‘Taking the helm’

As Teresa has said, Kay unfortunately can’t be here today and sends her apologies and best wishes. I am pleased to be able to stand in for Kay and have the opportunity to discuss some critical issues with you at what is one of the most important events on the RSL conference calendar.

I want to cover some major issues today. I certainly want to debunk some of the myths that we hear about our regulatory role. Myths that propagate the false view that we stifle innovation, that we favour particular business models or look adversely on diversification. I will return to these in greater detail later as I am more than keen to set the record straight about our role and our priorities.

It’s a reflection of the times we are working in that it’s rare to scan the programme of a housing conference and not see phrases like ‘challenging times’ and ‘strong leadership’. Today’s event is no different.

You don’t need me to tell you that these are tough times. Strong leadership has never been more important than now: setting a clear direction and challenging your organisation to respond effectively to the risks, while always focusing on good outcomes for tenants and other
service users. Everyone in this room has a critical role to play in leading your organisation through difficult waters. That's a big responsibility.

I want to spend some time this morning highlighting the Regulator’s analysis of some of the big issues that make strong leadership so important today. Alongside this I’ll highlight some of the challenges for you in your leadership role. And I’ll also take the opportunity to set out very clearly the Regulator’s position on some areas where I sense some misunderstanding of our role.

I may well repeat some of the messages that you may have heard from us on other platforms. I do this because those messages remain very relevant and important.

Now, I think we are all pretty clear that the next five to ten years look like they are going to be the most difficult social landlords have faced. Julian Ashby, the chair of the English regulator, has called this a “transformational decade”, our own chair has talked about the “perfect storm”. And Sir Mervyn King, when he was Governor of the Bank of England said in a rather understated way that the next decade “will not be nice” and will be “a sober decade”.

The new reality for landlords is one that is characterised by a broader range of risks and significantly increased levels of risk. Hopefully many of these risks will be contained: others may escalate. You need to be aware of them, managing them, and mitigating them.
Now I think social landlords rode out fairly well the immediate aftermath of the banking crisis and the subsequent economic turmoil. But it is also evident that the impact on social landlords has been a bit of a slow burn, albeit compounded by recent developments in UK policy. It feels like that sober decade has well and truly arrived for social landlords.

Pensions
You may have seen that Ian Brennan, our Director of Regulation (Finance and Risk), last autumn urged landlords to be candid and realistic in resolving the issues arising from the historic under-funding of pension liabilities.

The recent triennial review of SHAPS showed a marked deterioration in the proportion of assets to estimated liabilities (the funding ratio). As a consequence the scheme administrator has imposed substantial increases on the deficit contributions that most employer members must make. The aggregate amount of deficit contribution that will be payable by Scottish RSLs from 1 April 2014 will be more than £25m and that will increase by 3% each year for the next 13 years. We estimate that this will be approximately 2% of the aggregate sector turnover for the year ended 31 March 2015. For some RSLs the impact will be much greater: our analysis indicates that 20 RSLs will pay more than 5% of their turnover in SHAPS deficit contributions. This may have a major impact on your cashflows and so on your business plans.

I know that a number of you will be wrestling with this issue. There are some critical questions and challenges here for RSLs. Each of your
governing bodies needs to understand the scale of the risk to the financial health of your RSL arising from the funding of pensions for employees. And you must ensure that decisions about how to address any historic deficit and future pension provision are taken on an informed basis.

And of course that’s just looking at past service liabilities. Alongside dealing with the challenges all this raises, you also have decisions to make about future offering to employees. And then there’s auto-enrolment to handle, and from 2015/16 the requirements of Financial Reporting Standard 102.

**Welfare Reform**

Social landlords were amongst the first to appreciate the impact of the Westminster Government’s Welfare Reform. And most are now well advanced in preparing to handle the changes this brings, and to do what they can to mitigate the impact on their tenants.

As a backdrop, we saw from last year’s published information from the APSRs that while the figures for arrears as a percentage of rent due were pretty stable, there was an overall increase in arrears in cash terms, and that’s without factoring in write-offs. And of course that’s before the impact of Welfare Reform.

You’ll be well aware that Dunedin Canmore Housing has been participating in the DWP’s demonstration project for direct payment. Through their participation in the project Dunedin Canmore are very
clear that Welfare Reform is “a gamechanger”, and even in the more controlled environment of the demonstration project, it has seen a significant rise in arrears.

Clearly the range of changes that are happening will introduce a greater instability to landlords’ income streams. What is, at this time, less clear is the scale of the actual and potential impact and what some of the unintended consequences of the changes may be. And the timescales for implementation continue to be clouded in uncertainty, which makes the situation more complex and potentially more of a slow-burn.

Hopefully you saw late last year the publication of the research we did on the early impacts on landlords. Now we didn’t expect to see any dramatic results at this early stage, but the research shows an emerging and complex picture. We do need to get more information over time to see a fuller picture of what is happening and why. So we have a baseline which we are repeating each quarter and reporting the findings. We will publish the findings of our quarter two survey shortly.

What we saw through our research was an early, emerging picture, but with some clear indications that the pattern had differences from recent years. More RSLs than in the same period in either of the previous two years had an increase in arrears between March and June. And more had bigger rise in arrears as a percentage of rent due than in either of the two earlier years. And we also found a rise in arrears in monetary terms from landlords who gave us full data, compared with reductions over the same period in 2011 and 2012.
You identified increased workload and income reduction as the two biggest challenges in dealing with Welfare Reform. Support, advice and information to tenants featured prominently in the actions you’re taking to address the early impact.

We know that the early impact may be mitigated by Discretionary Housing Payments – and last year the Scottish Government announced a continuation of the funding for mitigation measures. And we have to recognise the anecdotal evidence of the success of the range of mitigating actions that landlords have been taking. And, of course there’s likely to be genuine attempts by affected tenants to pay. The question is, is this enough and can it be sustained?

The Westminster Government has made it clear that it plans to take more out of the welfare budget. George Osborne announced a couple of weeks ago a further £12bn of cuts to that budget. With his concurrent announcement that the state pension will be protected, and given that that accounts for just over half of the total welfare budget, it will not come as a surprise to any of us if the next largest component – housing benefit – is in for a big hit.

There are some really tough questions and challenges in there for you as leaders, and for your organisations. What can you do to mitigate that scale of loss? Clearly, you may already have undertaken a fundamental review of your business strategies. You may need to plan for smaller revenue, and consider tougher still cost control, and possibly a review of
your organisation’s ambitions. In this context, what kind of social landlord will you aim to be?

**Complexity**

I also want to use today to dwell a little on the issue of complexity.

I have already touched on some of the big risks and challenges that have made it a more complex operating environment for landlords. Perhaps as a response to the increasing risks and complexity in your operating environment, landlords are becoming more complex themselves – in terms of diversification, funding models and governance arrangements.

We are seeing evidence of broader diversification by landlords, to such an extent that it is increasingly difficult to think of social landlords as a single sector. We have a divergence of models for social landlords, which is likely to continue over the coming years. For example, over 80 RSLs now have subsidiaries, and there are over 125 subsidiaries. Inter-company lending has risen from £27m in 2011 to £52m in 2012, the result of both an increase in the number of such loans, and an increase in the average size of the loans. And of course the reality is that this lending is almost always funded from borrowing secured on the social housing assets or from the surpluses or reserves that are generated from the income from those assets.
Some of this increase in the number of subsidiaries and in on-lending comes from more landlords getting in to the provision of a different tenure type, partly as a response to new subsidy arrangements, and for others it is to pursue a more commercial focus. This is often about the objective to generate additional income to bring back in to the social housing business. Diversification is seen as a business strategy to handle the increase in risk to existing income streams.

However, there can be a question mark over whether such attempts at cross subsidisation will always produce a net contribution to the social housing business. We are aware that some RSLs show an operating deficit on "non-letting" activity. Now that may be because landlords have made a conscious decision to support an activity that they feel improves the quality of life for their tenants, residents and the wider community. That can be a legitimate business decision.

And landlords have always been involved in a wider role than simply providing housing. In many cases your organisations are the only institutional presence in local communities, and local people will look to your RSL to provide services well beyond those of the traditional landlord. It seems to me that the role as community anchor and a hub for a wider range of services is an entirely desirable and legitimate ambition for landlords. Wider regeneration and community capacity building are undoubtedly in local tenants’ interests.
We also know that diversification brings its own risks and can involve complex arrangements for delivery. And in some cases will involve quite significant resources from the RSL.

We also know that the Cosmopolitan Group in England got into catastrophic difficulties through diversifying its business. And Moody’s recently said that diversification, in to market sales for example, represents a rise in a less stable income source so there’s an inherent risk to credit ratings.

I said in my introduction that I want to use today to quash a few regulatory myths that we hear from time to time as we engage with landlords and other stakeholders. Here’s one – that the Regulator is against diversification. The Regulator is not against diversification; it can be a successful business strategy to handle the increase in risk to existing income streams. And it is incumbent upon us – the Regulator - to deal with greater complexity in regulated bodies that may follow diversification.

So let me repeat. We are not against diversification. But we are against reckless and poorly planned diversification which threatens tenants’ and others’ interests. You need to have your diversification plans well thought through and with clear benefits for your customers.

So what we expect of you, is that you and your fellow governing body members ensure that you understand what’s involved. You need to
understand the capacity of your organisation to handle increasing complexity in its activities, funding models and governance arrangements before you agree to taking on the risks. And we have seen landlords that do the due diligence, get independent advice where they have needed it, and kept it simple wherever possible. We would expect you to apply the same business planning principles to a decision to support diversification as you would when making any other business decision.

This is evidence of good governance, and good leadership.

Another myth we hear from time to time is that the Regulator stifles innovation. Now, I think we would all agree that your organisations, RSLs, have been amongst the most innovative of organisations over the last three or four decades. They have been regulated throughout that time. And, of course, many of your organisations are out there innovating right now. So, you will not be surprised to hear that I do not buy the assertion that regulation inhibits good innovation. Nor will I apologise for us fulfilling the task given to us by Parliament – to provide appropriate checks and balances that ensure the interests of tenants and others are protected.

When we consider a landlord’s business case for a new venture or funding model we ask for nothing that a landlord’s own governing body should not have considered. As the regulator, we do not seek to prohibit innovation, but we remain determined to protect social housing assets and the taxpayer’s investment in them. We are very mindful that this is
not just about the need to build new affordable homes, it’s also to protect
the six hundred thousand existing ones – and to help ensure landlords’
continued strong creditworthiness.

As I’ve said, there are many challenges and risks for landlords to face
today. Reflecting this, we will where necessary seek additional
assurance from landlords. We have regulation plans with 20% more
RSLs this year than we had last year. The greater the complexity in
your business, the more likely it is that we will need a higher level of
engagement with you. We are likely to see the number of regulation
plans increase as the risks, including those from pensions and welfare
reform, start to play through.

You’ll know that we have wide-ranging powers to intervene. You have
probably heard us saying in the past that we will act swiftly and
assertively where necessary to ensure that the interests of tenants and
other service users are protected. This is a point you’ll hear often from
us. And this is because our objective is all about protecting the interests
of tenants. Our accountability is to the Scottish Parliament. We
absolutely want to see landlords flourishing, but, to quash another myth,
we are not accountable to landlords, and our role is not about protecting
poor landlords. It is certainly not our role to sustain failing landlords.
Rather we need to ensure that any business failure is managed in an
orderly manner, protecting the interests of tenants and other service
users.

I’ve highlighted some of the challenges and posed some questions for
you to consider. What do the difficulties relating to pension and welfare
reform mean for you and your organisations? How will you respond? What implications might they have for your future income, activities and ambitions?

I’ll leave you by scotching another regulatory myth and making an observation about sustaining success in another sector. I recently read an article on the 800 year success of some of the Ox-bridge colleges. They are some of the most successful institutions in the world and are amongst the biggest landowners in the UK. The article was arguing that they have achieved and sustained this success by staying true to their principles, taking the long view, and growing when they can and waiting when they can’t. A strong sense that progress, innovation and growth are not always good, and there may be times when doing nothing – consolidating your position – is the right policy response.

We welcome the right type of innovation and we welcome sustainable growth that enables each of you to have enough financial headroom to deal with escalating risk.

Turning back to your own interests, we hear fairly regularly that the Regulator has an agenda to drive structural change, and in particular that we favour larger landlords over smaller, community based ones. This is simply not true. I want to be very clear that as a Regulator we have no remit to drive structural change. We have no powers to do this. We regulate individual RSLs.

And why have I raised this a myth? Because so many people accuse us of driving this agenda. I also have to say that we are often asked by
senior officers of Scottish RSLs why we are not driving change through mergers.

We think that this is a subject which the sector should be discussing in a positive and constructive way. And it strikes me that there is an appetite for discussion and debate on what the future shape of the sector needs to be to sustain the achievements of the past few decades, and that at least some in the sector are looking for leadership in that debate. As I have said, it seems to me that chairs of associations and cooperatives, and trade bodies such as the SFHA, would have an important role in providing that leadership – taking the helm.

In terms of our own leadership, we will continue to engage, continue our risk based proportionate approach, focusing on governance, financial health and outcomes for tenants, and we'll do so to continue to protect their interests.