3 February 2015

Briefing:

Changes to the Regulatory Framework

Changes with effect from 1 April 2015

Summary of key points:

• Substantial changes to the Regulatory Framework will take effect on 1 April 2015.
• The overall effect is a much greater emphasis on the identification and management of risk, on the part both of providers in running their own organisations and of the HCA in regulating the sector.
• Providers will be required to maintain a register of assets and liabilities and to subject their business plans to rigorous stress testing. The Federation will be running a series of roadshows in May and June 2015 to support members in responding to these specific requirements.
1. Introduction

On 29 January the HCA issued some important revisions to the Regulatory Framework 2012. These changes affect the Governance and Financial Viability Standard and the Rent Standard. In addition, the HCA issued a Code of Practice to support the Governance and Viability Standard, revised its Rent Guidance, and made significant changes to the rules governing consents, disposals, and the registration of new providers. All these changes will take effect on 1 April 2015.

2. Executive Summary

The central aim of these regulatory changes is to require providers to identify and manage risks, both to their financial viability generally and more specifically to their social housing assets.

- For the first time, there is an explicit requirement for providers to protect their social housing assets.
- Providers must prepare and maintain a clear and thorough record of their assets and liabilities. It is for each organisation to decide what form that should take, but it should be capable of being made available, if required, within a few days at the most.
- Providers must subject their business plan to robust and multi-variate stress testing, the form of which will vary according to the characteristics and vulnerabilities of each organisation. Providers will be expected to stress their organisations to destruction to identify potential risks and their likely impact, particularly in combination, and to develop strategies to manage and mitigate them.
- The HCA has strengthened existing requirements to comply with law and regulation and to proactively advise HCA of actual or potential non-compliance.
- The HCA has issued a Code of Practice to “amplify” the revised Governance and Financial Viability Standard.
- The Rent Standard and Guidance are amended to reflect the Secretary of State’s direction of May 2014: that is, the annual rent uplift will be CPI+1% and the former £2 allowance for rent convergence is revoked.
- Category 6 (Charging, &c) of the general consent for disposals is tightened. Individual approval will be required from the HCA for disposals to secure index-linked finance and for certain categories of disposal by providers in groups with unregistered parents.

For most associations, the greatest immediate impact will be the new requirements for asset and liability registers and for stress testing. These are considered in some detail in this briefing and are also the subject of a series of Federation roadshows in May and June.
Taking the changes as a whole, they represent a major shift in the HCA’s thinking from its initial suggestion, in its discussion paper of April 2013, of a general requirement for providers to set up separate entities to ring-fence their social housing from any other activities in which they are engaged. The Federation argued strenuously that this would have required extensive and unnecessary restructuring and that a better approach would be a much greater focus on risk. We are pleased that risk management is at the core of the HCA’s present package of changes. We also welcome the HCA’s decision to modify its proposals regarding disposal consents to take account of concerns raised by the Federation.

3. Regulatory changes from 1 April 2015

The formal changes to the Regulatory Framework are confined to the Governance and Financial Viability Standard and the Rent Standard. In addition, however, there is a new Code of Practice issued in relation to the Governance and Financial Viability Standard, and there are changes to the Rent Guidance and the General consent for Disposals.

Although the changes formally take effect on 1 April 2015, this does not mean that providers are expected to be fully compliant by that date. They are, however, expected to be working towards compliance within a reasonable timescale. Requirements involving statements and certificates to be included in the annual accounts will apply (for associations with a 31 March year end) to the accounts for 2015/16 and subsequent years.

It will be convenient to outline the changes in the following order:

- Governance and Financial Viability: including changes to the Standard and the issuing of a Code of Practice
- Rents: including the revised Standard and the Guidance
- General consent and Disposals
- Registration criteria

Asset and liability registers and stress testing raise exceptionally important issues for members and are treated separately at the end of this section.

Governance and Financial Viability

The changes to the Governance and Financial Viability Standard are so extensive as to amount to a virtual rewrite, although key features of the existing Standard are mostly preserved.

At the heart of the revised Standard are requirements for robust business planning. This should ensure that the organisation has access to adequate liquidity; that financial forecasting is soundly based; that the organisation monitors and reports on progress in achieving its business plan; that financial and other risks are taken into account; and that covenants are monitored...
and complied with. These arrangements should be approved by the board and their effectiveness should be reviewed at least annually.

Further to this, the Standard requires the preparation and maintenance of a register of the organisation’s assets and liabilities, and the carrying out of “detailed and robust” multi-variate stress testing. These requirements have significant implications for members, which are considered farther on in this briefing.

Additional significant changes to the Standard include:

- Registered providers are required to “protect social housing assets” and must manage their resources so as to ensure that social housing assets are not put at “undue risk”.
- Providers should manage their affairs with appropriate “skill, independence, diligence, effectiveness, prudence and foresight”.
- Providers are required to communicate with the regulator “in an accurate and timely manner” and they must alert the regulator to actual or potential non-compliance with any Standard (as opposed to the existing Standard, in which the corresponding requirement applies only to actual non-compliance with an economic Standard).
- Providers should adhere to all relevant law (as opposed to “legislation” in the existing Standard).
- Providers must review their regulatory compliance at least annually and must certify in their accounts that they comply with the Governance and financial viability standard.

Associations should note that the last of these requirements has far-reaching implications. For instance, the Governance and Financial Viability Standard requires providers to “adopt and comply with” a code of governance. In certifying that it complies with the Standard, therefore, the provider is certifying that it complies with its chosen governance code, including (for instance) any provisions of that code concerning the length of service permitted to Committee members.

The obligation to “protect social housing assets”, although arguably implied in the 2012 framework, is now made explicit.

The revised Standard strengthens the obligation on providers to keep the regulator informed about any issues of potential concern, including possible losses through fraud, threats to financial viability, governance problems, and actual or potential breaches of any regulatory Standard. It must be stressed that the expectation here is that associations will take the initiative and raise any such concerns with the regulator without waiting to be approached.

Associations should note that the former obligation to adhere to legislation has been broadened to cover “all relevant law”. This of course includes legislation but also common law and court rulings. The HCA originally proposed to go further still and extend this obligation to statutory
guidance; the Federation argued strongly against this on the grounds that it effectively transformed guidance into law, a status it is not intended to have. We welcome the HCA’s decision to apply the obligation only to “law” in a formal sense of the word.

The revised Standard sets out some specific requirements for providers in group structures. Where the group parent is registered, it is required to support and assist any subsidiary registered providers to ensure that they comply with regulatory requirements. Where the parent is not registered, registered subsidiaries must not enter into any arrangements with the parent that could have a “material negative impact” on their social housing assets; moreover, they must set up mechanisms to ensure that their ability to comply with regulation cannot be put at risk by activities elsewhere in the group and that they can call on the unregistered parent for support if necessary.

For-profit providers are required to operate their social housing activities with a separate entity, whose non-social activities may not exceed 5%.

**Rents**

The Rent Standard has been substantially rewritten but the changes are strictly in accordance with the Secretary of State’s direction to the regulator, issued in May 2014. The terms of this direction have been well publicised in the sector so the new requirements are summarised only very briefly here. The Federation issued a briefing on the rent settlement and convergence, which is available at [http://www.housing.org.uk/publications/browse/social-housing-rent-settlement-from-2015-16/](http://www.housing.org.uk/publications/browse/social-housing-rent-settlement-from-2015-16/).

For social rent increases taking place on or after 1 April 2015, the rent regime annual uplift is switched from RPI+0.5% to CPI+1%: this applies both to annual increases and to target rents (which are redesignated as “formula rents”); rent caps increase by CPI+1.5%. The upward tolerance above formula rents remains at 5% (10% for supported and sheltered), but the additional £2 convergence for properties below target is revoked. In practice, this means that it will no longer be possible for sub-target rents to be brought gradually up to target, although it will remain possible to set the rent at target (or “formula”) level on relet.

For affordable rent properties, the annual uplift is also CPI+1%, and the rules about rebasing the rent (i.e. on relet) are unchanged.

Where the tenant’s household income exceeds £60,000, the Rent Standard does not apply (although providers remain free to set rents on the same basis as Rent Standard).
General consent and Disposals

There are new restrictions on Category 6 of the General Consent for disposals.

- Providers with unregistered parents may not use the General Consent to grant a security interest: such a step will require individual approval from the HCA.
- The General Consent may not be used to secure index-linked finance; again, a consent required for this purpose will have to be sought as a one-off.

The HCA has explained its reasoning behind these changes. Where a group parent is unregistered, the HCA has no regulatory oversight of the group as a whole and consequently it cannot, without scrutiny of individual consent requests, achieve the same degree of assurance as it has when dealing with other registered providers. Regarding index-linked finance, the HCA argues that this creates new risk exposures given that providers’ income is constrained by regulation.

The HCA has decided not to proceed with its proposed restriction on the use of the General Consent for transactions for the purposes of supporting on-lending.

Regarding disposals, the HCA has responded to concerns about the new requirement that all net proceeds of sales under the Preserved Right to Buy should be placed in the Disposal Proceeds Fund. The HCA has now made it clear that this will apply only to properties transferred after 31 December 2014.

The HCA also proposes new rules for disposals by for-profit providers; these are the subject of a separate consultation launched on 29 January (the same day as the revisions to the Framework were announced), with a deadline for responses of 26 February. The Federation response is being led by Adam Morton (adam.morton@housing.org.uk).

Registration criteria

The HCA will make a number of changes to the registration criteria for Registered Providers. The key change is that new Providers will have to comply fully with the governance and financial viability requirements from the outset (instead of being allowed a period of leeway to come into compliance).

Asset and liability registers and stress testing

For many associations, the new requirements for asset and liability registers and for stress testing, taken together, are likely to have greatest immediate impact. These new requirements are set out in some detail below.
Members may wish to note that the Federation is preparing a series of roadshows in different parts of the country in May and early June. These will cover both the asset and liability registers and stress testing and will aim to support members not only in meeting these requirements but in doing so in such a way that they also generate useful business tools. Details of prices and how to book will be announced shortly.

Register of assets and liabilities

The HCA requires providers to prepare and maintain a record providing an accurate, up-to-date and comprehensive view of an organisation’s assets and liabilities in a form that can be made available virtually immediately if the organisation runs into difficulties. The background to this is that when HCA has been trying to organise an urgent rescue, it has sometimes taken an inordinate amount of time and labour to identify exactly what any potential rescuer would be taking on.

The requirement is focused on the importance of an accurate asset register when an organisation is in trouble, and HCA is clear that it will not routinely expect to see organisations’ registers – although if a problem arises, HCA will expect to be able to access a reliable register within a few days at the most.

The HCA does not specify the form that the register should take, so it is for each organisation to decide its own approach. The organisation’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 of staff are made redundant.

Although the HCA’s requirement is based on the need for a clear picture when an organisation is in trouble (and consequently the HCA is not likely to be ask for regular or routine sight of organisations’ registers), it obviously makes sense for any 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, besides meeting the HCA’s requirements.

It is perhaps pertinent at this point to mention that the HCA is not proceeding with any requirement for so-called “living wills” (also known as “rescue and recovery plans”). In effect, the asset and liability registers fulfil the many of the purposes that previously led the HCA to suggest living wills.
Stress testing

A major new requirement is that providers subject their business plans to “detailed and robust” stress testing against “identified risks and combinations of risks”. The stipulation of “combinations of risks” is particularly important because it requires multi-variate stress testing: that is, it is essential to test the impact on the organisation of different risks occurring simultaneously or cumulatively. This approach reflects historic experience: for instance, the crash of 2008 was characterised by a sharp fall in property prices, and the seizing up of money markets, and very high interest rates for what little lending remained available; and earlier crashes and recessions have likewise exhibited a concatenation of several different factors (not necessarily exactly the same ones each time).

The HCA has not specified the exact stresses that should be tested: this is for each provider to decide for itself, having regard to its own circumstances and vulnerabilities. For instance, although all providers are likely to be affected to some degree by a collapse in property values and market rents, for some the implications would be especially severe. Likewise, a major reduction in the availability of welfare would affect all providers, but much more significantly for some that for others.

In practice, stress testing is likely to involve a range of different adverse scenarios, also involving consideration of the impact if two or more of these scenarios should coincide.

The HCA has made it clear that it expects providers to stress their organisations to destruction. This should not be seen as a demonstration of weakness, since it is obvious that any business, no matter how financially and organisationally robust it may be, will collapse if it is subjected to sufficient stress. The aim of the exercise, therefore, is not to discover whether an organisation will “pass” or “fail” a given degree of stress; it is to see how much stress it can withstand before it fails and in particular, how it would manage and mitigate any stresses to which it becomes subject.

Indeed, it is likely that for associations, the greatest value of stress testing is likely to be the focus it will prompt on how the organisation will respond to potential adverse future scenarios.

4. Federation’s views

In general terms, but with some significant reservations as mentioned below, the Federation supports the changes to the Regulatory Framework. In particular, we think the HCA is right to focus its attention on the way Providers identify and manage risk; the HCA’s previous intention, as it suggested in 2013, to focus on ring-fencing would have been irrelevant at best, and in many cases, a damaging distraction.
The identification and management of risk, by contrast, is central to running a successful business, and we expect that Providers will be able to respond to the revised Framework in a way that not only meets the regulator’s requirements but also generates new or enhanced business tools for their organisations. This comment applies not only to the stress testing requirement but also to the asset and liability registers.

A specific point of concern with the HCA’s original proposals was the attempt to use the disposals consent regime to regulate on-lending. The Federation’s response argued that the consents regime was neither intended to be, nor capable of being, used in this way. We therefore welcome the HCA’s decision not to proceed with this proposal; and we argue that the Governance and Financial Viability Standard already allows the HCA sufficient scope to deal with on-lending that puts an organisation’s social housing or overall viability at risk, or that is ultra vires or otherwise improper. Regulatory intervention based on the Standard also has the merit of being available even if the inappropriate on-lending does not rely on transactions for which disposals consent is required.

The Federation much regrets the HCA’s decision to proceed with the issuing of its so-called Code of Practice. Leaving aside the fact that the role of the document is mainly explanatory so that it is hardly a “code of practice” as that term is ordinarily understood, we have argued both that this document is unnecessary and that any document of this kind, if issued by the Regulator rather than an independent source, will inevitably come to be seen as tantamount to regulation. This is so notwithstanding the clear statements in the Code’s opening paragraphs to the effect that only that Standards, not the Code, constitute formal regulation with which providers must comply.

A final point is that we note the HCA’s clear unease about group arrangements where the parent is unregistered. In this regard, it is unhelpful that under the Housing and Regeneration Act 2008, the HCA is not permitted to register the non-stockholding parent of a group containing one or more registered providers. This is clearly an anomalous and unhelpful restriction given that non-stockholding parents that were Registered Social Landlords under earlier legislation are allowed to remain on the register. We urge the Government to review this provision at the earliest opportunity and amend the 2008 Act to allow the HCA to register non-stockholding parents of Registered Providers if it believes that this will support more effective regulation.

5. Conclusion

This package of changes reflects significant and continuing changes in the operating environment for housing associations and other providers of social housing. The drastic...
reduction in grant rates, particularly since 2010, joined with the emergence of new forms of private funding and the increasing diversification of many providers, means that the sector is subject to increasing risk. The dangers were starkly illustrated by the near-collapse of Cosmopolitan Housing Group, the experience of which has certainly informed both the HCA’s proposals and the sector’s response to them; but the changing nature of the sector would have necessitated some form of regulatory change in any case.

At the same time as it has implemented these changes, the HCA has modified its own structures in order to increase the resources available for financial regulation in particular.

The overall effect will be a regulatory regime that will have a very different feel, with a much higher priority on dealing with risk and with much more attention on organisations where matters of concern have been identified.

As the new arrangements take effect, the Federation will monitor progress, in conjunction with members and with the HCA, to ensure that the regulatory regime continues to fulfil its essential role of supporting associations in meeting housing need.

John Bryant

5 February 2015