SFHA Finance Conference - 13 November 2018

This is an edited version of a speech given by Ian Brennan, Director of Regulation, at the SFHA Finance Conference on 13 November 2018

Today I want to cover three main areas,

- sector finances,
- the current consultation on our regulatory framework and
- lessons learned from statutory interventions

Sector Finances

Most of what I am about to say is based on the analysis that we published in March of this year.

Since that time we have received another set of accounts and another set of financial forecasts.

We are currently analysing these returns so, wherever possible, I will give an update based on our analysis to date.

But please bear in mind that this is still at an early stage.

Over the past few years – and certainly since the implementation of FRS 102 – the role that statutory accounts play in our annual financial risk assessment of individual RSLs has been diminishing.

Accounts are still important to us but increasingly we are looking to the financial forecasts when we monitor and assess financial well-being.

The accounts are still the main focus though for our overall review of sector finances.

Although this year, even here, we looked in a bit more detail at what the forecasts and projections are telling us.

Our overall conclusion is that financial performance continues to be strong.

The sector as a whole, and most providers within the sector, have the resilience to cope with adverse events and scenarios.

But we are seeing a tightening of sector finances.

There are clear signs of a reduction in headroom for most RSLs.

When we use the term head-room we mean the ability to cope with a range of adverse scenarios.

With regard to the cost of borrowing

The amount paid in 2017 was £163m.

By 2022 this is forecast to rise to around £260m.

An increase of 60%.

We don't see this as a weakening in sector finances.

Rather we think this reflects a sector that is using its assets more intensively in order to invest in its housing stock for both existing and future tenants.

But there will be less financial capacity available to meet potential adverse scenarios.

Turning now to the important subject of rent.

In June 2016 the inflationary outlook changed markedly as a consequence of BREXIT.

There was an immediate fall in Sterling as soon as the referendum result became known.

And inflation increased as a consequence.

And that meant that for the first time in many years the average increase in rents being charged was noticeably less than inflation whether measured by RPI or CPI

In their business plans most RSLs use a formula based on **past** inflation when setting their rents for the year ahead.

It is therefore a likely that the increased inflation experienced since June 2016 will result in higher rents for RSLs in future years.

And this is broadly what we saw last year when we analysed the financial forecasts.

Looking to the next four years, if things go as forecast, average rents are expected to track the increase in RPI.

But they are likely to be around 1% above the increase in CPI.

It is probable that over this period any indexation of welfare benefits will be based on CPI.

So any rent increase, particularly one which is in excess of CPI, may create issues around affordability for tenants in receipt of benefits as well as for those in work whose pay may not keep pace with inflation.

We set out our expectations on rent affordability in our Business Planning Recommended Practice.

We expect RSLs to:

- be clear on what is affordable for tenants now and consider future affordability when determining annual rent increases;
- demonstrate transparency on costs and a vigorous pursuit of VFM;
- wherever possible give tenants genuine options and choices during rent consultations;
- engage in dialogue with tenants about costs versus service levels; and
- be clear on how tenants' views are taken into account.

All RSLs should look constructively and creatively at ways in which they can reduce costs without detriment to the interests of tenants and service users.

Moving on now to pensions.

Over the past 6 years there has been a substantial change in the way in which RSLs have provided pensions for employees.

Three separate movements are evident from the latest returns provided to us by RSLs.

Firstly there has been a move from defined benefit provision to defined contribution as RSLs try to manage their future liabilities.

Secondly, within defined benefit provision, there has been a move from final salary to average earnings as RSLs try to reduce the overall cost of pensions.

And finally there has been a substantial increase in both the number and proportion of staff for whom a pension is provided.

Auto enrolment means that the number of staff who have no pension provision has fallen.

As a result of these shifts RSLs in aggregate have greater control over their costs.

And pensions are more affordable.

But even with this recent shift more than half of all RSLs still have some exposure to Defined Benefit schemes.

This means that the RSL is carrying the risk of any shortfall on return on investment.

And in an uncertain world – BREXIT and the rest – that's a risk that needs to be very carefully managed.

Moving on now to look at investment in new and existing properties

There has been a substantial increase in the amount spent by RSLs on the acquisition and construction of properties and investment in existing properties.

And our initial analysis of the 2018 accounts shows another sizeable increase.

And even at a time when capital grants are at a high level, private finance is contributing almost as much to new build as government grants.

This tells us that whatever else may change private finance is here to stay.

The providers of private finance are therefore going to be important stakeholders for RSLs going forward.

So a core competence for any RSL is how to manage this.

Good treasury management and good stakeholder management is essential.

The aggregate sector Statement of Financial Position (formerly known as Balance Sheet) shows that RSLs currently have outstanding borrowing of just under £4bn.

Our analysis of the Financial Forecasts shows that RSLs are planning to increase that to around £5.4bn by March 2022.

So that's a rise of more than £1.4bn over the five year period.

To put this in context, the increase in net borrowing over the previous 5 years was approximately £950m.

And, in addition to new net borrowings, the information from loan portfolio returns indicate that RSLs will have to re-finance around £300m of their existing debt over this period.

This represents a step change for the sector and for many RSLs.

Some RSLs will be borrowing more over the next 5 years than they have in their entire history to date.

The last area that I want to look at is voids, arrears and bad debts.

When welfare reform came onto the agenda a good few years ago now, lenders were concerned about the potential impact on the financial health of the sector.

For our part we always saw voids, arrears and bad debts as a useful early indicator of how welfare reform might affect the financial health and ultimately the credit worthiness of the sector.

This continues to be a good news story for the sector.

Looking across the last 4 years there really has been very little change.

Total arrears, current tenant arrears, former tenant arrears and voids have all stayed the same or have shown modest reductions.

And our initial impression of the 2018 numbers is that this continues to be the case.

As ever there is no cause for complacency.

There remains much uncertainty about the scale and pace of change.

And we think that Discretionary Housing Payments are probably doing a lot to keep these numbers steady.

But nevertheless it is appropriate to commend the sector as a whole for a job well done.

And also, I want to send out a message to lenders and investors and potential lenders and investors:

We are monitoring this issue and will continue to monitor it closely.

So what have we learned from carrying out our analysis of sector finances?

1 Sector finances remain strong but there is less financial headroom than in previous years.
2 Rents rose by less than inflation in 2017 but are forecast to be above CPI inflation going forward.
3 There have been significant changes in pension provision.
4 There has been a substantial increase in investment in new and existing housing.
5 In future more RSLs are planning to borrow more money than ever before.
6 Voids, bad debts and arrears remain under control.

Regulatory Framework

Turning now to our review of the regulatory framework.

The first thing I want to do is to thank those of you in this room and indeed beyond for your enthusiastic participation so far.

We received a good reaction to the Discussion Paper – around 90 formal responses – and these helped us to shape the formal consultation which was published on 9 October.

We are proposing a regulatory framework centred on landlord self-assurance.

This is about landlords assuring first themselves, then their tenants, and last the regulator.

And I deliberately put the regulator last as this is principally about board and committee members getting the assurance they need. If they are getting the right assurance about the right things, we will be able to take our own assurance from that.

It's about landlords knowing that they are able to give tenants and other service users the best possible homes and services at a price they can afford.

So that's the broad theme.

I want to now say something about three specific aspects of the forthcoming consultation.

Annual Assurance Statement

Almost all of our stakeholders told us that they support the idea of the introduction of an Annual Assurance Statement for each social landlord.

Through the Annual Assurance Statements, each landlord would confirm that it meets regulatory standards and requirements.

Or it will set out what it is doing to address any instances of non-compliance.

The statements would be approved by each Registered Social Landlord's (RSL) governing body or the appropriate committee of the local authority.

It is intended to be a short statement confirming compliance with requirements or disclosing material non-compliance 'by exception'.

We know from our self-assessment thematic which was published last year that there's a lot of really good work going on.

Many landlords are already taking steps to assure themselves that they are compliant.

We don't see this as a one-off, end year exercise. It's about assurance on a rolling basis, using multiple sources.

In many cases this is evidence that governing bodies are already getting as part of performance management, tenant feedback and audit activity.

Regulatory Requirements

We anticipate that there will be few new requirements but we are planning to make sure that all requirements will be together in one place.

This section will cover things like:

- Submitting the Assurance Statement
- Reporting on Charter performance
- Having effective whistleblowing arrangements
- Learning from complaints
- Publishing accessible information about governing body membership and how to get involved

We are proposing specific requirements around ***equality and human rights.*** We've been talking to the Equality & Human Rights Commission about this.

Landlords will be expected to have assurance and evidence that they are giving proper consideration to equality and human rights in how they take decisions and set policies.

Increasingly our work in this area will focus upon the new annual assurance statements and thematic work.

There will be some changes to **the Standards for RSLs**- mostly to draw into one place and add emphasis, but also some new things.

Presenting our regulatory view of RSLs

The final area from the review that I want to raise is around how we give our regulatory view through a regulatory status.

At present our regulatory status reflects our level of engagement.

And we say that an RSL is high, medium or low engagement.

This doesn't tell you anything about our regulatory judgment.

I spoke earlier about the need over the next few years for RSLs to raise much more private finance than they have at any time in the past.

With that in mind we speak to a lot of potential new lenders to try to build confidence in how we regulate the sector and the sector itself.

And when we explain the high medium and low classification they tend to say that we can see **how** you do this.

But we don't understand **why** you do it.

We also hear that lenders value regulatory engagement. And so low regulatory engagement for an RSL may actually be seen as a disadvantage.

So we are proposing moving towards a regulatory status which incorporates an element of regulatory judgment.
In this way we will make it clear to tenants, service users and other stakeholders whether we judge that an RSL meets regulatory standards and requirements.

And where we judge that an RSL meets regulatory standards but we become aware of new information that may impact on that judgment we will flag this by saying that the status is under review.

Just a final word on the framework. When we started out on the review of the framework our view was that the current framework had worked reasonably well.

And so our mindset wasn't that there needs to be radical change.

But when you step back and look at the consultation in its entirety it does look quite significantly different from what we have at present.

When we published our recommended practice on business planning we said that the process that you go through in order to arrive at a business plan is as important, possibly even more important that the business plan itself.

And I think that will also apply to the assurance statements.

Lessons Learned From Concluded Interventions

When we first used our powers of intervention in 2014 we said that we would publish a report following each intervention that would set out why we intervened and how the issues were resolved.

And we also said that after the conclusion of the third intervention we would publish a consolidated report that looked at the lessons learned to date.

In March of this year we published our third report on a concluded intervention.

Sometime before the end of the year we are planning to publish the consolidated report.

And it will look not only at the lessons learned from the first three concluded interventions but also more broadly at lessons learned from all of the interventions.

In total there have been 11 to date.

A key issue in many of the interventions has been a lack of effective challenge.

Providing effective challenge in a non-executive role is a tough thing to do.

From my own experience, I know that when I join a Board for the first time I have limited knowledge of what the organisation does.

But I have a very high degree of objectivity.

Over time my expertise increases but my objectivity declines.

And as a general rule I think it gets harder to challenge as you get more experience of the organisation and get more invested in the plans and the people.

So the idea of balance is really important. Any governing body needs to balance newer members and more experienced members, objectivity and expertise.

Within our current regulatory framework we have a requirement for all RSLs to review whether a governing body member who has been in place for nine years or more is still able to demonstrate objectivity and independent challenge.

And looking ahead, in the context of assurance statements and regulatory compliance, we will expect all RSLs to be able to demonstrate that they have complied with this requirement.

As far as SHR is concerned what have we learned from the use of our intervention powers?

Our view is that the problems and issues are usually serious and deep rooted and it will take time to address these.

Building governance and leadership capacity is vital. This can be through training and development for existing members or through recruitment of new members.
A key lesson for us is the importance of determining quickly whether the RSL has, or can establish and then maintain, a governing body with the insight and the skills to function as a compliant RSL.
And we have tried to reflect those lessons in the proposed regulatory framework.
So we are proposing to strengthen the place of prevention in our approach to regulation in our current consultation on the Regulatory Framework. The changes are aimed at preventing landlords getting to a position that would require intervention.

For any RSL seeking to minimise the risk of statutory intervention it is really important to actively manage that risk.

Occasionally when we raise concerns around compliance with RSLs we are told that it would be a disaster were we to use our powers of intervention.

This is usually because of the impact that this would have on the RSLs finances as statutory intervention would represent a breach of the loan agreement and that would add costs to tenants.

And because our statutory objective is to protect tenants then we cannot possibly intervene.

There are a number of reasons why we don’t accept that line of reasoning.

Firstly the actions of the RSL that lead to the intervention may themselves represent a loan agreement breach.

And secondly, if we were to accept that onerous penalties for an RSL as a result of intervention are a reason for not intervening then we would be creating a perverse incentive.

Given the serious implications of regulatory intervention for individual RSLs, we require governing bodies to take all appropriate action to avoid such intervention.

If statutory intervention is one of the worst things that can happen to an RSL then the Governing Body should ensure that it is doing everything possible to ensure that it doesn't happen.

And the most appropriate mitigating action in relation to this risk is to demonstrate a commitment across the organisation to a positive and constructive relationship with the Regulator.
Prior to any decision to intervene we will always take account of the implications of that decision for the landlord and its tenants and service users.

But we will always be mindful of the provisions of the Housing (Scotland) Act 2010.

And we won't be deterred from intervening where we believe it is appropriate and proportionate to do so.

The simplest and the best way to avoid statutory interventions is to make sure that you have in place the building blocks of good governance.

These include

- A culture of openness, transparency and constructive challenge
- Governing body members who understand regulatory requirements and standards and the importance of appropriate assurance of compliance
- Governing body members who are supported to fully understand and exercise their role, particularly around effective internal challenge

- Each governing body member being able to demonstrate continuing objectivity and the ability to provide independent challenge
- Effective appraisal of governing body members, and particularly for those with nine or more years of service
- A clear approach to identifying and managing conflicts of interest
- A positive approach to whistleblowing, that makes clear to staff that the RSL will take seriously any concerns raised by them and they will be supported to do the right thing; and
- Regular testing of the effectiveness of internal controls

Before I finish I want to mention 2 key dates.

First of all the consultation closes on **Friday 14 December**.

So please do make sure that you have your say on our proposals by that date.

And secondly our Board is currently seeking to recruit 2 new members.

So if you or anyone that you know want to play a part in the future of housing regulation in Scotland please note that the closing date for applications is **Friday 23 November** at midnight.

We have covered a lot of ground today.

There are three major messages from each of the main topics.

Firstly, sector finances remain strong.

But major challenges lie ahead, in particular the need to raise substantial amounts of private finance to fund future business plans.

Secondly we are looking to the new regulatory framework to make sure that we continue to safeguard the interests of tenants and service users.

And an important consideration in the changes that we are proposing is the need for RSLS to continue to access the funding that they require.

And finally the intervention cases highlight what can go wrong.

And they also indicate the need for sustainable governance that is compliant with regulatory standards.