forecast to increase more sharply than general inflation. There has been a significant uplift in the Building Cost Information Service (BCIS) forecasts for construction costs, with prices expected to rise by 4.2% in 2017/18, up from 3.1% in the November 2016 forecasts, continuing to rise (with a slight dip in 2018/19) to 5.1% in 2021/22. Graph 2 below demonstrates that in the past, registered providers would have been relatively insulated from an increase in inflation due to the existence of an index-linked formula linked to CPI (pre 2014: RPI). This is no longer the case.

Graph 2[8]



[7] http://www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx

[8] Max permitted rent increase based on guideline limits set out in the Rent Standard Guidance 2015.
These guideline rents were set with reference to inflation in September of the previous year.
The rent inflation outturn figures, however, are based on September of the named year (e.g. in 2012 the permitted increase is based on September 2011 and the outturn inflation relates to September 2012).
Forecast figures from June 2017 compiled by Her Majesty's Treasury.

1.12 Should inflation continue to rise, it could place significant pressure on some registered providers' business plans. This may be heightened for registered providers who have extensive development or reinvestment programmes. While registered providers revisited their business plans in 2015 following the announcement of the rent cuts, inflation was significantly lower at that point. It is therefore important that boards fully understand their cost base, ensure that a range of inflation assumptions are factored into their stress testing, and have plans in place to absorb rising inflation particularly over the period in which rents will continue to fall.

2.13 Changes in CPI will also affect index-linked finance, in particular, sale and leaseback arrangements, which some registered providers have entered into over recent years. We expect registered providers to have mitigations in place to manage the financial impact should the cost of funds rise in line with, or higher than, inflationary expectations.

Welfare reform

2.14 Since many registered providers' tenants receive Housing Benefits, existing welfare reform measures, in particular the roll-out of Universal Credit will need careful management in order to protect social rental income. The latest Quarterly Survey[9] shows that 92% 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 the majority of tenants are not yet in receipt of Universal Credit so plans may not yet have been fully tested by the roll-out of the new system.

2.15 A number of additional welfare reform measures announced in the 2015 Summer Budget and Autumn Statements have now been implemented. This includes freezing of working-age benefits for four years from April 2016, changes to tax credits and the removal of automatic entitlement to housing benefits for those aged 18 to 21 from April 2017. From Autumn 2016, the cap on benefits for an out-of-work working-age family was reduced to £23,000 in London and £20,000 elsewhere, and currently affects around 20,000 provider households[10].

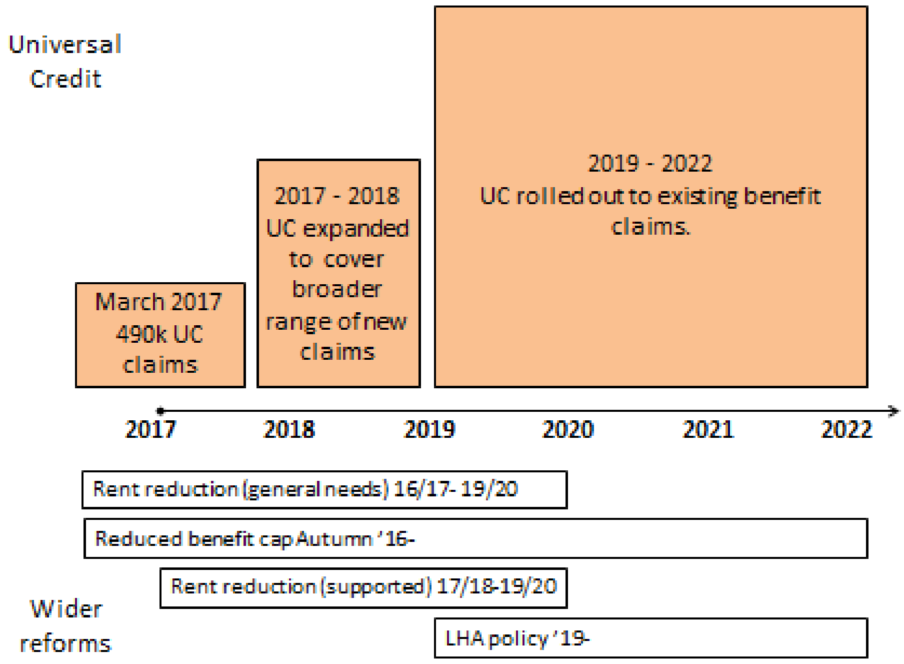
[9] https://www.gov.uk/government/publications/quarterly-survey-for-q4-january-to-march-2016-to-2017
[10] Department for Work and Pensions data, February 2017

2.16 The November 2016 Autumn Statement[11] confirmed plans to restrict Housing Benefit to the Local Housing Allowance (LHA) rate for households in social housing. This policy will apply from April 2019 for those general needs tenants on Housing Benefit with new tenancies signed after April 2016, and to all those on Universal Credit. The LHA policy and reduced benefit cap have a more significant effect on particular locations, household and property types, and development schemes based on Affordable Rents. For example, large households are most likely to be affected by the reduced benefit cap while under-35s in general needs could see benefits constrained by the LHA Shared Accommodation Rate. The LHA policy will apply to all supported housing tenants from April 2019, with top-up funding proposed to mitigate funding shortfalls (see supported housing section below). It is essential that registered providers understand the relationship between the rents that they charge, and the local LHA rates that their tenants will be able to claim. Boards should assess the potential revenue risks and mitigations required based on their particular stock and tenant profile.

2.17 Universal Credit, in particular direct payment of housing costs to tenants, remains the reform with the greatest potential risk for most registered providers, (although the differing geographical impact of other measures, such as the LHA cap, will mean that they are of particular importance to some individual organisations). While the pace of roll-out has picked up in the last year, it is still relatively limited to date. Up to March 2017, there were 490,000 live Universal Credit claims across all tenures in Great Britain, compared to a total potential pool of around seven million claims. However, in July 2016 the Department for Work and Pensions (DWP) announced that roll-out will accelerate from October 2017 and should be completed by 2022. The diagram on the next page sets out the key welfare reform timelines.

[11] https://www.gov.uk/government/topical-events/autumn-statement-2016

Diagram 1



2.18 Evidence from the Direct Payment Demonstration Projects (DPDPs) and early roll-out of Universal Credit run by DWP suggests that there is a risk of an increase in arrears in the short term during the initial transition to the new system. The extent of any risk will depend on the exposure of each registered provider, the effectiveness of their rent collection, and the implementation of government measures such as alternative payment arrangements for tenants. As well as potential cash flow 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 they have been making in advance of these reforms.

2.19 Registered providers must stress test the implications of the full range of welfare reform measures. In addition, they must also ensure that cash flow performance and forecasts are regularly reviewed in order to mitigate against risks to liquidity.

2.20 The regulator will seek assurance on the quality and effectiveness of strategies to manage the range of potential impacts of welfare reform measures on rent collection, including evidence that demonstrates how these feed into business plans, financial forecasts and stress testing.

Supported housing

2.21 Supported housing has been a relatively low-margin activity for many 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. While the introduction of the rent cuts was deferred for a year for supported housing, social rents for most supported housing properties were reduced by 1% per annum from 2017/18.

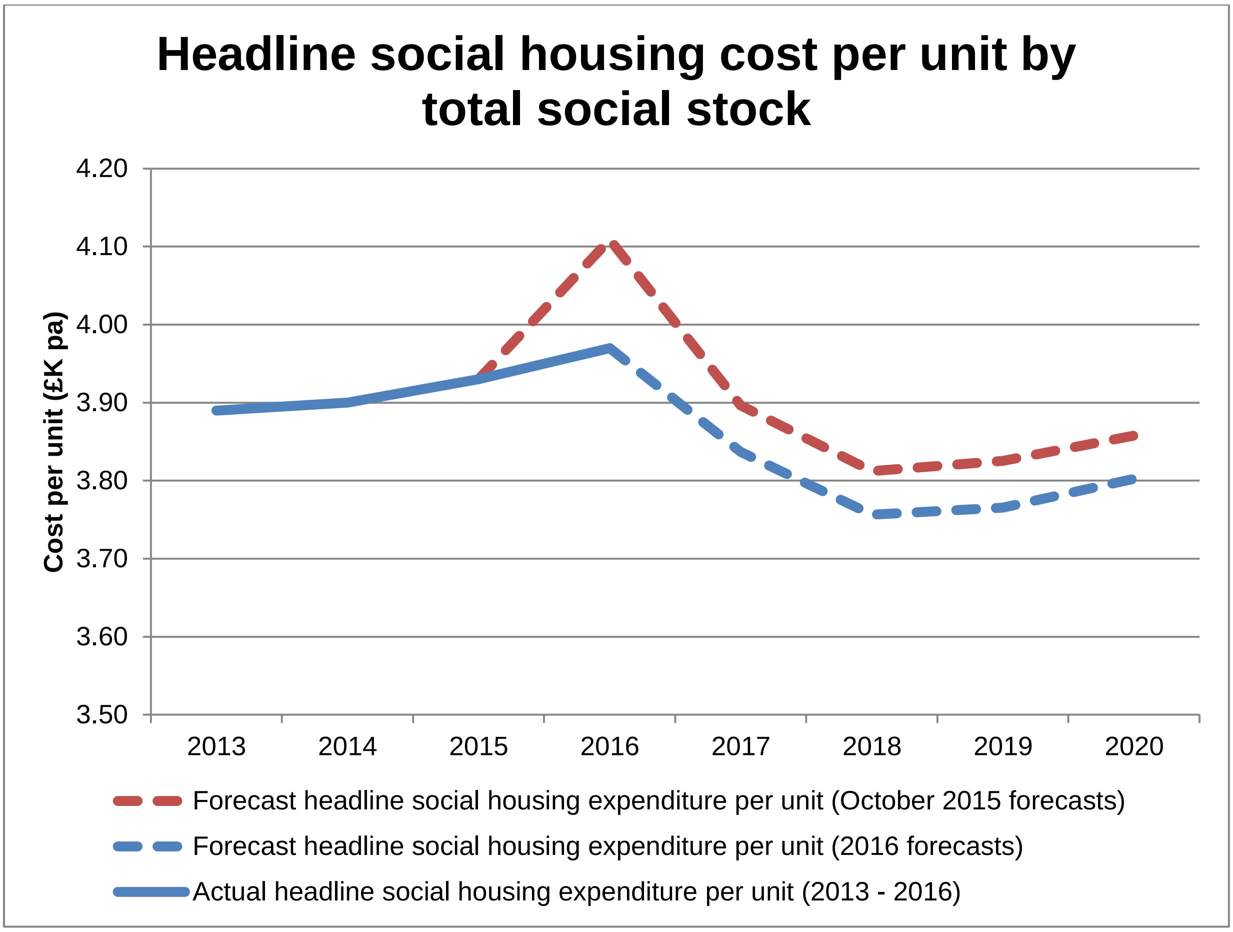
2.22 The November 2016 Autumn Statement confirmed plans to restrict Housing Benefit to the LHA rates for all households in supported housing from April 2019, and to introduce a new local top-up fund. In contrast to general needs, the LHA Shared Accommodation Rate will not apply to tenants in supported housing. The LHA policy is likely to limit housing benefits payable to tenants in large numbers of supported housing schemes, and introduce a greater reliance on local authority or other funding if existing services are to be delivered. Supported housing with high rent and Housing Benefit eligible service charges are most likely to be affected, in particularly in lower-value areas where social rents are closer to LHA rates.

2.23 The government published a consultation on future funding in November 2016. This set out an intention to continue to fund supported housing at current levels through top-up funds disbursed by local authorities, and to establish separate funding arrangements for short term and emergency supported housing. At the time of writing, the government response to this consultation has not been finalised. Pending further announcements, it is important that registered providers with significant supported housing operations understand the potential implications of the LHA policy on their businesses, including on maintenance of compliance with both social housing and care regulatory standards and statutory requirements. If these effects are material, registered providers must have a clear strategy to manage risks involved in securing top-up funding from April 2019.

Cost efficiencies

2.24 In recent years, pressure on rental income has led most registered providers to drive down costs and improve operational efficiencies. The 2016 FFR projections indicate that headline unit costs[12] are projected to fall by 4.3% between 2016 and 2020. This is demonstrated in graph 3 below. The average (mean) headline social housing costs per unit were £3,970 per annum and increased 1.0% between 2015 and 2016. Initially, major repairs and maintenance costs have fallen faster than management costs as registered providers reconsidered immediate investment plans in light of the social rent reduction. Reductions in managements costs often take longer to implement, and can require up-front expenditure (for example redundancy payments, or investment in new IT systems). Boards must have assurance that any planned savings programmes are deliverable, and have contingency plans in place in the event that savings are delayed, or are not delivered at all.

Graph 3[13]



[12] https://www.gov.uk/government/publications/2016-global-accounts-of-private-registered-providers

[13] **(Source data: Global Accounts & 2016 FFRs)**

2.25 The regulator will seek assurance that boards have a strategic approach to delivering value for money that is embedded throughout the business, and focusses on the effective delivery of organisations' objectives. It is important that registered providers do not simply cut costs but look to make the optimum use of their own resources, and assets, and carefully consider how their delivery structures and returns on investment help to achieve their objectives, allowing them to sustain investment in the existing stock as well as new supply.

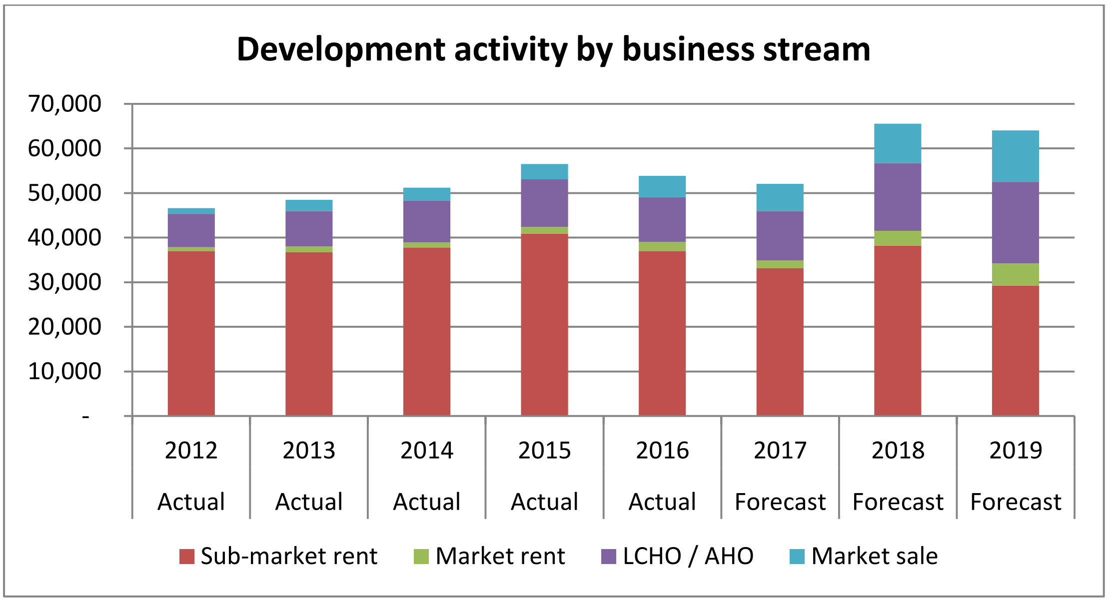
2.26 It is important that boards have an understanding of any implications of cost reductions for the achievement of the business plan, and ensure that short term savings do not undermine compliance with the regulatory standards. Deferral of repairs expenditure may ultimately undermine the quality of the housing stock, and may lead to greater expense in the long run.

2.27 Following the Grenfell Tower fire, boards are seeking to understand any essential remediation works required where they have stock identified and affected by the government's Building Safety Programme. This may lead some registered providers to further reappraise their business plans, and plans for investment in existing stock.

3. Operational risks – New supply and diversification

3.1 To date, a large majority of the sector's development has remained either sub-market rent (increasingly Affordable Rent) or shared ownership. However, in recent years there has been an increase, albeit from a low base, in the level of market-facing development, both for outright sale and for market rent, to cross-subsidise social housing supply. And in future registered providers are forecasting a significant change in the tenure mix of future supply. Graph 4 below demonstrates the number of units that large registered providers (those with more than 1,000 properties) have developed, and are planning to develop by tenure.

Graph 4



3.2 In 2012, registered provider groups delivered c. 1,300 new properties for sale on the open market, and around 800 homes for market rent. In total this constituted less than 5% of the sector's overall development that year. By 2016, this had risen to 4,800 properties for outright sale and around 2,000 homes for market rent (12.5% of overall supply). The contribution of market sale and market rent units is forecast to accelerate. If the most recent forecasts are delivered, by 2019 less than half of all units developed will be for sub-market rent. The sector is projecting to build around four times more properties for sale (outright and shared ownership) by 2019 in comparison to 2012.

3.3 These forecasts may change to some extent given the announcement of additional grant funding specifically for rented tenures in the Autumn Statement 2016, which may lead to some registered providers delivering an increased proportion of their forecast development as rented stock rather than for sale.

3.3 Nonetheless, it is clear some registered providers' business plans will in future be much more heavily predicated on sales revenues. This will mean that these organisations will be more exposed to sales risk and their business models will be more pro-cyclical. Absolute levels of market sale activity remain very concentrated in a small number of registered providers. In 2016, the sector's ten largest registered providers generated 80% of the sector's turnover from outright sales, and the majority of the forecast increase in sales activity also sits with these organisations. However, there are also many registered providers who will be either new entrants or growing their exposures to market rent, market sale and shared ownership markets over the next five years.

3.4 Development of homes for sale is a key risk area for registered providers and exposes them to a range of housing markets. In much of the country, particularly London and the South East, house prices have risen strongly over the past five years, mitigating sales risk and providing growing sales revenues from shared ownership and open market sale to cross-subsidise the provision of rented housing. However, past experience suggests that this is not guaranteed to continue; many providers faced significant challenges in 2008-09 when sales of shared ownership properties slowed and reduced the cross-subsidy available for development of other tenures. There is some evidence that house price growth, particularly in London, has begun to slow in 2017. Boards of registered providers must therefore ensure that their organisations fully understand the risks associated with market sale activity, and have the appropriate skills to manage them. Providers' approach to risk management and stress testing should include identifying mitigations to sudden and significant market slow-downs, and even market shut-downs for example, triggered by changes to mortgage providers' appetite for lending. Providers should understand the risks associated with all market-facing income sources i.e. market sale, shared ownership first tranche sales and stair casing, right-to-buy and asset management sales. In particular, the regulator will maintain a sharp focus on those registered providers where the EBITDA–MRI SH Interest cover ratio suggests that they are reliant on asset sales in order to meet current and future interest payments.

3.5 The increased focus on market-facing products is also reflected in the way that registered providers intend to finance their planned new development. For the first time, in aggregate across the sector, sales revenues are forecast to surpass combined grant and debt as a means of financing new development. Over the five years to 2021 the sector is forecasting total investment in new supply of £55bn. Of this £31bn[14] is to be funded by sales revenues. Registered providers must understand the range of other risks associated with development programmes in the event of a wider market downturn and have robust plans in place to mitigate this risk. This could include for example the financial impact if sales revenues fall or the risk of impairment for registered providers who have acquired significant amounts of land for future development.

3.6 This forecast increase in sales revenues is intended to support a marked increase in the level of overall supply. The latest financial forecasts show that the sector is planning to develop more than 280,000 new units over the next five years – equivalent to around 10% of existing stock, with peak delivery of over 65,000 units pa forecast for 2018. The scale of development ambition is varied across the sector. A small number of registered providers are planning to develop homes equivalent to more than 20% of existing stock over the next five years. Where registered providers are planning a significant increase in the ambition of their development programmes, the regulator will seek assurance that registered providers have the appropriate skills and risk mitigation strategies in place in the event that development does not proceed as planned.

New build quality

3.7 Perception of poor quality of new build is a potential reputational risk for both individual registered providers and the broader sector as recent press coverage has shown. This is not unique to the registered provider sector. However rectifying problems and dealing with complaints (which can be covered by the regulator's consumer standards, depending on tenure) can take considerable time, effort and resources. Boards of developing registered providers must consider carefully how they gain adequate assurance that new homes are built to achieve relevant standards and planning requirements, as well as any standards which apply as a condition of publicly funded financial assistance, and that there are robust arrangements in place to ensure that appropriate build quality is delivered (regardless of the contractual route through which the homes are procured). Providers will also need to consider how they manage the experience of the occupiers of new homes.

[14] Source: FFR 2016

Diversification

3.8 In more recent years the sector has become increasingly diverse, investing in a wide range of products mainly in response to the key risks to the core rental business set out above. These include a wide range of non-social housing activities as well as development for sale, for example student housing, property management, commercial property and nursing homes. These activities are commonly undertaken through unregistered subsidiaries or joint ventures. As of March 2017, 141 registered providers had investment in, or lending to, non-registered subsidiaries, special purpose vehicles or joint venture companies. The total value of this indebtedness is reported to be £5.4bn, an increase from £3.2bn in March 2016. Half of the exposure is within three registered providers; almost one third of the exposure is within one registered provider.

3.9 Where registered providers engage in activities with non-registered entities, the regulator will seek assurance that boards understand the associated risks and that social housing assets are not exposed to undue risk by potential puncturing of ring-fences by guarantees, recourse and impairment effects.

3.10 Diversification can be an important way in which registered providers can increase surplus in order to cross-subsidise their core social housing purpose as well as meeting their wider social or charitable objectives. It is important, however, that boards of charitable associations have assurance that investment in non-social housing activity is consistent with charitable vires and is likely to produce a level of return that is commensurate with the risks involved; if necessary boards should seek appropriate advice. Providers should stress test their assumptions about rates of returns on investment in diversified activities.

3.11 It is also important that any registered provider who has entered into or who is entering into diverse ventures has the appropriate range of skills in place both at Executive and Board level in order to proactively challenge performance. Moreover, registered providers must also have mechanisms in place to mitigate risks to the core social housing business and satisfy themselves that current and future social housing tenants are not put at risk should business ventures fail or projected revenues not materialise.

4 Financial and treasury management risks

4.1 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.

4.2 Although sales revenues have become increasingly important, and are forecast to become more so, the sector is still reliant on long-term debt. Total debt has grown rapidly over the past five years, as the lower grant rates associated with the Affordable Rent programme required greater levels of debt to support new development. Total debt[15] has grown by 25% since 2012 to over £66bn in 2016. This is forecast to rise to around £77bn by 2020-21. Although the forecast £11bn increase in debt required represents the net increase in debt, the actual level of finance that is required to support the sector development programme over the next five years is in the region of £24bn once repayments of existing debt are factored in.

4.3 The sector is forecasting that interest cover will continue to strengthen over the coming years, although at a slower rate over the next two years, as the rent cuts continue. Registered providers must therefore consider the risk that higher interest costs on new and floating rate debt would have on their business plans and take into account a range of potential interest rate movements.

4.4 The regulator continues to highlight how important it is for registered providers to have precautionary measures in place that enables them to protect and withstand extreme and unexpected shocks to their business. Effective treasury management therefore remains essential. This includes undertaking multi-variate stress testing to help identify potential vulnerabilities and to gauge its resilience to adverse developments that are pertinent to each registered providers business to ensure adequate liquidity, continued compliance with loan covenants and the viability standard.

[15] In order to measure on a like-for-like basis at a Group level, the 2012 data has been drawn from the HCA Quarterly Survey of private registered providers for Q4 (January-March) 2012 and the 2016 data from the Global Accounts 2016 and 2020/21 forecast data FFR 2016

Existing debt

4.5 The latest Quarterly Survey[16] results show that registered providers are generally well placed to service financial commitments and repay and refinance loans as they fall due. The sector currently has £14.8bn of undrawn facilities in place while it raised £0.9bn of new finance in the quarter from banks and capital markets. Cash balances stood at £5.8bn.

4.6 While the pace of development has increased over the past couple of years, encouraged by grant funding from the latest affordable homes programmes, these funds will be deployed as development plans are implemented. At the same time, there is a significant amount of debt falling due for repayment, over the next two years. Bank loans are now typically available on shorter terms than in the past; terms of five, seven and ten years are most commonly available. This means that registered providers must seek new finance promptly and ensure that they have sufficient security in place in order to arrange new finance on time.

4.7 Some registered providers still hold substantial amounts of bank finance with margins as low as 20 basis points. A continuing risk to registered providers is that funders may seek ways in which to recover any shortfall resulting from the low borrowing margins on long-term debt issued before the financial crisis of 2008-09. For example, the bank may require renegotiation of the margin when the registered provider seeks consent for another revision to its loan agreement.

4.8 EBITDA MRI[17] (Earnings Before Interest, Taxation, Depreciation and Amortisation – Major Repairs Included) Interest cover has grown steadily over the past five years rising from 115% in 2012 to 158% in 2016[18], due to a combination of falling interest rates, and the maturing of the Large-Scale Voluntary Transfer (LSVT) sub-sector. Not only have borrowing costs not risen, as they had been forecast to do, they have continued to fall with the Bank of England further cutting the Base Rate to 0.25% after the European referendum, with all-in borrowing costs following suit.

[16] https://www.gov.uk/government/publications/quarterly-survey-for-q4-january-to-march-2016-to-2017

[17] Includes receipts and costs from current asset sales, but excludes development spend and receipts from fixed asset sales

[18] Source: FVA entity level

4.9 Since the introduction of the Financial Reporting Standard 102 (FRS 102), there have been significant movements in registered providers' accounts to reflect reporting changes. Movements including derivative reporting are anticipated to increase year-on-year volatility within registered providers' accounts. Registered providers must satisfy themselves, either through advice from their own appropriately qualified staff or from appropriate advisors that they can comply with new financial covenants under a range of scenarios. Registered providers need to also think about their exposure to counterparty risk amongst new and existing funders and ensure that they understand the exposures faced by their counterparties in both the capital and banking markets.

4.10 The regulator will continue to collect data through the quarterly survey and will actively engage with registered providers where there are concerns over liquidity, covenant compliance with existing debt facilities, or availability of security for new facilities.

New debt

4.11 New debt is available from three main sources:

a) Bank debt;
b) Bonds – both through public and private placement;
c) Non-debt finance, including off-balance-sheet structures.

Investment in new supply and existing assets continues to be primarily funded through the use of internally generated reserves, particularly from property sales, and to a lesser extent by new debt. Gearing, measured as debt as a proportion of the net book value of housing properties, increased by less than 1% to just less than 50% between 2015 and 2016. The 2016 FFR projections indicate that gearing will remain broadly unchanged between 2016 and 2020; this may well reflect the degree of investment in new and existing stock through registered providers' internal reserves and sales receipts. Nevertheless, the regulator expects registered providers to assess their performance against a wide range of scenarios to demonstrate that they can remain compliant with loan covenants.

4.12 As at March 2017, the central forecast was for the London Interbank Offered Rate (LIBOR) to increase to 0.7% in 2018/19, then steadily increase to 1.1% in 2021/22[19]. Both of these are below the equivalent forecasts in the last update set out in November 2016 of 0.9% and 1.3% respectively; with many forecasters predicting that there will not be an increase in the Base Rate until 2019. If inflation increases, the Bank of England may choose to increase policy rates in order to curb inflation. Other disturbances in the financial markets could increase the margins that lenders seek and this is something registered providers must be aware of when running their sensitivity testing.

4.13 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 2017, further economic uncertainly following the EU referendum result prompted a further reduction in the Bank Rate. The median margin charged by banks for new five-year debt is c. 1.25%, although the range has widened as banks have differentiated offers based on credit quality. Combining this with the LIBOR forecasts gives a predicted average 'all-in' rate on new floating rate debt of c.1.7% in 2018/19 increasing to c. 2.1% in 2021/22, for forecasts at March 2017.

4.14 All forms of finance carry a level of risk and reward and the regulator does not have a view of which types of finance are more suitable. Registered providers must think carefully about their debt structures and ensure that they are matched to their type of business activities. This must include consideration of what mitigations can be built into contracts or hedging strategies to mitigate exposure to potential macroeconomic and other changes to the operating environment.

4.15 To meet long-term financing needs, providers have also looked to instruments such as index-linked finance which is often embedded in sale and leaseback structures. These sources of finance offer an opportunity for providers to meet their growth ambitions, but also pose different risks than the more traditional funding they have typically accessed. Boards need to make sure they fully understand any proposed financial instruments, including how they are different to more traditional sources of debt, for example the impact of any indexing, and whether the instrument is fully off-balance-sheet if that is an objective, and gain sufficient assurance that the organisation's treasury management function is managing them effectively.

[19] http://www.bankofengland.co.uk/statistics/pages/yieldcurve/default.aspx

Hedging strategies

4.16 While the majority of the sector’s bank debt is fixed through embedded derivatives, some registered providers have made the alternative choice of drawing variable rate debt and then purchasing a standalone derivative – typically an interest swap – either from the same or another funder.

4.17 The use of these instruments can be an appropriate mitigation against interest rate risk and other exposures. At the same time, however, derivatives are regularly Marked to Market (MtM) by the counterpart and the purchaser can find under contract that they have to provide cash or other security within a very short period. Registered providers must regularly monitor between the counterparts formal MtM dates, undertake sensitivity analysis of the full range of potential future movements and ensure that cash and security are in place to accommodate potential security calls.

Pensions

4.18 Boards must proactively manage a range of risks including pension liabilities. Although pension risks will differ between the two main types of scheme (defined benefit and defined contribution), common to all schemes are issues of scheme membership and legal obligations. Registered providers must review the options available to them and ensure that they seek independent legal advice where appropriate. The impact of the introduction of FRS102 means that the present value of the agreed deficit contributions will be shown as a liability and may give rise to material changes in the statement of comprehensive income.

5. Risk management in a changing regulatory context

5.1 The deregulation measures in the Housing and Planning Act 2016 (HPA 2016) have created new freedoms (and therefore responsibilities) for registered providers. Boards must ensure that they receive all of the information they need so that they can manage any associated reputational, legal, and financial risks of undertaking any of the activities which were previously subject to the regulator's consent. The Governance and Financial Viability Standard[20] expects registered providers to have governance arrangements that ensure that registered providers safeguard the reputation of the sector; 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.

5.2 Given that the de-regulation measures came into force in April 2017, we have included as an annex to this SRP, a report on some of the issues encountered in operating the regulator's consents regime. It is intended that the report will help registered providers think through the issues and risks associated with disposals and mergers that boards will need to consider in the changed regulatory landscape.

[20] https://www.gov.uk/government/publications/regulatory-standards

Annex: De-regulation

1. Introduction

The purpose of this document is to share the regulator's experience from the operation of the consents regime and to highlight some of the issues it has encountered. We hope that this document will prompt discussion about the implications of the deregulatory measures and how boards can have assurance that relevant risks are being managed.

Many providers have welcomed the new freedoms introduced by the Housing and Planning Act 2016, which included the removal of the requirement to seek consent for restructures (and other constitutional changes) and for the disposal of social housing, and have been considering how they will manage these effectively.

We are aware that some providers placed value (and in some cases reliance) on the regulator's involvement in consents to provide assurance before the transaction was finalised. This paper aims to help inform boards of a range of considerations they may need to factor into their deliberations where they are taking decisions under the new regime. Notwithstanding the removal of consents, providers will need to continue to operate in line with regulatory standards and meet any legal and other obligations.

Providers should be aware of changes in requirements made by other bodies as a result of deregulation. For example:

- The Homes and Communities Agency (HCA) has introduced new reporting requirements about the disposal of grant funded property that apply *before* the disposal is completed as part of the 2017 Capital Funding Guide[21].

- The Charity Commission has issued guidance on requirements that apply to disposals made by providers that are registered charities[22]

Boards will wish to understand how the issues outlined in this document may affect their organisation and what, if any, additional safeguards or controls may be needed to ensure that the organisation continues to meet all relevant requirements.

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[21] The GLA has issued a consultation on requirements for grant inside Greater London

[22] www.gov.uk/government/news/commission-reminds-housing-associations-of-changes-to-the-land-disposal-framework

2 Restructures

Mergers and other business reorganisations can enhance a provider's ability to achieve their objectives and deliver improved value for money. However, they can also present challenges and risks that boards need to identify and manage. Boards considering business reorganisations will want to determine what the business needs to do during and after the restructure to ensure it continues to meet its objectives and regulatory requirements. Whilst the regulator's consent is no longer needed for a restructure, the regulator will consider an interim grading for a provider once it has restructured and, in doing so, will look at how the provider's risk and financial profiles will be affected by the changes.

The areas highlighted below are based on the regulator's experience of considering consents for restructures. They highlight where incomplete or poor quality information has meant there have been gaps in our, and therefore boards', assurance on the nature of risks in the change being proposed.

Business cases and managing the change

As a matter of good governance, boards will wish to have a sound business case for any proposed restructure. This is likely to identify the key drivers and aims of the proposals which will link to the objectives of the organisations involved. The business case also needs to explain how the key aims of the proposal are to be achieved, with timescales and how success – in whatever form – is going to be measured.

During the consents regime it was very unusual for the regulator to turn down a proposal for a merger. However, there were many occasions where the regulator asked questions about the business case that often gave providers helpful feedback and sometimes caused boards to question whether they should continue with the proposals. For example, did boards:

- understand the overall objectives for the restructure?
- understand the benefits of the restructure and why these represent a better outcome than could otherwise have been achieved?
- have assurance that the risks of the restructure, including the risks inherent in the implementation process, have been identified and to understand how the proposed benefits outweigh those risks (including recognition of any opportunity costs)?
- understand the risks and benefits and gain assurance that regulatory standards will be complied with throughout the process (and within the new structure) and that the information provided at each stage enables them to make sound decisions?

Due diligence

Boards should be clear that undertaking a process of due diligence is a critical safeguard in any restructure. It is important that boards have assurance that there has been a suitably comprehensive, independent and robust due diligence process, set at an appropriate degree of materiality. This includes considering whether those carrying out the due diligence are able to undertake the work with sufficient independence and give the board sufficient warning of any material risks. Our experience shows that sometime a desire to 'get the deal done' can influence the type of due diligence specified. Boards should remember that before the deal is completed they are the custodians of their organisation and must act in its best interests.

Other areas where our experience of the due diligence process has led to us asking questions included:

- where due diligence has identified areas for concern, have boards reviewed plans to deal with these issues and mitigate any associated risks?

- have boards ensured that the evidence generated by the due diligence process is used in preparing the business case and is taken into account when making decisions about whether to progress the proposed restructure?

Risk management

Since corporate restructures can present significant risks to providers, it is important that boards understand the degree of any new or augmented liabilities and plans to manage those, especially those that could impact on regulatory compliance. In particular, since restructures are likely to result in a different configuration of legal entities, it is important that boards have a clear understanding of how and when risks to social housing assets might crystallise.

Boards and executive teams

Based on our experience of constitutional consent applications it is not always evident that boards have considered the skills and experience necessary to effectively lead, control and manage the change process or the reorganised business. This is both at board and executive level and the regulator often sought further assurance on this point. Boards will want to ensure that the board and executive team, after restructure, has the capability to lead and manage what is likely to be a larger and potentially more diverse organisation with all the challenges and risks that will present.

In deciding whether to make severance or redundancy payments (and the appropriate level of any such payments) to departing staff, boards should ensure that they have effectively discharged their responsibilities. This will mean being properly supported and advised and considering the implications of the decision on the sector’s reputation as well as that of their own organisation, following the guidelines set down in their chosen code of governance or code of conduct.

3 Conversions of corporate form or charitable status

A proposal to convert to charitable status is one area where the regulator has consistently had to seek additional assurance. Boards need to have a clear understanding of what it means to be charitable and how they can still achieve their objectives within a charitable framework. Where boards decide to convert to charitable status, they should have assurance about how being a charity will be reflected in the organisation’s approach to governance.

Our experience has been that providers do not always fully consider how charitable status must permeate day to day business. This is especially important given that the provision of housing is not of itself a charitable activity but has to be carried out for a charitable purpose, such as relief of poverty. The Charity Commission website has full details about charitable purposes under the ‘Setting up a charity’ section.

Finally, boards will want assurance that appropriate legal advice has been taken on the position of tenants in any corporate conversion. Tenants can be impacted where they were assured tenants with a statutory right to buy and when considering consent applications, the regulator has expected to see evidence of how that has been taken account of in decision making and what arrangements had been made to preserve tenants’ rights.

Changes to governing documents

A provider's governing document should be integral to all decision making procedures and the wider governance of the organisation. Our experience from consents identified sometimes confusing, inconsistent or outdated governing documents, particularly where providers did not follow any particular sector model.

Boards will wish to ensure that their governing document is clearly drafted and effectively supports the organisation's objectives and governance. Failure to do so could mean that the board takes action or a decision that is ultra vires or that an action has to be delayed as the rules are not clear.

It is important that boards are also aware of equality law requirements, especially where the organisation's governing document limits, or is being amended to limit, their housing provision to particular groups based on a "protected characteristic"[23] as set out under the Equality Act 2010. This legislation provides "exceptions" to charities in meeting particular requirements but in order to fall within an exception, charities must be able to demonstrate that they meet certain tests. Charities are also required to keep any restriction of service based on protected characteristic under review.

In addition, where governing documents do not restrict services based on a protected characteristic, but restrictions in service on this basis are operated in practice, boards should be aware that this also engages equality legislation.

4 Disposal and charging of social housing assets

Whilst the requirement to seek consent to dispose has been withdrawn, there are still a range of considerations that providers must take account of when deciding to dispose of social housing. Previously these considerations were addressed through the consent process and the regulator sought assurance where necessary. Experience indicates that providers were not always fully aware of their legal or regulatory obligations or the implications arising from particular disposals.

[23] The Equality Act 2010 refers to disability, gender, race, sexual orientation, age, religion or belief, age, pregnancy and maternity, gender reassignment, and marriage and civil partnerships as protected characteristics.

Unless social housing is disposed in a way consistent with sections 72-76[24] of the Housing and Regeneration Act, it remains social housing and subject to certain requirements. These requirements include the levels of rent that may be charged, restrictions on alternative use, (particularly where homes are funded with public subsidy) and restrictions about to whom a disposal can be made of a property subject to a secure tenancy. In terms of rent, in particular, this means that providers cannot simply increase rental levels on social housing such that it ceases to be social housing but must comply with the rent setting provisions of the Welfare Reform and Work Act 2016 (and regulations made under it) and, where relevant, the Rent Standard, as well as any grant conditions.

The regulator has set out below some areas that providers should consider based on its experience of considering disposal consents. These cover:

- Balancing objectives
- The position of tenants
- Charitable status
- Finance disposals.

Balancing objectives in a disposal

The regulator sets economic and consumer standards, all of which need consideration when disposals are made with inevitable tensions between the requirements of the different standards. Where these tensions arise, boards will need to balance the competing interests of, for example, value for the business and tenant interests.

As an example of this, providers may find that they receive a higher purchase offer for a property from a buyer outside the sector than from another registered provider. In financial terms the offer may be attractive, but the provider will need to weigh up the interests of tenants against the interests of the organisation and make reasoned judgements based on the relevant considerations.

[24] Sections 72-76 of the Housing and Regeneration Act 2008 states that social housing only ceases to be such if it sold out of the sector, if the leasehold interest held by the provider expires or if the regulator makes a direction to declassify the property as social housing.

The position of tenants

The position of tenants is something that boards will need to consider in a range of disposals. The regulator has been clear about its concerns about tenanted disposals out of the sector and has recently made changes to the Tenant Involvement and Empowerment Standard[25] as a result of the deregulatory measures to clarify and strengthen the requirements on consultation with tenants.

For regulatory purposes, “out of the sector” refers to any disposal of social housing assets to any entity which is not a registered provider. This includes:

- disposals to (unregistered) group members or joint ventures
- disposals to other charitable organisations.

Providers must ensure that any consultation with tenants is meaningful. Tenants will need to see accurate information that is sufficient to allow them to take an informed view. The consultation should be actively seeking views rather than just advising what is proposed and setting out the implications.

The regulator’s experience has been that providers do not always advise tenants of the full implications of the changes for them in the proposed disposal and we have often sought additional assurance about the extent of consultation. Providers will wish to ensure that their consultation with tenants sets out (for any tenanted transfer, even those within the sector), where relevant, the matters listed below:

- any changes to the tenancy agreement
- any changes to service provision
- any potential for changes in rents or fees for care and support
- the impact on rights of any individual tenants, such as a secure tenancy[26], right to buy or right to acquire (including, for example, sale of a garden or access land when a tenant has a right to buy or right to acquire).
- the potential impact on tenants of being outside the regulated sector such as loss of rent controls, decent homes standard requirements, the monitoring of ongoing financial viability.

[25] www.gov.uk/government/publications/regulatory-standards

[26] The restrictions in the legislation (s171 of the Housing and Regeneration Act 2008) on disposals of the landlord interest in secure tenancies remains in force so disposals can only be made to another non-profit registered provider.

- the status of the provider (such as charitable or non-profit) and how this compares to the status of the proposed new landlord drawing out any restrictions, or other frameworks, under which the buyer operates.

Providers should remember that consultation is always important, even where the tenants themselves may not be able to participate directly. This might be, for example, in cases of supported housing/care where the tenants have special needs and may not be able to understand information included in the consultation. Providers will wish to ensure that effective alternative or additional arrangements are put in place with representatives of those tenants.

When considering the sale of social housing where support or care is provided, the regulator saw cases where providers had failed to carry out due diligence or follow up concerns raised during that exercise. Providers will want to ensure that any potential purchaser is capable of running the service effectively, for example, where relevant, providers can look at the Care Quality Commission record of the proposed buyer or seek assurance on the relevant skills and experience of the proposed buyer.

There may also be implications for tenants from finance disposals. One example that the regulator has encountered is with sale/lease and leaseback transactions. Providers should take appropriate advice to understand how, if at all, tenants' right to buy or right to acquire is impacted by the transaction. The provider's leasehold interest in the property may be for a shorter period than is necessary for right to buy and right to acquire to apply. Providers will also want to ensure that the arrangements contain provision for substitution of properties if the right to buy or right to acquire is exercised by a tenant.

Providers should understand the impact of defaulting on lease payments and consider what additional safeguards might be provided and note that the regulator's moratorium powers are unlikely to cover properties under leaseback arrangements. In some cases, this has been addressed by creating a "contractual moratorium" that replicates, so far as possible, the regulator's powers.

Charitable status

Many registered providers are exempt rather than registered charities. This means that those providers are, largely, not subject to direct regulation by the Charity Commission. However, those providers are still subject to the general requirements of charity law and should take account of guidance issued by the Charity Commission when considering disposals and seek appropriate advice. This should include the Charity Commission guidance on managing conflicts of interest.[27]

This is especially relevant when providers are proposing to dispose of properties at less than best value. Sales to other charitable organisations or to other organisations within the same group still engage charity law obligations and the requirement on the disposing charity to get best value for the charitable assets remains (except in the case of a disposal to another charity benefiting the same beneficiary group). It is likely to be value to the disposing provider (charity) that is relevant in such circumstances and not value to the group as a whole.

Providers also need to consider their charitable objectives when disposing at less than best value with the aim of increasing home ownership in a particular area. Whilst in many cases this will be in keeping with their objectives, we have seen examples where a provider has decided it cannot go ahead with the scheme as planned after seeking legal advice about its charitable obligations.

Charging social housing assets

As well as the physical disposal of the property the consents regime also made the charging of properties to finance agreements subject to regulatory consent. For the most part this was carried out under the general consent and did not require proactive regulatory consent. However, there were times when this requirement led the regulator to challenge boards about the decisions they had made. In particular, the regulator often challenged providers over a desire to use non-debt forms of finance and the use of social housing assets with pension deficits.

[27] https://www.gov.uk/government/publications/conflicts-of-interest-a-guide-for-charity-trustees-cc29.

Non-debt finance

Although the regulator rarely turned down applications for charging assets, on occasions it would ask boards questions about the decision to use the finance product selected. These questions included:

- Where the instrument was complex, how far did all board members understand it and did they have the skills within the organisation to manage the complexity?
- Did the board understand how the covenant structure of the new instrument interacted with their existing covenant structures?
- How far was the instrument in line with their existing treasury strategy and articulated risk appetite?
- Did the board understand how the instrument would perform when the business was under stress?

Whilst many providers had compelling and convincing answers when asked these questions, this was not always the case. Where boards could not answer these questions this raised governance and viability issues for the regulator.

Pension deficits

The regulator is aware of the scale of the pension deficit in the sector and the considerations that providers sometimes give to using social housing assets as security for these deficits. The regulator has said in the past that it would be unlikely to consent to such an arrangement, although it would consider each proposal on a case by case basis.

Providers need to consider whether using social housing assets in this way is an efficient use of resources or whether it unduly fetters the discretion of a provider to raise finance or utilise their assets. Providing such security may be an open-ended commitment of uncertain duration. This introduces uncertainty for a provider and potential risk that must be fully considered. It may, for example, be a cause for concern for other lenders in a potential default situation or make it more difficult for the regulator to align the interests of all parties during a moratorium.

5. Conclusions – overarching themes

Whilst the regulator did not often refuse a consent application, by raising questions and requiring providers to reflect on these before the transaction went ahead, providers had an opportunity to modify their proposals to ensure that they continued to comply with the standards, as well as charitable and other relevant requirements.

The types of issues raised were not confined to any particular type or size of provider but spread across the sector. Providers should be mindful that the risks of non-compliance with the range of regulatory requirements may crystallise if providers overlook some of the considerations outlined in this document. The potential detriment, delay and cost of addressing these issues after the fact can far outweigh the significance of the initial issues.

The regulator's view is that for the most part these errors and omissions are not about the overall standard of governance in the sector but about managing compliance risks across disciplines within the business. For example, finance and treasury teams may not consider tenants' rights to buy or rights to acquire when considering a new finance arrangement.

Boards should ensure that the organisation is sighted on the potential interplay of risks from across the business when considering their compliance obligations and take appropriate advice at an early stage.

As organisations that usually have a social purpose, and often charitable status, stakeholders have high expectations of registered providers. In a dynamic and rapidly evolving sector, it is important that boards recognise such expectations, both in exercising new freedoms and delivering their responsibilities to stakeholders, including tenants.