

TSA: 'VIABILITY: A DISCUSSION PAPER'

Introduction

- 1 We believe that viability and governance should form the dual primary strands of regulation for the TSA. Good governance must put capacity for survival at its core, and we believe that the regulatory regime should reflect this.
- 2 In our view the Discussion Paper recognises some of the key shortcomings of the arrangements inherited from The Housing Corporation and we welcome it. This review of viability regulation provides an excellent opportunity to refocus the TSA's approach to regulating housing associations' viability, to make it more proportionate, flexible and successful at identifying failure and potential failure.
- 3 We would be happy to meet representatives of the TSA to discuss our thoughts in more detail if that would be helpful.

Summary

- 4 The last 18 months have shown clearly that associations must guard their financial capacity carefully so as to ensure that they remain viable in the long term in order to protect the interests of existing and future residents. This is a multifaceted issue that requires a more sophisticated approach by both the regulator and associations than either has adopted historically. We agree that a discrete national standard on viability is more appropriate than local standards.
- 5 In considering a new approach to regulation we believe that the TSA should seek to develop a framework which encourages associations to maintain robust financial positions. This could be targeted in part at increasing the sector's global surpluses, which at just 0.3% of turnover¹ do not seem to us to be sufficient to reflect the risks the sector has taken on over the last few years and which it is likely to continue to shoulder. It would also take account of a number of other key financial indicators.
- 6 One of the features of the last year has been much welcome support for those housing associations that ran into difficulties as a result of the recession. Longer term, whilst the implied government and regulatory support for the sector is critical to the continued confidence of the sector's lenders and investors, it is essential that the TSA moves to dispel any notion that UK government underwriting is available on demand. Consequently, we believe that the TSA has a critical role to play in generating a robust and self-sufficient sector able to weather bad times as well as good.
- 7 We do not believe that the TSA should engage directly on either the proper consideration by an association of its approach to investment, or in any detailed way on the question of efficiency or value for money (VfM).

Developing a Framework

- 8 The TSA should reasonably expect associations to develop a simple, high level framework of parameters for financial improvement over time aimed at helping boards focus on financial strength, value for money and prudence. This could be based on a set of self-determined rules or targets, with efficiency at their centre, which target minimum performance and financial improvement levels across a range of financial indicators. It should also include an assessment of the "value at risk" from their development activities,

¹ Housing Corporation Global Accounts 2008

alongside a clear view of how a worsening position might affect its financial performance, including compliance with funders' covenants and liquidity.

- 9 The aims of the new framework would be for associations to be able to demonstrate in a transparent way to the TSA and other stakeholders:
 - a. A profitable, cash generating business;
 - b. A solid liquidity position;
 - c. Ample headroom to deal with the value at risk on development activity;
 - d. Effective balancing of social objectives with financial strength;
 - e. A focus on improving efficiency;
 - f. Measured and proportionate utilisation of financial capacity.
- 10 The TSA should seek to avoid any inclination to over regulate here, or to be prescriptive on the framework that associations might follow. It should however, set out the broad expectation that associations will develop, maintain and routinely monitor a framework that has these principles at its core. This could then form the basis for any regulatory code which the TSA seeks to develop.
- 11 Housing associations are independent organisations. We strongly believe that they should determine for themselves how they use their capacity. The framework described above would incorporate a balanced approach to the development of new homes, investment in existing homes and communities, and improvements to services. "Unlocking the Door"² was based on a misunderstanding of associations' capacity and failed to take sufficient account of the risky nature of their activities. The TSA must avoid any repetition of an approach which seeks to interfere in the legitimate role of a board in determining investment strategy.

Regulatory Methodology

- 12 The framework above would recognise that financial viability is about more than a prudent 30 year financial model. In conjunction with this framework therefore, we would support a shift away from rigid formulaic analysis towards more regular and fluid engagement between the regulator and associations. In particular, the TSA should consider introducing a high level quarterly return to the TSA with self-declaration on a very limited number, say eight to 10, key indicators, with the proviso that it was designed to minimise the impact on associations' resources. Appendix 1 sets out some possible indicators; it would be critical to limit this to a handful of well considered indicators that should be supplemented by disclosures against a limited number of standard questions. Possible questions (which might be more appropriately dealt with through discussion than via written responses), are set out in Appendix 2. Getting the indicators and questions right would be critical to the success of viability regulation and we would be happy to be consulted in more detail by the TSA on what those indicators and questions should be.
- 13 The Housing Corporation placed too much emphasis on "financial planning based on a robust business plans that demonstrates current and future financial obligations can be met"³ and the TSA should avoid this pitfall. This is of course, a vital element of any viability regulation, but it should only be one dimension in the assessment of viability and cannot stand alone. It is, for example, possible to demonstrate robustness in a business plan whilst ignoring serious risks or making cash losses on an ongoing basis. It is as important to look at risks associated with binary decisions or outcomes. For example, the purchase of a piece of land pre-planning on the grounds that planning will probably be achieved could have a major impact if the value drops significantly if planning is not obtained. Similarly, a plan might look viable if it is based on an assumption that additional or future funding is available, but unviable if that funding is not available. A more nuanced approach to regulation needs to be developed using financial modelling in parallel with

² Housing Corporation - February 2007

³ Viability Discussion Paper Highlight - Page 7

other tools. In particular, it needs to reflect the emerging shift in funding availability away from long-term (30 year) to much shorter term (5 to 10 year).

- 14 We do not support the retention of the Housing Corporation's capacity model. Whilst modelling must remain a core element of viability regulation we believe that the TSA should consider departing from a rigid and inflexible standard model, and that it should look to associations' own models which are best placed to reflect the activities and complexities of their business. Essentially the TSA must trust associations to do their own financial planning based on solid governance arrangements and to this end it should restrict itself to getting comfortable with the models that associations are themselves using, if necessary, looking for them to be audited periodically.
- 15 In addition, it seems to us that there is very little value in assessing 30 year based models. The landscape for developing associations, the riskiest group, is constantly changing and looking much beyond the medium term is inevitably going to be of limited value. Over the long term it will be relatively straightforward for most associations to recover viability through the sale of stock or the cessation of development activity. The focus for longer term modelling should therefore be shifted to no more than 10 years.
- 16 We would support the development of a suite of financial health indicators reported regularly, say quarterly. The Discussion Paper helpfully acknowledges the importance of short term solvency, liquidity and covenant compliance. Associations can demonstrate viability over the medium and long term, but can find themselves in serious difficulties as a result of short-term liquidity issues. Short term liquidity problems, or problems resulting from short-term technical breaches of covenants might indeed be even more serious than long term problems since they are likely to be harder to rectify. Regular reporting would allow the TSA to refocus on a limited number of key indicators covering these and other things which should be readily available at short notice. We would stress that any such returns to the TSA would need to be proportionate and should be designed to draw out information that many associations will be monitoring as a matter of course.
- 17 The approach here might be to capture a small number of key indicators which focus on liabilities (committed and expected) and cash (drawn and available) over the short to medium term.
- 18 In addition, as part of this the TSA might look to develop a more discursive relationship with associations. This would have the added advantage of providing the TSA with a "heads up" before problems emerge (or at least as they emerge) and move the focus away from a narrow analysis of the business plan. It would also provide informal market intelligence and enable the TSA to form an overall view on credibility and risk.
- 19 In order develop this more targeted and flexible approach the TSA would need to undertake a reassessment of the people resources required to develop a deeper understanding of an individual association's pressure points and key risks. It must ensure that its regulators are sufficiently qualified and experienced to adopt a flexible approach to regulation and not to assume "one size fits all".

Treasury

- 20 It is a role of the boards of housing associations to ensure that their treasury arrangements meet best practice, are proportionate to the scale of the business, and deal effectively with risk.
- 21 If landlords do not have "skills, knowledge and experience necessary at board and officer level to properly manage treasury management risk"⁴, then this is a clear failure of governance. Consequently, we do not believe that the regulation system needs to single out treasury for special attention, since good governance must include appropriate treasury arrangements.

⁴ Housing Corporation Circular 01/07

- 22 The restrictions on foreign exchange transactions, and the requirement that derivatives may only be used for the purpose of managing risk should be retained. However, they would seem to fit better within associations' governing instruments (ie – Rules) than as part of the regulatory system. The TSA should look for these to be reflected in the NHF Model Rules and for associations to plan to adopt any necessary changes.
- 23 We do not see a need for blanket collection of associations' covenant arrangements. Instead, associations should be encouraged to build significant headroom to weather negative movements in financial performance.

Cost Benchmarking and VfM

- 24 Although one of the TSA's objectives is to ensure that providers demonstrate value for money, we do not believe that the TSA should introduce a standard on VfM. Instead it should use the framework we have suggested above to ensure that associations focus on VfM as a key strand of governance and financial management.
- 25 Whilst the OCI was a complex and sophisticated approach to cost benchmarking, it failed the important test of credibility, and we believe that it would be difficult to replicate it in any meaningful way. The difficulty here is obtaining simple and comparable information from a large cohort of organisations with quite different historic and current profiles and operating activities. We believe that VfM should be a core responsibility of the board of every provider and should be demonstrated to the TSA at a high level and not by cumbersome and formulaic modelling with limited practical use or strategic value.
- 26 We believe that operating costs extracted from annual statutory accounts provide as meaningful an indicator as it is possible to get without engaging in a lot of work in an attempt to obtain spurious accuracy. Associations should be able to demonstrate to the TSA that they keep efficiency under regular review and have plans in place to reduce per unit operating costs over time. Operating cost reductions year on year should be monitored by associations (both including and excluding major works, perhaps) and the TSA should satisfy itself that this is happening.
- 27 Beyond that, the TSA should essentially rely on (a) the existing rent regime (b) viability regulation and the generation of surpluses, and (c) resident satisfaction results, to ensure that a focus on cost control and VfM are important strands in an association's governance toolkit.
- 28 In addition, it should expect associations to be able to demonstrate that they have due regard to the role of benchmarking.

Other Matters

- 29 Resident feedback: We do not understand the role that residents might play in helping the TSA to understand the question of viability. (Page 9, second bullet). However, as indicated in paragraph 27 above, there is a link between satisfaction and VfM, but in this context associations must be free to make a judgement about when it ceases to be good value to invest more in service delivery in order to derive only marginal improvements in satisfaction.
- 30 Peer Review: Since housing associations' business plans are commercially confidential we do not understand how peer review can work in the context of viability. (Page 9, third bullet).
- 31 Grading: We think that this is a very difficult area. In principle, we would support option "(c) Pass, Pass with closer regulator monitoring, Fail". However, it is important to acknowledge that the post-credit crunch funding landscape in which the sector operates is very much less benign than the old world. There is a real danger that the middle rating might be interpreted by lenders as tantamount to a "red light" and that it could prompt

lender action. This could have very serious consequences for individual associations and for the sector as a whole. If the TSA does adopt three grades it must be made absolutely clear that a middle rating does not imply that an association is not viable. As well as the response of the banks, we would urge the TSA to confirm that the middle rating would not lead to disproportionate regulatory action.

For further information contact:

Calum Mercer, Executive Director (Finance)
Circle Anglia
1-3 Highbury Station Lane
London, N1 1SE

Appendix 1 – Possible quarterly indicators

The following indicators could be provided for either the year to date or the forecast for the full year, or both, depending on what is appropriate. Detailed calculations would need to be thought through and where suggested here they are only designed to indicate the thrust of the health indicators.

- Adjusted cash generation. This would be designed to ascertain the extent to which existing stock is managed within ordinary operating surpluses and calculated as: Operating surplus, plus depreciation and impairment, less net interest payable, less capitalised major works.;
- Interest Cover;
- Interest Cover stressed to take account of significant property falls;
- Debt per unit;
- Operating cost per unit;
- Cash and Undrawn facilities cf committed expenditure;
- Value of development programme, WIP, sales, landbank etc at risk;
- Forecast annual surplus against Turnover %;
- Forecast annual surplus.

Appendix 2 – Possible quarterly questions (or probably better, questions for regular informal engagement)

The following questions are suggestions for high level soundings which could be taken at intervals. These are intentionally not as detailed or prescriptive as the questions asked over the last year by the TSA/Housing Corporation.

- Are you at risk of breaching any funders' covenants in any group member in the next 12 months?
- Do you have funding available and in place sufficient to meet all contractual commitments? If not what is the size of any shortfall?
- Have any discussion on concerns about material financial loss or viability taken place at executive or non executive director level within the last quarter? If so, please provide details.
- Are there any events, decisions or triggers that are due to occur in the next [three/six/12] months which have the potential to affect the association's financial viability?
- Do you have any concerns over the level of your activity which is exposed to adverse movements in the property market, such as stock for sale, landbank? If so, please provide details.