Llywodraeth Cymru
Welsh Government

Sector risks facing housing associations in Wales

March 2016

Purpose:

This paper should influence the sector's approach to managing risk effectively and should prove helpful in assisting Boards, the Executive Team and other stakeholders to have a better grasp of the risks Registered Social Landlords face in an increasingly complex and diverse sector.

The primary focus of this paper continues to be the risks that may cause RSL to fail to meet the delivery outcomes (standards of performance) in relation to governance, finance and landlord services.

This paper will be reviewed regularly and revised, as necessary, to reflect new and emerging significant risks to the housing association sector.

Expectations: The Regulator expect Boards to:-

- **Delivery outcomes:** Demonstrate they are meeting the 'Delivery Outcomes' set out in the Regulatory Framework. This includes adhering to the standard of governance the RSL has adopted e.g. Community Housing Cymru's Code of Governance, and providing assurance of compliance on a 'comply or explain' basis.

- **Risk management and stress testing:** Understand the business environment they operate in and associated risks and to have in place a fully considered business plan and robust risk and control framework. Boards are required to assess, manage and, where appropriate, address risks to ensure the long-term viability of their organisation. Fundamental to this approach is a combination of robust business planning assumptions combined with sensitivity/stress testing. This should include multi-variation analysis to stress test the business across the whole organisation to demonstrate the extent to which it can cope with a number of changing factors. Stress testing will help underpin the Boards' understanding of where the risks lie and inform their consideration and planning for remedial action if the risks crystallise either singly or in combinations.

- **Asset and Liability registers:** Understand their housing assets, security position and associated liabilities and have access to this information quickly in decision making and risk management.

1 Introduction

1.1 This is the first update of the paper setting out sector risks facing Registered Social Landlords (RSLs) in Wales.

1.2 The principal driver for the update is the increased risk and complexity in the RSLs' operating environment.

1.3 Although our risk based approach to regulation amplifies our expectations around risk management, we remain firmly committed to a co-regulatory approach. Boards are responsible for managing their own businesses. This means they must fully understand the risks the organisation faces and be appropriately skilled to manage them. One of the key messages in this document is that strong governance and effective risk management support each other in well-run organisations.

1.4 Where the Regulator is unable to gain sufficient assurance a Board understands the risks to its business or where there is evidence that, through poor quality decision making, it is mismanaging them, the concerns will be reflected in the published regulatory opinion and financial viability judgement reports. This will be accompanied by, where necessary, the appropriate regulatory action.

1.5 Poor governance within an organisation can often be an indicator of potential problems in the future. If a Board does not fully understand the implications of, and risks associated with, the decisions it makes, it is often unable to act quickly to resolve issues when they arise in the future. The independent review of the Cosmopolitan Housing Group (commissioned by the Homes and Communities Agency and Sanctuary Housing Group and conducted by Altair) contains a number of recommendations for Board members. It serves as a timely reminder that Boards must retain sufficient control of their Association and has the required skills in order to manage risk effectively.

1.6 The structure of this updated paper reflects feedback received from stakeholders, For example, the risks are themed in relation to governance, finance and services and provide a link to the 'Delivery Outcomes' (standards of performance) set out in the Regulatory Framework.

1.7 The risks identified in this publication have been identified through discussions with the sector representatives via the Regulatory Advisory Group, Tenant Advisory Panel, CHC Regulation Network and the Regulatory Board for Wales.

2 Operating context

2.1 RSLs face a range of risks in delivering their objectives and managing their businesses. This publication draws out those risks that are of particular concern to the Regulator at this time but recognises the broader environment in which RSLs operate. It does not seek to identify every risk that could potentially affect an individual RSL. It is essential that Boards should understand the particular set of risks and issues that confront their business.

2.2 The issues of housing supply and affordability are very high on the political agenda. Boards should consider the extent to which their strategies and business plans could cope with changes in housing policy and related areas including welfare, health and social care. Factoring in the impact of potential policy changes into the scenarios used for stress testing is likely to be helpful to achieve this.

3 Regulatory and enforcement powers

3.1 It is anticipated that, Boards will act voluntarily to address any matters of concern identified through regulatory activity. However, should this not be the case, the Welsh Ministers have the powers to intervene to require appropriate action to be taken. These powers are contained in the Housing Act 1996, as amended by the Housing (Wales) Measure 2011. These are set out in paragraphs 4.30 to 4.32 in the Regulatory Framework and could also affect capital or revenue funding from the Welsh Government.

4 Key Governance risks

4.1 Boards are responsible for ensuring effective running of their organisations. The Regulator is looking for assurance from each Board that risks faced in relation to governance, finance and landlord services are being managed effectively. Clearly, one of the major threats to the long term success of any RSL is having a Board and/or senior staff with inappropriate or inadequate skills trying to manage risks they do not fully understand.

4.2 The Regulator expects Boards to demonstrate they are meeting the 'Delivery Outcomes' set out in the Regulatory Framework. This includes adhering to the standard of governance adopted by the RSL – for example, Community Housing Cymru's Code of Governance which was launched in February 2014.

4.3 From the analysis of the regulatory assessments/opinions and our regulatory engagement with RSLs to date, we have identified a number of areas that pose governance risks , for example:

- **Governance & Leadership:** *quality of the leadership of the Board and senior management team, effective and robust relationships between the board and the Chief Executive and other senior management, board and senior management behaviours and culture in driving and managing change;*

- **Risk management and stress testing:** *further improvements are required in relation to effective risk management and multi-variant scenario stress testing of business plans;*

- **Tenant involvement and scrutiny:** *effective tenant involvement in decision making and scrutiny is essential to ensure tenants are at the heart of the organisation;*

- **Equality and diversity including Board diversity:** *RSLs' activities and services should reflect the diversity of communities where they operate and are free from discrimination and promote equality of opportunity. RSLs are expected to implement the equality and diversity requirements set out in the Equality Act 2010; as is the case in other sectors, women and other under-represented groups are under-represented on housing association Boards. Returns from RSLs in 2015 indicated that there is a wide range across the sector in relation to gender balance, from 64% to 20% women Board members with the sector average being 39%. A number of RSLs need to do more work to improve board diversity and develop comprehensive approach to equality and diversity;*

- **Value for money:** *further improvements are required in developing a comprehensive strategy for value for money, setting out efficiency outcomes to be achieved. Examples to date are limited to procurement of repairs and maintenance contracts;*

- **Data Protection and security:** *Boards are responsible for ensuring compliance with requirements of* the *Data Protection Act 1998 as the Information Commissioner may, in certain circumstances, serve a Monetary Penalty Notice on a data controller (RSL). The Information Commissioner has warned social housing organisations must keep their tenants' data secure. In February 2014 the Information Commissioner's Office* *published a report (Findings from ICO advisory visits social housing organisations) on the social housing sector, which highlighted areas where social housing organisations should improve their compliance with the Data Protection Act, as well as areas of good practice.*

- **Quality of self evaluation:** *further improvements are required by ensuring the circular guidance is followed and the evaluation is supported by a robust evidence base. The approach adopted to self evaluation is embedded in strategic planning and performance management process;*

- **Horizon scanning** – *effectiveness of Boards in 'being strategic', in forward planning, scenario consideration and the 'bigger picture' (the creative and innovative aspects of governance; be aware of the implications of the fast changing external environment.*

4.4 The underlying message is that good governance is at the heart of a strong business and that those organisations most likely to mismanage these risks are those with poor governance. Where the Regulator sees evidence of this risk materialising, it will look to intervene appropriately.

4.5 We expect Boards to have adopted a Code of Governance and provide assurance of their compliance on a 'comply or explain' basis via a statement as part of their self evaluation.

4.6 The Regulator will seek assurance that Boards understand the full (organisation-wide) impact of risks and make sure that multi-variant scenario-testing is carried out to identify those circumstances that would "break the business".

5 Key financial risks

5.1 This section sets out financial risks that will need to be considered by the Boards and which the Regulator is most concerned about. The Regulatory Framework and risk based approach to regulation is set against the continuing environment of an increasingly complex sector and a higher level of associated risks.

5.2 The Regulator expects Boards to understand the business environment they operate in and associated risks, and to have in place a fully considered business plan and robust risk and control framework. For the benefit of all RSLs, a new expectation is set out in paragraphs 5.24 to 5.28 and 5.52 in relation to development and maintenance of assets and liabilities registers. Boards are required to assess, manage and where appropriate address risks to ensure the long-term viability of their organisation. Fundamental to this approach is a combination of robust business planning assumptions combined with sensitivity testing. This should include multi-variation analysis to test the business across the whole organisation to demonstrate the extent to which RSLs can cope with a number of changing factors.

<u>Income</u>

(i) Rents

5.3 The majority of the RSL's income continues to come from social rents and recently the sector has had a high degree of certainty over this income stream due to the existence of an index-linked formula. As part of the Housing Supply Pact and the Policy for Social Housing Rents, the Welsh Government agreed the methodology for increasing social rents for a five year period (2014 to 2019), which is linked to CPI at the previous September each year.

5.4 The UK Government announced in its budget that Registered Providers in England would have to cut social rents by 1% per annum for four years. The UK Government brought forward legislation to implement this change in England and chose to use this as a mechanism to reduce the cost of the Housing Benefit element of their welfare budget. The legislation applies in England only.

The Welsh Government worked closely with key stakeholders to identify the potential implications of any change from the existing rent policy in Wales and the impact this may have on current and future tenants, social landlords and their funders. The Minister for Communities and Tackling Poverty agreed to maintain the Welsh Governments' Policy for Social Housing Rents for 2016/17. The rent uplift for Social Landlord properties covered by the policy for 2016/17 is 1.4% (previous September CPI of -0.1% +1.5%). The maximum amount a Social Landlord can increase an individual tenant's weekly rent is CPI +1.5% plus £2 (i.e. 1.4% plus £2).

5.5 It is not possible to predict future changes in the policies of the UK Government and whether they will impact on England only or whether they will also affect Wales (e.g. Welfare Reform). The Regulator will continue to seek assurance that Boards understand the impact of changes on their financial plans and business activities, together with volatility to cash flows arising from welfare reform. Assurance will also be sought on the use of appropriate sensitivity analysis and that appropriate mitigating actions to manage the potential risks have been identified.

(ii) Welfare reform

5.6 The effects of the changes are well documented and impact of these changes will vary from RSL to RSL, but they represent a change in the operating environment and potentially introduce several risks to net income that will need to be managed effectively. Sincewelfare reform changes were confirmed in March 2012, we have been monitoring how RSLs have dealt with the changes affecting them and their tenants.

5.7 RSLs have shown an understanding of the numbers of tenants affected by the most important reforms to date and have modelled a range of potential financial impacts on their business that arise as a result. Based on their findings, they have developed plans to more actively manage income collection, and targeted their resources on working with potentially affected tenants to minimise the impact on their income cash flows.

5.8 RSLs have taken steps to manage risks from welfare reform, including increasing business plan tolerances and strengthening rent collection processes and providing advice to tenants'. Our monitoring shows that arrears, rent collection and rent lost due to vacant properties and bad debts are within business plan projections for the majority of RSLs.

5.9 The most recent announcement is for Housing Benefit in the social sector to be capped at Local Housing Allowance level. This has potentially significant impacts for RSLs who will need to ensure they assess the potential impact for their organisations and use their analysis to identify how they can mitigate associated risks.

5.10 The UK Government announced in the 2015 autumn statement that it will apply the relevant Local Housing Allowance rates as maxima for Housing Benefit paid in the social rented sector. The proposed Housing Benefit for social housing will be capped at Local Housing Allowance rate. The cap will apply from 1 April 2018 to tenancies signed after 1 April 2016 – including Pension Credit age claimants. The UK Government announced in March 2016 that the cap will apply to social sector supported housing tenancies that are signed from April 2017. The cap will also apply to the Shared Accommodation Rate for single claimants aged under 35yrs without dependent children and supported accommodation. Whilst the exact details are being worked on by the Department for Work and Pensions, it has been signalled that additional Discretionary Housing Payment funding will be made available to Local Authorities to protect the most vulnerable including those in supported accommodation. Nevertheless, this change presents a significant risk to RSLs' ability to fully collect their rental and service charge income. Reduction in tenants' benefit income may increase the risk of arrears for households. Stress testing and planning of mitigations by RSLs and their boards are important to ensure cash flow and covenant compliance can be sustained for a range of possible scenarios.

5.10 The Regulator will continue to ensure that Boards understand and are closely monitoring the financial impacts of welfare reform. In particular, we will seek assurance on the quality and effectiveness of strategies to manage the impact of welfare reform measures on rent collection, arrears, and evidence of how these feed into business plans and financial forecasts. The Regulator will continue to engage with RSLs where there is material exposure, particularly where our information and analysis suggests the actual impact on RSL is greater in realty than anticipated in forecasts. Robust stress testing and agreeing appropriate mitigation strategies will be critical.

(iii) Supported housing and care

5.11 Supported housing is a low margin activity for RSLs in Wales. Whilst the Supporting People budget has been protected by the Welsh Government, there is continuing pressure to ensure the best possible use if made of the available funding to meet local needs and priorities. Local Authorities, Housing Associations and other providers, and Regional Collaborative Committees all have a voice in commissioning and influencing patterns of service delivery.

5.12 Changes to legislation in Wales e.g. homelessness, has increased the focus on prevention and may influence the pattern and shape of supported housing provision. Changes to housing benefit over the coming years may also impact on the future rent levels of supported housing projects.

5.13 The Supporting People Grant still plays a critical role in financing supported housing and wider support activities in the sector. Most large RSLs access some Supporting People Grant funding, but for many specialist supported housing RSLs, financial reliance on Supporting People Grant is much greater than average.

5.14 RSLs will need to ensure that they understand the impact of the national living wage and the removal of automatic Housing Benefit entitlement for those aged 18 to 21 depending on the nature of any exemptions, which are yet to be determined for supported housing.

5.15 In considering the impact of the range of changes, some RSLs may have to consider the need to have exit strategies in place in the event that services need to be reduced or de-commissioned, especially if they rely on a small number of contracts or contracting organisations. The Regulator will continue to engage with those RSLs where the loss of a contract or contracts or service provision costs would have a material impact on their viability.

Costs

5.16 With increased focus on diversified activity, welfare reform, new funding streams, income volatility, future interest rate rises**,** value for money, costs associated with provision of information in Welsh language and affordable rent it is important that RSLs continue to control their cost base. Delivering efficiency savings or providing enhanced services for the same money will be increasingly challenging for the sector, especially as it comes under greater scrutiny by funders, tenants/service users and the Regulator.

5.17 The Regulator will continue to seek assurance from Boards they have a robust understanding of the cost of running their businesses and a clear strategy for controlling future costs by making efficiencies, and/or reducing expenditure. Boards will be expected to provide assurance that they have a robust and strategic approach to managing their costs and achieving value for money.

(i) Pension costs/deficit

5.18 Pension costs remain an area of risk for many RSLs although the precise issues will be unique to each RSL. The projected funding gap in Social Housing Pension Scheme (at March 2014, a deficit of £1.3 billion), will have to be recovered and RSLs are likely to have to make increased payments to the pension fund over a period of time. The financial uncertainties created by The Social Housing Pension Scheme and The Local Government Pension Scheme (remain significant even if many are closed to new entrants. Closed schemes still need to be managed to ensure the future commitments are paid to members.

5.19 With the introduction of Financial Reporting Standard 102, Social Housing Pension Scheme Defined Benefit deficit will appear on balance sheets for the first time and increases in contributions will need to be included in income and expenditure accounts. The financial implications of the pension schemes will therefore become an increasingly integral part of RSL's risk management and stress testing processes.

5.20 We expect Boards to keep pension schemes under review to determine whether their existing schemes are fit for purpose, affordable and whether or not alternative scheme should be considered. RSLs will also need to consider any potential impact from the introduction of auto-enrolment. They should identify the risks of, and to, their pension provision, and develop effective mitigating strategies.

5.21 They should understand the longer term cost of remaining in the scheme and undertake some form of cost benefit analysis covering a range of options they could introduce to mitigate the impact of rising costs.

(ii) Differential inflation rates

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

5.23 A focus on differential inflation rates is likely to be particularly important for RSLs with existing liabilities that remain linked to RPI e.g. existing index linked debt or lease and lease back arrangements. The Regulator will continue to seek assurance that flexibilities are built into business plans to ensure RSLs have the ability to meet unexpected costs.

Assets

(i) Asset Register (cross reference with Liability Register)

5.24 All RSLs are expected to prepare and maintain an accurate, up-to-date and comprehensive view of their assets and liabilities in a form that can be made available if the organisation runs into difficulties. The background to this is one of the recommendations set out in the Cosmopolitan Housing Group: Lessons Learned report that Boards must make it a requirement that the organisation has an accurate list of its asset base which must include which assets are linked to a specific transaction and the associated party (and where they sit within a group structure if relevant). This should be updated at least annually.

5.25 The Regulator would not routinely expect to see (or audit in any way) RSLs' registers – although if a problem arises, we would expect to be able to access a reliable register within a few days at the most.

5.26 It is for each Board to decide its approach to the form that the register should take. The RSL's property assets should be clearly identified, as should any associated liabilities and encumbrances: not merely legal charges against the property but also matters such as planning restrictions, covenants, leases, wayleaves and easements – anything that might impair the value of the property. It is also important to record non-property assets and liabilities, for instance, investments owned by the Association, or pension liabilities that will crystallise if staff are made redundant.

5.27 Although this expectation is primarily based on the need for a clear picture when RSL is in trouble, it obviously makes sense for any asset based organisation to have a clear view of its assets and liabilities. It is hoped that what will emerge from this process is a register that is a valuable operational tool in its own right.

- Necessary for emergencies - information should be at a sufficient level to allow business to be priced effectively by a rescuing organisation
- Good practice for any asset based organisation (effective asset management and financing)
- Stronger grasp of what is owned, what is owed, and how they relate to each other
- Understand the risk flows around the group

5.28 The primary purpose of this expectation is to ensure that Boards understand their housing assets, security position and associated liabilities and have access to this information in decision making and risk management.

(ii) Managing a housing development programme

5.29 One of the main aims of the sector is to increase the new supply of affordable housing.

5.30 Whilst grant will contribute to the cost of financing these homes, most of funding will come from debt. A key part of effective management of a development programme is careful monitoring of cash flows, early years' cash deficits, income from sales receipts and grant payments. The potential volatility of these cash flows means that there are risks associated with development activity which Boards will need to have strategies in place to manage. This further highlights the importance of effective treasury and cash flow management especially at a time when income may potentially become more volatile due to welfare reform and the other risks to income outlined in this publication.

5.31 As well as the cash flow implications of managing a development programme, Boards should understand a range of other risk exposures and their impact on delivery of their development programme. Examples of these are increases in costs related to labour or supplies, the cost of acquiring land – which can often be inflated when there is competition from a number of developers – and the potential for impairment as a result. It is therefore important RSLs should undertake thorough due diligence of planned investments. In addition, because balance sheet capacity can be quickly expended when developing with little or no grant, Boards should understand how their risk appetite is reflected in any cushion on their tightest covenant or covenants.

5.32 The Regulator will seek assurance RSLs are effectively managing their development programmes and that Boards understand and gain assurance on both the risks associated with individual schemes, including environmental risks and risks associated with contaminated land and the cumulative impact of its overall development programme. It will also seek to understand what early systems, triggers for exit and mitigations are in place should there be adverse variations from delivery plans or adverse variations elsewhere in the business that affect their development capacity. The Regulator will also wish to understand how deliverable such mitigations might be in practice and whether there are any financial or contractual constraints on RSL's ability to revise its development plans if necessary.

(iii) Diversification into other activities

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

5.34 A challenge for the Regulator is to ensure that RSLs are contributing to the Welsh Government's agenda for the supply of new affordable homes and the regeneration of communities, where appropriate for them to do so, by making best use of their assets, financial capacity and resources. This needs to be balanced against ensuring individual RSLs continue to be financially viable, maintain their existing stock to required standards and do not overstretch, thus ensuring that the sector overall remains financially viable.

5.35 Whilst we will focus on RSLs that are actively diversifying their activities and making best use of their assets, financial capacity and resources to ensure they are effectively managing the associated risks and do not *overstretch* themselves, we will also focus on RSLs which are perceived to be not making the best use of their assets, financial capacity and resources.

5.36 It is not the Regulator's intention to stifle innovation in the sector or reduce RSLs' flexibility to plan, structure and develop their business in the most effective way. Indeed, the Welsh Government wishes to encourage ways in which innovative forms of funding for new homes, for example, can be generated in sound ways which do not threaten individual RSL or sector viability. The case for finding additional income streams to cross subsidise core operations is recognised in an increasingly challenging operating environment. The Regulator's interest is in ensuring that RSLs effectively manage increased diversification, while providing enough assurance that tenants are protected, social housing assets are not put at risk, the public value within them is protected and the sector continues to attract private finance at advantageous rates.

5.37 RSLs should not assume that because an activity is carried out in an unregistered element of their business that the Regulator will not be, or has no right to be, interested in it. Understanding the interdependencies and ultimate control mechanisms between the regulated and non-regulated elements remain key areas where we gain assurance to ensure social housing assets are not unduly put at risk. In a world where many loans carry cross-default clauses, the problems of an unregistered subsidiary can swiftly impact on the parent RSL.

5.38 Boards should have access to adequate information on the potential cost benefits and risks of undertaking a wider range of diverse activities. They should be clear how entering in to new markets or activities fits into their overall strategy and helps them meet their core objectives. Increased diversification often leads to increasingly complex organisational structures, made up of a wide range of companies that sometimes have very different aims, legal requirements and financing structures. Therefore, a Board should retain adequate oversight of all the activities and companies within their groups while ensuring the fundamental objectives of their organisation do not get neglected in favour of new areas of business.

5.39 It is important for Boards to understand the different types and timeframes over which risks need to be managed. Some of the activities will expose RSLs to shorter term revenue risks and other activities that will expose RSLs to liabilities over a longer term. Boards should understand the implications and impact of the different types of risk, both individually and in aggregate, and have appropriate mitigations in place to manage these.

5.40 Boards need to ensure they understand the interdependencies between all the parts of their organisation including where there are any guarantees or cross default clauses between the registered entity and non-registered elements which may give rise to recourse to social housing assets; and have appropriate arrangements in place to mitigate these risks. In addition Boards need to be clear that any mitigating actions, break clauses or exit strategies in place to manage the risks they identify are actionable and possible in practice as well as on paper.

5.41 The Regulator will seek sufficient assurance that Boards fully understand the range of risks that involvement in a range of diverse activities exposes their organisations to. We will need to understand how the activities contribute to and subsidise the core objectives and aims of the RSL. We will seek assurance Boards understand the importance of these activities making a surplus, or, where they are done to meet wider social objectives, that Boards appreciate the opportunity cost of undertaking the activity. Increasingly Boards should expect challenge from the Regulator where social housing assets appear to be actually or potentially at risk. The Regulator will also seek assurance Boards have consciously made decisions concerning the long term sustainability of regeneration projects, especially where there is the potential for loss making activity that may have wider implications for future viability

(iii) Existing stock

5.42 The sector is meeting the challenge of bringing its stock up to the Welsh Housing Quality Standard (WHQS). RSLs, which have not met the standard yet, have identified resources in their business plans to meet the standard no later than 2020.

5.43 A key challenge for the sector will be to ensure that the stock continues to meet the Welsh Housing Quality Standard in an operating environment where Boards need to balance their ambition for growth against the need to invest in existing stock. This is also dependent on Boards ensuring they have high quality, up to date, stock condition data and an appropriate long term investment strategy.

5.44 Failure to achieve Welsh Housing Quality Standard is one of the key risks for the sector so RSLs are responsible for ensuring they can demonstrate achievement of WHQS and provide evidence in relation to the delivery outcome *“we repair and maintain homes in an efficient, timely and cost effective way”*. RSLs are required to develop and implement a Compliance Policy in line with the recommendations set out in the WHQS – verification of progress in achieving the standard report produced by Altair Consultants. The Regulator will not carry out a separate activity to monitor compliance with the Welsh Housing Quality Standard, However, we will seek assurance that Boards have put policies in place and ensure compliance.

5.45 Expenditure on repairs and maintenance forms part of our viability assessment. The Regulator will challenge Boards where there are significant variations from budgets/plan or reductions in expenditure based on the financial information we receive each year to understand the reasons for this and to gain assurance this is not a sign of RSL failing to maintain its stock.

5.46 Community decline could be a risk for a number of RSLs, (particularly Large Scale Voluntary Transfer organisations) being locked-in to areas which are declining (jobs/ industries disappearing; tenants increasingly unable to pay, properties hard to let). This can result in a mismatch between the ability of the local economy to support the viability of an Association so it can meet its long-term financial obligations. The Regulator will seek assurance that Boards understand risks as they make decisions about long-term sustainability of their stock, as this is likely to impact on their investment and income stream.

Liabilities

5.47 Most economic forecasters expect the Bank of England's base rate, and hence LIBOR, to rise. This could lead to an increase in lending margins. Boards should therefore consider the risk that higher margins on new debt has on their business plans and take into account a range of potential interest rates as part of their stress testing.

5.48 Effective debt and cash management is essential to maintain liquidity and ensure obligations are met as they fall due. We expect Boards to aim to have funds available to meet obligations greater than 18 months but no less than 12 months. While funding may remain available to RSLs who have shorter periods before needing funds, the cost of this debt may be higher and the covenants more demanding, as funders price in a higher level of perceived risk.

5.49 This requires Boards to have a sound treasury management strategy in place. This allows Boards to ensure that clear parameters are set that manage liquidity, ensure access to sufficient debt and adequate security when it is required and ensure interest rate risk is managed.

5.50 Effective treasury management has become increasingly important due to significant changes in the finance markets, the greater variety of products available and the different relationships RSLs have with an increasingly wide range of funders. Boards should also understand the impact of different accounting treatments for the various sources of finance, particularly those which appear off balance sheet. In these instances we would expect Boards to receive information that reports variances in cash flow against budgets to fully appreciate the real impact on the business plan.

5.51 These changes also heighten the need for Boards to ensure they have the skills and knowledge to understand the diverse range of risks their organisations will be exposed to as a result of the increasingly complex nature of the transactions they enter into. Boards must be able to identify when and where there are skills gaps and ensure they have an appropriate strategy in place to access the relevant expertise. However, in seeking expert advice from third parties, Boards need to retain sufficient control and understanding to be able to constructively challenge where they believe the advice is not truly independent or in the best interest of their organisation. The Regulator will seek assurance Boards understand and are rigorously challenging investment decisions entered into.

(i) Liability Register (cross reference with Asset Register)

5.52 The Regulator expects all Boards to prepare and maintain a record providing an accurate, up-to-date and comprehensive view of RSL's assets and liabilities in a form that can be made available immediately if the organisation runs into difficulties.

(ii) Counter party risk

5.53 The issue of counter party risk is not new but as financial and non-financial transactions increase in complexity, the potential for organisations to be exposed to counter party risk increases both in terms of likelihood and impact. However, it is not only new transactions where counter party risk needs to be understood. Many RSLs will have existing contracts – with lenders; suppliers; development partners or insurance companies for example – which expose them to varying levels of counter party risk.

5.54 The Regulator will seek assurance Boards understand the implications of the terms and conditions of their existing and future contracts or agreements and ensure they understand the potential liabilities and risks associated with each. This needs to be in the widest context rather than assuming the relationship is simply on a one to one basis; a development contractor for example may sub contract elements of its work to a third party and Boards need to understand what, if any, counter party risk this exposes their organisation to. Boards also need to fully understand the potential circumstances in which they or the counter party has an option to vary or break a contract, and put in place mitigations to manage the risk in the event this happens.

(iii) Existing debt

5.55 The operating environment is also likely to remain challenging. A key risk to RSLs is that funders will seek ways to reduce their losses as a result of low borrowing margins in the past. In some cases this will be through mutual agreement where RSL is seeking consent for a revision or waiver to their loan agreement. In addition, the base rate is widely predicted to rise and this could reduce RSLs' financial capacity, and decrease the head room in their business plans. Boards should ensure, through effective liquidity management and covenant compliance monitoring, that they have sufficient cash to meet their obligations as they fall due.

5.56 The Regulator regards the active monitoring of financial covenants an essential part of an effective treasury management. The majority of RSLs do this on a regular basis, either within the organisation or by using external treasury management specialists. However, we expect that RSLs stress test their business plans against a range of scenarios including understanding 'what could bring the business down'. Although in many cases breaching a loan covenant may not in itself break a business plan, it may significantly weaken RSL's financial position. It may remove the control from the organisation over its loan portfolio and impair its ability to negotiate with its funders. This could result in funders triggering a re-pricing or even lead to demand to repay the loan. The Regulator is likely to view such failures as ineffective governance in risk management and not meeting the delivery outcomes in relation to governance and financial management.

5.57 While it is sensible to ensure there is enough liquidity within organisations to meet obligations as they become due, RSLs must manage this actively as part of an effective treasury management policy. Investments are now in a range of counterparties and different structures. Boards must have a clear understanding of the nature of these arrangements and their associated risks before making the decision to invest. Conversely, Boards need to understand the associated risks where all of the cash is invested in a single institution.

5.58 Through our viability assessment, we will seek assurance that treasury management arrangements are effective. This includes gaining evidence that Boards understand the risks when making investment decisions and have sought high quality external advice where appropriate. Where we conclude this indicates deficient treasury management, we will reflect this in our regulatory opinion and financial viability judgement of the RSL.

(iv) New debt

5.59 RSLs seeking new finance are faced with 3 broad choices:

a. bank debt – term finance of between 5 and 10 years duration is now available from the traditional banking market to existing and new clients, but with some making available more limited amounts for periods up 25 years
b. bonds – whether through a public placement, private placement or aggregator this form of finance has become predominant for long term debt including fixed and index linked rates

c. complex products such as sales and leasebacks have attracted interest from some RSLs in support of non-social housing provision.

5.60 The relatively small size of individual RSLs in Wales is a barrier to entry to the capital markets. Associations can make and some have already made use of the sector "bond aggregator" The Housing Finance Corporation . However, we recognise that bond funding provided through the Corporation is considered by some to require relatively stringent and high quantities of security requirements. The sector, together with some support from Welsh Government, has put in place a collective borrowing initiative with two institutional investors and currently 20 RSLs are part of the exercise. As more RSLs access the capital markets and seek alternative sources of funding, it is important that they understand and manage the risks inherent in different forms of debt.

5.61 The capital markets provide a range of financing opportunities, but Boards must be aware of the wider implications of raising funds through this route. Public markets have specific legal requirements, they demand much greater transparency and disclosure and the investors generally have different expectations and needs. Boards need to understand that the on-going relationship with these institutional investors will be of a very different nature to the relationships with funders they are traditionally used to.

5.62 Refinancing risk and the need to have adequate security in place in plenty of time is also a key issue that Boards need to consider and monitor closely. Boards should be aware of the complexity, quality requirements and timescales for arranging new finance**,** charging security and gearing**.**

5.63 Raising new finance, regardless of its source or type, is always going to carry a degree of risk. Boards should understand the implications and obligations associated with any new debt arrangements they choose to enter into and the risks should be understood by the full Board to avoid placing an over reliance on one or two key Board or executive members. Boards should ensure specialist advice commissioned and received is credible.

(v) Hedging strategies

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

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

6 Accounting issues

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

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

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

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

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

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

6.5 Where covenants need to be renegotiated with funders following the introduction of FRS 102 Boards should obtain appropriate independent expert advice to ensure that they understand the implications of the revised covenants and to assure themselves that they have secured the best deal for their organisation in the current economic climate.

6.6 As part of its on-going financial monitoring and assessment of viability the Regulator will seek assurance that Boards understand the implications of FRS 102 and are effectively managing the transition to maintain current and future covenant compliance.

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

7 Key Service risks

7.1 Boards are responsible for ensuring good quality services are delivered to tenants and service users. Indeed, at the heart of the co-regulatory approach is an expectation that Boards understand and respond to the needs of their tenants and service users. Boards also need to ensure they understand the risks to the delivery of good service and make sure they manage those risks effectively.

7.2 The Regulator will continue to work with the Tenant Advisory Panel to identify key issues of concern. The Panel has raised the issues that concern them most, for example, delivery of improvements under the Welsh Housing Quality Standard including the standard of work and how RSLs deal with the acceptable fail criteria; welfare reform – direct payments, under-occupation and 'Universal Credit', in particular, how these might impact on future financial viability assessments or self evaluations themselves, effective participation of tenants and service users in decision making, scrutiny of RSL's performance and accountability.

7.3 The Regulator will continue to engage with RSLs where information and analysis suggests there is a risk to the performance and to the delivery of services to the satisfaction of tenants and service users. We will use for example, the RSL's own performance information and findings from independent surveys (e.g. sector tenant survey).

7.4 We expect Boards to ensure, where appropriate, they are contributing towards delivery of service outcomes, for example, in relation to:

- duty of care/health and safety e.g. fire safety, gas servicing, asbestos, Legionella;
- safeguarding tenants and service users e.g. protection of vulnerable adults and young people;
- helping tenants and residents to cope with welfare reform changes;
- tenant/service user scrutiny/participation/engagement/accountability;
- delivery of Welsh Housing Quality Standard e.g. standard and quality of work, customer care;
- supporting Local Authorities in preventing homelessness and accommodating people who become homeless
- tackling anti-social behaviour
- helping the victims of domestic abuse/violence;
- promoting equality and diversity.

8 Lenders confidence in regulation

8.1 The Welsh Government's risk based approach to regulation and improvements in the regulatory opinion and financial viability judgement report aim to provide lenders with confidence about robustness of regulation of RSLs in Wales. The Welsh Government will continue to review the approach to regulation to ensure it delivers the required confidence. This will be reflected in future consideration of risks facing the sector.

9 Emerging risks

(i) Office for National Statistics classification of RSLs

9.1 On 30 October 2015, the Office for National Statistics announced "Private registered providers" of social housing in England are public, market producers and as such they will be reclassified to the Public Non-Financial Corporations for the purpose of national accounts and other economic statistics.

9.2 This means the "Private registered provider" (Housing Associations) debt will be counted as public borrowing pushing approximately £60 billion on to the UK Government's balance sheet.

9.3 There are no immediate implications for Wales arising from this announcement, as it relates to Housing Associations in England. However, reports suggest the Office for National Statistics may assess the statistical classification of housing associations in other parts of the UK.

9.4 RSLs in Wales are a very important part of our housing system and something we value. The Welsh Government is considering the matter, liaising with the Department for Communities and Local Government and other devolved administrations

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