

17 June 2014

Briefing:

Changes to the Regulatory Framework

Consultation by the HCA, May 2014

Summary of key points:

- The focus of the HCA's consultation paper is on the protection of social housing assets by means of robust risk management by registered providers. The primary responsibility for this rests on boards
- Providers' business plans should be subjected to rigorous stress-testing and providers should identify the risks to which they are subject and the steps that are necessary to manage and mitigate those risks.
- Every provider should maintain an accurate and up-to-date register of its assets and liabilities.
- There are special, more demanding, provisions affecting specific categories of registered provider, such as those trading for profit and those in group structures with an unregistered parent.
- The consultation also incorporates changes to the rent standard, changing the annual adjustment from RPI+0.5% to CPI+1% and removing the provision for convergence with target rents.

Contact name: John Bryant
Job title: Policy Leader
Direct line: 020 7067 1082
Email: john.bryant@housing.org.uk

Lion Court
25 Procter Street
London WC1V 6NY
info@housing.org.uk
www.housing.org.uk

1. Introduction

On 27 May 2014 The Homes and Communities Agency formally issued a consultation document setting out a number of important changes that are planned to take effect on 1 April 2015.

This briefing summarises the HCA's proposals and indicates the Federation's initial thinking.

The Federation will, of course, submit a formal response in advance of the official deadline of 19 August.

2. Executive Summary

The consultation takes the form of a formal document supported by 7 annexes and a "Business engagement assessment". The annexes are:

1. Governance and Viability Standard as it will read following the proposed changes
2. Proposed Code of Practice on Governance and Financial Viability
3. Rent Standard Guidance
4. Changes to the General Consent
5. Changes to Registration Criteria
6. Consultation questions
7. Statutory consultees

This briefing does not follow this format. It is based on the consultation document itself; information from the annexes is incorporated where relevant.

The consultation affects only private registered providers (RPs) of social housing: that is, housing associations and for-profit RPs. It does not affect public RPs (stock-retaining LAs). Most of its provisions apply to all private RPs, but some elements apply only to certain categories of RP and this is noted at the relevant points.

The underlying purpose of the proposed changes is to ensure that social housing assets are protected. The focus is on effective risk management, requiring providers to show a clear grasp of their business, its assets and liabilities; and to show that their business plan has been stress-tested. In addition, there are some specific requirements for certain categories of RP, such as: for-profit RPs; RPs with unregistered group parents. There are a number of restrictions on the use of Category 6 of the General Consent, and some changes to the registration criteria.

The consultation therefore represents a marked change of direction from last year's discussion paper, in which the HCA proposed a general requirement for separating associations' core social housing functions from their other activities, so that they took place in separate ring-

fenced entities. The Federation argued strongly that ring-fencing in this way would hamstring the sector without getting to grips with the fundamental issue, which is the need to manage risk.

Accordingly, the Federation welcomes the change of approach that the consultation outlines, and commends the HCA's willingness to listen to issues raised in response to last year's discussion paper.

We do, however, have concerns about some specific elements of the HCA's proposals, and these are discussed below.

It should be noted that the consultation sets out changes to the Rent Standard; essentially, to change the rent increase formula to CPI+1% and to remove rent convergence. These changes are in accordance with the formal direction by the Secretary of State, which allows the HCA virtually no discretion on the issue. The changes to the rent regime have already been the subject of separate member briefings and consequently, this briefing does not deal with the proposed changes to the Rent Standard set out in section 6 of the consultation paper and in appendix 3.

3. Background

This comes two years after the formal commencement of the Regulatory Framework (1 April 2012) and represents a response to three main factors.

- The increasing complexity and difficulty of the operating environment for the sector.
- The advent of for-profit registered providers, which represent a major new challenge for a regulation regime that has grown up in the context of non-profit bodies.
- Experience of stresses within the sector, most obviously demonstrated by the near-collapse of Cosmopolitan Housing Group, that have shown how social housing assets can be put at risk.

These are broadly the same concerns as prompted the HCA's discussion paper in 2013, outlining a general requirement for providers to ring-fence social housing from their other activities. However, the current proposals take a very different approach, focusing instead on the need for robust management of risk.

4. Main text

The most important changes are to the Governance and Financial Viability Standard. However, they are far from amounting to a complete rewrite; most of the standard remains unchanged. The HCA is at pains to state that it remains committed to the principle of coregulation, and the Federation agrees that this is the right approach. This means a continued – indeed,

Contact name: John Bryant
Job title: Policy Leader
Direct line: 020 7067 1082
Email: john.bryant@housing.org.uk

Lion Court
25 Procter Street
London WC1V 6NY
info@housing.org.uk
www.housing.org.uk

strengthened – emphasis on the responsibility of boards to ensure that their organisations remain well governed and financially viable.

Code of Practice

The HCA also proposes to adopt a formal Code of Practice. The purpose of the Code is “to amplify requirements in the [Governance and Financial Viability] Standard, making it easier for registered providers to understand what is expected of them”. The HCA states that it does not intend to return to the Housing Corporation’s regime of “best practice guidance notes” and is at pains to say that the Code is not a “set of rules” and that only the Standard (and not the Code) has regulatory force.

While welcoming these assurances in theory, the Federation is unpersuaded that they will apply in practice. All past evidence suggests that “advice” from the regulator is treated, by the regulated bodies as well as by regulatory staff, as being of equal force as formal regulation. The Federation accordingly opposes the adoption of the Code and urges the HCA not to proceed with this element of its proposals.

This is not to say that the Federation necessarily objects to the content of the Code. Much of it is eminently reasonable and sensible. But it is not the regulator that should be providing advice of this nature; there are many other ways of disseminating sensible and reasonable advice to the sector.

Governance outcomes

There is a new requirement on providers to protect social housing assets. In addition, they are required to comply with “all relevant law”, rather than “all relevant legislation”, as previously.

The Federation agrees with the requirement to protect social housing assets. The requirement to comply with “law”, rather than “legislation” is reasonable, given that important areas of law are based on common law or court rulings rather than on legislation; but we do not agree with the HCA that statutory guidance, by bodies such as the Charity Commission and presumably the HCA itself, should be regarded as “law”.

The requirement to “safeguard ... the reputation of the sector” is not a new one, but it is somewhat developed in the Code. While the Federation agrees about the importance of upholding the sector’s reputation, it is important that this requirement does not become a catch-all provision allowing the HCA to act against anything it dislikes.

Contact name: John Bryant
Job title: Policy Leader
Direct line: 020 7067 1082
Email: john.bryant@housing.org.uk

Lion Court
25 Procter Street
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info@housing.org.uk
www.housing.org.uk

Financial Viability outcomes

There is a new obligation to manage resources so as to ensure that they remain viable and that social housing assets are not put at “undue” risk.

Skills and capability

The proposed Standard sets out the characteristics that providers should show in managing their business: “skill, independence, diligence, effectiveness, prudence and foresight”.

The proposed Standard strengthens requirements on RPs to ensure that they possess appropriate skills, at board and executive level, for the activities that they propose to undertake. The Code unpacks the thinking behind this: that the sector’s increasing diversity imposes greater demands on its leadership. RPs should have “an appropriate skills strategy”, including a regular “skills audit”, and they should manage their affairs with “a suitable degree of independence”. In addition, RPs should adopt and comply with a suitable Code of Governance, and should annually review the effectiveness of their Governance arrangements. The regulatory Code stresses the need for board members to be independent in “character and judgement” as well as free of conflicts of interest.

Risk and protecting social housing assets

This is at the heart of the proposed changes. The Standard is substantially extended to require an “appropriate, robust and prudent business planning, risk and control framework”. This should be approved by the board and reviewed at least annually.

The Standard will include a new requirement for RPs to protect social housing assets, including a specific requirement to ensure that these assets should not be put at “undue” risk to maintain an organisation’s viability. This does not mean that existing assets must be retained at all costs, and the HCA recognises that it is important to allow providers to “churn” their assets. The HCA’s concern is with unplanned and unintended losses of social housing assets.

In addition, providers are required to

- maintain a register of their assets and liabilities;
- engage in “detailed and robust” stress testing of their business plans; and
- ensure that they understand the impact of any new liabilities on the business and on regulatory compliance.

These new requirements represent a very welcome shift in emphasis from the suggestions made by the HCA last year that providers should be required to structure themselves so as to insulate core activities from non-core.

The HCA does not propose to spell out, either in the Standard or the Code, exactly how providers should go about stress-testing; the Code does, however, suggest examples based on the organisation's profile. Whatever stress-testing approach is adopted, the HCA expects it to be rigorous and robust, reflecting the reality of economic pressures to which providers may be subject. For instance, it should reflect the multi-variate nature of financial crises (i.e. events such as a crash in property values, a seizing up of capital markets, and very high interest rates generally occur at the same time, reinforcing each other (and adding to the problems providers will face)). The Federation suggests that members may find it helpful to study the stress tests for the banking sector announced by the Bank of England in April 2014 (www.bankofengland.co.uk/financialstability/Pages/fpc/stresstest): this is not to say that associations should subject themselves to these exact tests, but the Old Lady's paper gives an idea of what a robust multi-variate stress test will look like.

The Federation agrees with the HCA about the importance of effective risk management, and welcomes the HCA's move away from the ring-fencing requirements it outlined in its discussion document last year. We note, however, that the HCA's discussion of risk is based on general business issues affecting the wider economy (e.g. property values, the cost of credit); there is an argument that it should also refer to risks that are more specific to the sector. We think the HCA should be clearer that the management of risk must apply to all parts of the organisation, including its core function of social housing; it is important to avoid giving the impression that social housing is inherently less risky than other types of activity.

The asset register is another key part of the proposals, reflecting the regulator's experience that some providers that have got into difficulties have been unable to provide timely and reliable information about their asset base and any liabilities and encumbrances to which it is subject. RPs will be required to hold an up-to-date register of their assets and liabilities, taking a broad view of liabilities to include, for example, loans, guarantees, leases, derivative exposures, cross default provisions, &c. The aim is to ensure that RPs are fully aware of their assets and liabilities; and also, that the regulator can be provided, if necessary at short notice, with comprehensive and reliable information.

Arrangements with third parties

The Governance and Viability Standard will require RPs to act in furtherance of their own interests and purposes, not for the personal or professional benefit of third parties. The Code makes it clear that (for example) board members and other entities within a group structure

Contact name: John Bryant
Job title: Policy Leader
Direct line: 020 7067 1082
Email: john.bryant@housing.org.uk

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25 Procter Street
London WC1V 6NY
info@housing.org.uk
www.housing.org.uk

are “third parties”; they should not receive any benefits except in furtherance of the organisation’s objectives. This does not prevent providers from benefiting third parties in pursuance of their objects; nor does it stop for-profit entities from paying a dividend.

Reporting to the HCA

Requirements are strengthened, stating that providers must “communicate” with the regulator in an accurate and timely manner. They are also required to certify annually that they comply with the Governance and Financial Viability Statement.

Ring-fencing (NOTE: This applies to for-profit RPs only)

For-profit RPs are required to undertake their social housing in a separate entity with not more than 5% of that entity engaged in activities other than social housing. This requirement will not affect housing associations, which are non-profit bodies. While the Federation does not support ring-fencing as a general requirement, we agree that it is appropriate for for-profit bodies to prevent leakage of assets away from social housing.

Assistance within Groups (NOTE: This applies where the group parent is itself registered)

Where a group parent is itself registered, the HCA will expect it to “support and assist” all RPs within the group to ensure their regulatory compliance (including viability).

Group arrangements (NOTE: This applies where the group parent is not registered)

The HCA proposes special requirements for RPs that are members of groups with unregistered parents to allow for the fact that it has no regulatory oversight of the parent. RPs in these groups will be unable to enter into arrangements with the parent or with other members of the group that could result in a call on the RP’s social housing; and there should be mechanisms in place that require the parent to provide the RP with support, if needed, and that prevent the parent or other parts of the group from acting in ways that prejudice the RP’s ability to comply with regulation.

These are substantial changes that are likely to have a significant impact on RPs with unregistered parents. These requirements imply, but do not explicitly state, that the RP should have a significant level of independence from the parent. (There is no explicit link with the new requirements on board independence more generally.)

It should be noted that some group parents do not hold stock and are therefore not qualified to register, even though group parents without stock already on the register are permitted to retain their status. It remains the view of the Federation that this anomaly should be removed by amending the law to give HCA discretion, on receiving an application, to register a non-stockholding parent of a group including at least one RP, if the HCA considers that this is in the interests of effective regulation.

See also the notes on changes to the Disposals regime (below), which also make special provision for RPs in groups with unregistered parents.

Disposals (NOTE: Some of these changes apply specifically to certain categories of RP, e.g. for-profit RPs or RPs with unregistered parents)

In 2010 a system was introduced requiring RPs to obtain a letter of authorisation from the regulator which allowed access to Category 6, a General Consent to charge and dispose of social land and property. The letters remain valid until the Regulator withdraws or amends them and they reduced the administrative burden previously requiring RPs to obtain specific consent for each transaction.

The new proposals restrict application of the General Consent in the following circumstances:

- a) to support lending between unrelated RPs
- b) on transactions between an RP and its unregistered parent
- c) intra group on-lending of facilities secured on social housing assets already requires specific consent. The proposals extends the on-lending restriction to group to either
 - i. profit-making RPs or
 - ii. unregistered bodies

unless the funds are used for social housing purposes and to group members that operate in England

- d) to secure index-linked finance and
- e) for security to support a guarantee.

The new proposals do not seek to outlaw these transactions but allow the Regulator an opportunity for pre-scrutiny.

The Federation agrees with the aim of preventing social housing assets from leaking from the sector, or being put at risk of doing so. However, the Federation is studying the practical impact of these proposals before arriving at a formal position. A further concern is that it may take the regulator an inordinate amount of time to consider and approve transactions which in most instances may be relatively risk-free and part of the RP's normal activity.

Contact name: John Bryant
Job title: Policy Leader
Direct line: 020 7067 1082
Email: john.bryant@housing.org.uk

Lion Court
25 Procter Street
London WC1V 6NY
info@housing.org.uk
www.housing.org.uk

Placing sales proceeds in a Disposal Proceeds Fund (NOTE: This new requirement applies only to for-profit RPs)

In addition, for-profit RPs will be required to put the net proceeds of disposals into a Disposal Proceeds Fund (DPF), the further use of which will be subject to direction by the regulator. No change is proposed to the rules governing disposals by non-profit RPs.

The HCA justifies the distinction between for-profit and non-profit RPs on the grounds that non-profit RPs have no incentive to make funds available for distribution to shareholders. The Federation strongly supports this distinction and the reason for it. However, the Federation is not convinced that the HCA's proposal delivers its stated aim of achieving "as far as possible consistency between the different types of RPs". This is because, for non-profit RPs, the obligation to put funds into a DPF applies only to certain categories of sales proceeds based on past grant; whereas in the case of for-profit RPs, the obligation will apparently apply to all net proceeds. This is a dangerous precedent that could be used, in future, to apply the wider obligation to non-profit providers as well (an objective in which the regulator has shown interest in the past). These concerns are reinforced by the HCA's assertion that the taxpayer has a legitimate claim to a stake in capital gains: if this "legitimate claim" applies to for-profit RPs, why not to non-profit RPs too? The Federation agrees that sales proceeds should not be distributed as profit, but argues that the objective of achieving consistency between different types of RP would be best achieved by applying the existing DPF obligations equally to all RPs and imposing an additional duty on for-profit RPs to spend any additional proceeds on charitable or public-benefit purposes. Provided they comply with this requirement, this spending should not be subject to specific direction by the HCA.

Use of Disposal Proceeds Funds

The DPF determination will be revised (subject to a separate consultation) to tighten up procedures to ensure that RPs spend funds within the three-year limit. Also, DPFs will be ring-fenced between proceeds of shared ownership sales and other proceeds. Only shared ownership proceeds can be used to support shared ownership housing. (In practice, this will affect only for-profit RPs since non-profit RPs are not required to place shared ownership proceeds in a DPF).

Proceeds from sales under Preserved Right to Buy

For stock transferred from local authorities after 30 September 2014, proceeds of sales under the Preserved Right to Buy must be used for new social housing, and must be handed back if not spent within three years.

Registration criteria

Contact name: John Bryant
Job title: Policy Leader
Direct line: 020 7067 1082
Email: john.bryant@housing.org.uk

Lion Court
25 Procter Street
London WC1V 6NY
info@housing.org.uk
www.housing.org.uk

The registration criteria will be amended to take account of the changes to the Governance and Viability Standard. In addition, applicants will be required to meet governance requirements from the outset, as opposed to being allowed to show only a “reasonable path” to doing so.

Rent Standard

The consultation sets out major changes to the Rent Standard but we are responding to this separately.

Rescue and Recovery Plans (also known as “Living Wills”)

This idea, which was outlined in last year’s discussion paper, has been dropped.

Fees

It is worth noting that the consultation is also silent on the subject of regulatory fees. Any proposal to introduce fees will therefore have to be the subject of a separate consultation.

5. Federation's views

The Federation’s considered view will be embodied in the formal response to the consultation, which will be submitted by the deadline of 19 August. Meanwhile, the Federation will be extensively consulting with members throughout the country.

The Federation’s immediate response has been noted in the previous section.

6. Conclusion

The Federation agrees that a more complex and demanding operating environment requires a regulatory response, and feels that the proposals in the HCA consultation paper represent a welcome advance from the ring-fencing approach outlined in last year’s discussion paper. It is right to focus on risk and how it is managed, and the prime responsibility for this is rightly placed on boards.

However, a number of the HCA’s proposals are likely to have far-reaching implications: for example, changes in the consents and disposals regime and the treatment of groups with an unregistered parent. We shall be consulting with members before arriving at a final view.

John Bryant

Contact name: John Bryant
Job title: Policy Leader
Direct line: 020 7067 1082
Email: john.bryant@housing.org.uk

Lion Court
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Policy leader

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Contact name: John Bryant
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Email: john.bryant@housing.org.uk

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