



THE SCOTTISH HOUSING REGULATOR

Beyond the Crunch?

January 2011

**The Scottish Housing Regulator's Analysis of the Finances
of Registered Social Landlords 2009/10**

Beyond the Crunch?

Highlights from the Report

| | | |
|----------------|------|---|
| 87.8 | 86.0 | In 2008/09 RSLs used 87.8% of their annual turnover to meet their operating costs. In 2009/10 this fell to 86.0%. |
| £1.2bn | | In 2009/10 turnover was just over £1.2bn, an increase of 7.6% on the previous year. |
| 84.2 | 19 | Interest payable totalled £84.2m in 2009/10, a reduction of just under 19% on the previous year. |
| £95.2m | | The total pension deficit shown in the sector's accounts was £95.2m, a more than eight fold increase on 2008/09. |
| 86 | 66 | In the last 20 years the Retail Price Index (RPI) has risen by 86%. Over the same period the Consumer Price Index (CPI) has risen by 66%. |
| £3,073 | | The rent receivable per unit in 2009/10 was £3,073, an increase of 3.7% on the previous year. |
| 68 | 24 | 68 RSLs made a net deficit (after interest charges) in 2008/09. In 2009/10 this dropped to only 24 RSLs. |
| £174.2m | | The total operating surplus on social letting activities was £174.2m, an increase of 17.5% on the previous year. |
| 78.5 | 21.5 | 78.5% of turnover was in respect of social letting activities: 21.5% of turnover was in respect of other activities. |
| £5.3m | | The total operating deficit on other activities was £5.3m. In 2008/09 the operating deficit was £12.0m. |

Summary

When and how we engage with individual RSLs depends on the circumstances at each organisation. We also look at the sector as a whole to understand the context that landlords operate in and any emerging trends, particularly around the major risks to the sector.

Based on our analysis we conclude:

Operating Context: The operating environment for Scottish RSLs is challenging and likely to remain so for the foreseeable future. VAT has just increased to 20%, inflation (either measured by CPI or RPI) is increasing, there is considerable exposure to any increase in the rate of interest, there are likely to be significant changes to the benefits system and in November 2010 the Scottish Government's draft budget set out the first real terms reduction since devolution. These matters were covered in the Regulatory Advisory Note that we issued last year and we provide more detail in Section 3 of this report.

Given that context there is much within the aggregate financial performance of the sector for the year ended 31 March 2010 that suggests RSLs are managing the situation.

At a time when cash management is of paramount importance:

- the sector's current ratio¹ rose from 119% to 137%; and
- borrowing costs fell by 19% even though the sector's aggregate borrowings at 31 March 2010 were up by 12% on the previous year.

Its also worthy of note that

- the sector's aggregate surplus rose by 35% to £88.5m; and
- the number of RSLs making a net loss fell to 24 (from 68 in the previous year).

However it is clear from the nature of the business environment and the emerging risks that RSLs are facing challenges which are likely to be significant and long term. When we published *Shaping Up for Improvement* in July 2009 we said:

¹ Current assets divided by current liabilities.

“organisations need to be sure they have the right skills in place, particularly around treasury management, investment, asset management, finance and business planning. In less benign times, strong leadership and the ability to drive through tougher business disciplines should be even more important.”

The relatively favourable financial results returned by most RSLs for 2009/10 provide evidence of their success in rising to the short term challenges. However the nature and scale of these challenges - some of which we describe in Section 3 - indicate the extent to which RSLs’ management and governing bodies need to continue to adapt and improve to ensure that they are equipped to deal with the future.

Financial Sustainability: In the sector as a whole turnover has grown at a faster rate than the increase in costs. However, our view is that the short and medium term future is likely to be more of a challenge than the immediate past. We believe it will be difficult for most RSLs to continue to increase turnover by more than inflation and therefore a focus on cost control and operational efficiency is essential.

Cost of Finance: RSLs continue to be able to attract private funding on good terms. The aggregate cost of finance was lower in 2009/10 than at any time in the past five years although the amount borrowed grew by 63% during that period. But we believe RSLs, particularly those with variable rate financing, should plan for higher interest rates in future. Although the overall cost of debt fell in 2009/10, margins on new debt are significantly in excess of those for historic debt. This means that borrowers are vulnerable to increases in base rate and LIBOR. Moreover, pressures within the banking sector, including the end of the Special Liquidity Scheme (SLS), may exert upward pressure on margins and lead banks to be more vigilant in monitoring covenant compliance and more willing to seek repayment and possibly penalties in the event of any breach. Each RSL should consider its treasury management arrangements in order to manage its future exposure to higher rates and to ensure sufficient access to private finance at affordable rates.

Business Planning & Governance: We have seen significant improvements in business plans and have evidence of improvement in the governance of business planning. The difficult economic environment means that it remains essential for management and governing bodies to continue to understand the risks involved in the strategies that they are following. In some cases actions taken to mitigate and minimise risk may themselves expose the organisation to new risks. The

governance of risk management and business planning should be a priority for all RSLs in the short and medium term.

Pension Provision: During 2009/10 the aggregate pension liabilities reported by the sector increased more than eightfold to £95m. But the manner in which landlords are required to treat this in their accounts means that the true liability will likely be in excess of this amount. All governing bodies of RSLs which are members of multi-employer defined benefit schemes need to incorporate explicit consideration of the risks attaching to this form of pension provision in their business planning processes. Particular attention should be paid to any covenant risks that may arise from an increase in pension liability or changes in accounting practice.

Future Challenges: Our analysis for 2009/10 provides assurance about the manner in which management and governing bodies are coping with the difficult economic circumstances. When we issued *Shaping Up for Improvement* in July 2009 we said:

“RSLs are facing tougher times and will need to make decisions about their purpose, what sort of business they want or can afford to be in, and what impact they are aiming to have on an area or community.”

The emerging issues, including those identified in Section 3 of this report, make that task more difficult but more important still.

Conclusion: We have carried out an assessment of the financial risks facing the sector based on the latest information from the RSLs that we regulate. We conclude that the sector is facing significant but manageable financial stresses.

The challenges that will now confront RSLs are likely to be more formidable than those of the recent past. So, we are reviewing the financial data that we collect from RSLs to ensure it allows us to exercise our statutory function effectively and proportionately. We will shortly be discussing with the sector the changes that we see as necessary

We are now comprehensively assessing the risks of all RSLs, covering financial viability, governance, stock and service quality. Our findings from this will determine which RSLs we need to engage with. Where we need additional assurance on financial issues we will engage with individual RSLs as part of this overall process. We will update our regulation plans for those RSLs that we are currently engaging with and publish new plans for those RSLs that we intend to have a high or medium engagement with in future. We will do this by 31 March 2011.

There are many emerging issues, particularly in relation to the economic climate, government policy and the lending environment, that have the potential to increase the risks to the ongoing financial viability of RSLs. So it is important that RSLs maintain a clear focus on cost control and operational efficiency and continue to improve their business plans and business planning. RSLs need high standards of governance which demonstrate that the governing body has given informed consent to the plan being followed with a full understanding of the inherent risks.

1. Introduction

The Scottish Housing Regulator is the agency that independently operates the regulation and inspection powers in the Housing (Scotland) Act 2001 to:

- protect the interests of current and future tenants, and other service users;
- ensure the continuing provision of good quality social housing in terms of decent homes, good services, value for money and financial viability; and
- maintain the confidence of funders.

This report is concerned with RSLs and provides commentary and analysis on the information that we have collected from their most recent annual accounts, loan portfolios, and five year financial projections. Statistical and performance tables for landlords were published on 30 September 2010 and a summary of the main findings is attached to this report as an Appendix. The report is also informed by our experience of engagement and interaction with RSLs over the last year. It provides more detail and analysis in relation to the emerging risks that we identified in our Regulatory Advisory Note that we sent to all RSLs in August 2010.

We have analysed data over a five year period for most of the time-trend analysis throughout this report. We chose this time-span because it is long enough to provide a good indication of direction (i.e. whether a measure is generally increasing, decreasing or remaining stable) but also remains short enough to reflect the current composition of the sector. We will from time to time consider a longer time frame where that is appropriate.

2. The Sector's Finances: A Review of the Accounts for the Year Ended 31 March 2010

2.1 Financial Stress & Sustainability

General

There are a number of indicators that point to a slight lessening of financial stress in 2009/10 relative to previous years. These include:

- a reduction in the proportion of turnover needed to meet operating costs;
- a reduction in the proportion of turnover needed to meet interest charges;
- a reduction in the number of RSLs making an operating deficit;
- a reduction in the number of RSLs making a net deficit; and
- a reduction in the number of RSLs with interest cover below the historic and generally accepted benchmark of 110%

But despite this we believe that the financial challenges in the short and medium term future are likely to be more significant than those of the immediate past. In particular we believe that many RSLs remain vulnerable to the effects of a rise in interest rates from their current historic low, and we set out in Section 3 our view of the emerging risks that RSLs will need to take into account in their business planning.

Operating Costs, Interest Charges and Turnover

In 1997/98, sector-wide aggregate operating costs represented approximately 72% of aggregate turnover. Ten years later this had risen to almost 90%. At that point, when interest charges were included, total costs were in excess of 100% of turnover.

In 2008/09 we reported a marginal reduction in this ratio from the previous year. There was a further fall during 2009/10 with operating costs accounting for 86.0p of every pound of turnover earned (compared to 87.8p in 2008/09), and interest charges costing an additional 7.0p (2008/09, 9.3p). Total costs therefore reduced to 93.0% of turnover in 2009/10, from 97.1% in 2008/09.

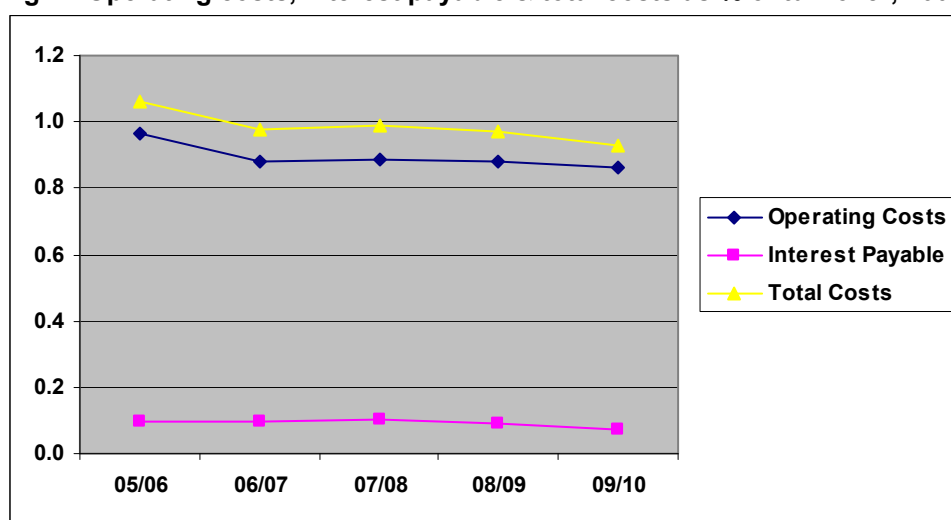
The improved aggregate position for 2009/10 was due to the fact that RSLs were able to increase turnover at a higher rate (7.6%) than total costs (3.0%). The increase in total costs of 3.0% is made up of a rise in operating costs of 5.3% and a reduction in debt servicing costs of 18.8%.

Previously we have commented on the risks arising from the long term trend for operating costs to rise at a faster rate than turnover. The fact that turnover is now

rising at a faster rate than operating costs will assist financial sustainability. But in the current economic climate it looks challenging for RSLs to be able to continue this particular trend. Operating costs, although rising more slowly than turnover, continue to rise at a faster rate than inflation, whether measured by the Consumer Price Index (CPI) or the Retail Price Index (RPI). Therefore, it remains necessary for RSLs to have a continued focus on cost containment and control.

The reduction in debt servicing costs comes despite an increase in debt outstanding from £2.12bn to £2.36bn. This is further discussed at 2.4 below, and Fig. 1 illustrates the five year position.

Fig. 1: Operating costs, interest payable & total costs as % of turnover, 2005/06-2009/10



Source: SHR Accounts Consolidation System
 (the substantial fall in costs in 06/07 was mainly due to an accounting policy change resulting in the capitalisation of items that would previously have been charged to Income & Expenditure)

This is an aggregate position, the extent to which we engage with individual RSLs and the manner in which we engage is determined by the circumstances of each RSL. In that context, in 2009/10 there were 24 RSLs where operating costs, plus interest charges exceeded turnover (a significant drop from 68 the previous year). Further, of those 24, there were 12 where operating costs alone exceeded turnover (21 in 2008/09).

Not generating a surplus in any particular year is not necessarily a matter of regulatory concern. We look at a number of information sources in order to gauge the financial health of the organisations we regulate and wherever necessary we seek additional information in order to gain the assurances that we need.

Social Lettings and Other Activities

Our analysis indicates that the sector is earning operating surpluses on social letting activities (those related to owning and managing houses) but deficits on the other activities that they carry out. But the gap between income from and expenditure on these other activities has shrunk in 2009/10, dropping by more than half to £5.3m.

Fig. 2 below summarises the position:

Fig. 2: Analysis of Turnover and Operating Costs 2008/09 & 2009/10

| | Social Lettings £000's | Other £000's | Total £000's |
|------------------------------------|---------------------------|-----------------|-----------------|
| 2008/09 | | | |
| Turnover | 886,994 | 233,027 | 1,120,021 |
| Operating Costs | 738,808 | 245,094 | 983,902 |
| Operating Surplus/(Deficit) | 148,186 | (12,067) | 136,119 |
| 2009/10 | | | |
| Turnover | 946,149 | 258,623 | 1,204,772 |
| Operating Costs | 771,949 | 263,959 | 1,035,908 |
| Operating Surplus/(Deficit) | 174,200 | (5,336) | 168,864 |

Source: SHR – Accounts Consolidation System

2.2 Income

Aggregate Sector Income

Total sector income in 2009/10 was £1,211.0m, an increase of 4.9% on the previous year. Fig. 3 gives the breakdown of total income for the past five years.

Fig. 3: Total Sector Income, 2005/06-2009/10

| | 05/06 £000's | 06/07 £000's | 07/08 £000's | 08/09 £000's | 09/10 £000's |
|---|-----------------|-----------------|------------------|------------------|------------------|
| Turnover | 856,068 | 930,714 | 1,012,262 | 1,120,019 | 1,204,772 |
| Profit on sale of fixed assets [∞] | 19,704 | 29,126 | 35,015 | 19,367 | 663 |
| Interest receivable & other income | 16,462 | 15,117 | 21,831 | 15,445 | 5,596 |
| Total Income | 892,234 | 974,957 | 1,069,108 | 1,154,831 | 1,211,031 |

Source: SHR Accounts Consolidation System

[∞] Profit on sale of fixed assets is an aggregation of individual amounts taken from RSLs' accounts & represents the difference between sale proceeds & book value at the time of sale.

Turnover

Turnover includes income from all sources, with the exception of the profit on the sale of fixed assets and interest receivable. Aggregate sector turnover in 2009/10 was £1,205m, an increase of 7.6% on the previous year.

Just over 20% of the sector's turnover (£244.5m) was attributable to Glasgow Housing Association (GHA), the largest RSL in Scotland. This is more than the combined turnover of the next eight RSLs ranked in order of turnover. In 2008/09 GHA's turnover of £249.6m represented 22% of sector turnover and was more than the combined turnover of the next nine RSLs ranked in order of turnover. The relative size of GHA within the sector is expected to reduce further as a consequence of the program of second stage transfers (SST) that is currently under way.

In s.2.1 above we made reference to the fact that RSLs are earning operating surpluses in social lettings activities but deficits in the other activities that they are carrying out. Some £946.1m or 78.5% of turnover can be attributed to social lettings (2009: £887.0m and 79.1%). The detailed analysis of turnover is as follows:

Fig. 4: Analysis of Turnover: 2008/09 and 2009/10

| | 08/09 £000's | 09/10 £000's | % Change |
|---------------------------------|--------------------|--------------------|------------|
| Rent Receivable | 818,629.2 | 863,403.2 | 5.5 |
| Service Charges | 60,519.4 | 64,465.5 | 6.5 |
| Gross Income | 879,148.6 | 927,868.7 | 5.5 |
| Voids | 15,459.4 | 14,832.3 | -4.1 |
| Net Income | 863,689.2 | 913,036.4 | 5.7 |
| Grants from Scottish Ministers | 19,835.2 | 27,600.0 | 39.1 |
| Other Grants | 3,469.7 | 5,512.7 | 58.9 |
| Social Lettings Turnover | 886,994.1 | 946,149.1 | 6.7 |
| Other Activities | 233,027.3 | 258,623.0 | 11.0 |
| Total Turnover | 1,120,021.4 | 1,204,772.1 | 7.6 |

Source: SHR – Accounts Consolidation System

The number of units either owned or managed by RSLs rose from 276,342 to 280,930 in 2009/10. This means that the rent receivable per unit per annum increased from £2,962 to £3,073 or by 3.7%. Inflation as measured by RPI was 4.4% during the year with a corresponding figure for CPI of 3.3%. The UK government's stated intention to link benefits to changes in the CPI rather than the RPI (see also 3.5 below) presents a future challenge to those RSLs which have used RPI as the benchmark for rent increases.

It is unlikely that the rate of grant increase illustrated above can be sustained in the current fiscal climate (see 3.12 below).

Profit on Sale of Fixed Assets

When we published *Shaping Up for Improvement* in July 2009 we commented:

“Substantial and lucrative asset sales have been possible in a growing and buoyant property market. The downturn in the housing sector, alongside the likely pressure on other income streams, will constrain the sector’s ability to secure substantial non-rental incomes from such sources in the coming months and years.”

Profit on the sale of fixed assets fell by 45% in 2008/09 and has fallen by a further 96% in 2009/10. This latter figure is partly influenced by one-off entries relating to GHA’s SST programme. Excluding the effects of this from the last two years, the rest of the sector recorded a more modest fall of approximately 28% in 2009/10 to show a total profit on sale of fixed assets of approximately £9.5m. But by any measure it is clear that profits (and revenues) from asset sales have fallen. This is mirrored in the drop in the number of houses sold to existing tenants through Right To Buy, with sales down by 45% from 2005/06 to 2008/09 and by a further 50% in 2009/10. The change to the RTB in the Housing Scotland Act 2010 will exert further downward pressure and it is therefore unlikely that RSLs will achieve the profits and revenues realised during the period 2005-2008 in the foreseeable future. This is seen also in our examination of RSL business plans which show a considerable reduction in anticipated revenues and profits from this source.

Interest Receivable and Other Income

The limit on the ability of RSLs to secure non-rental income streams is further illustrated by the decline in interest receivable and any other income. The sector total of £4.4m represents a reduction of around 72% on the corresponding figure in the previous year (£15.4m) which itself was a drop of nearly 30% on 2007/08.

2.3 Expenditure

Total Expenditure

Total expenditure by the sector increased by £32.5m or 3.0% in 2009/10 and Fig.5 illustrates how the sector’s costs have changed over the past five years.

Fig. 5: Total Expenditure 2005/06–2009/10

| | 05/06 £000 | 06/07 £000 | 07/08 £000 | 08/09 £000 | 09/10 £000 |
|--------------------------|----------------|----------------|------------------|------------------|------------------|
| Operating Costs | 823,493 | 806,514 | 899,742 | 983,902 | 1,035,908 |
| Interest Payable | 85,180 | 89,360 | 103,284 | 103,656 | 84,160 |
| Total Expenditure | 908,673 | 895,874 | 1,003,026 | 1,087,558 | 1,120,068 |

Source: SHR – Accounts Consolidation System

Operating Costs

Operating costs in 2009/10 were £1,035.9m, an increase of 5.3% on the previous year. Not only have costs risen less than income in 2009/10, but they have risen by 4% less than the annual increase in 2008/09. Figs. 6 and 7 below show the distribution of these costs, in line with the categories specified in the 2007 Accounting Order.

Lettings costs (costs of owning and managing houses), at £771.9m represented around 74% of all costs. Around 82% of lettings costs are attributable to management and maintenance activities.

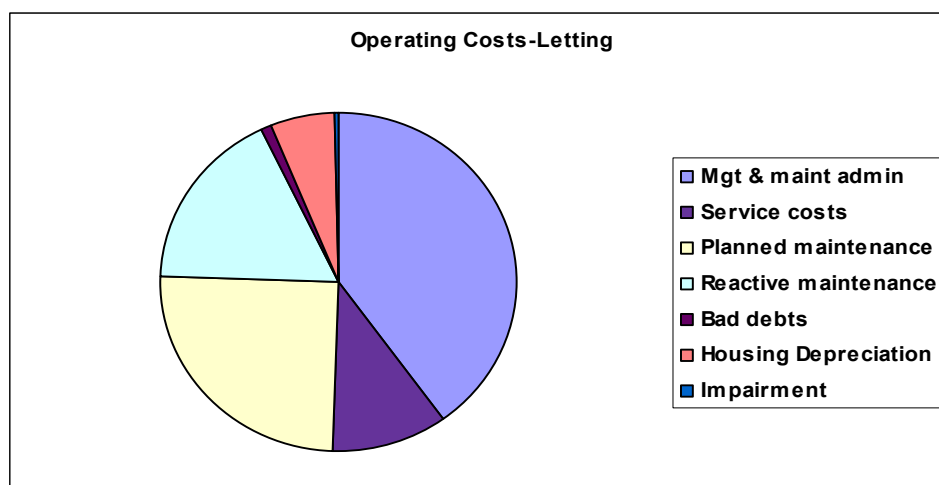
Fig. 6: Social lettings operating costs 2005/06-2009/10

| | 05/06 £000's | 06/07 £000's | 07/08 £000's | 08/09 £000's | 09/10 £000's |
|-------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Mgt & maintenance admin | 242,831 | 251,811 | 271,848 | 291,949 | 309,378 |
| Service costs | 65,119 | 70,948 | 74,064 | 79,452 | 80,987 |
| Planned maintenance | 117,257 | 135,082 | 166,002 | 186,553 | 192,120 |
| Reactive maintenance | 104,591 | 112,268 | 136,510 | 138,937 | 133,878 |
| Bad debts | 11,931 | 9,459 | 8,390 | 9,163 | 8,763 |
| Depreciation – housing | 26,403 | 28,424 | 35,603 | 38,750 | 45,610 |
| Impairment | -757 | 1,768 | 8,830 | # -5,996 | 1,213 |
| Total | 567,375 | 609,760 | 701,247 | 738,808 | 771,949 |

Source: SHR – Accounts Consolidation System

This is affected by one-off issue related to a single large provider. For comparative purposes the true figure is approximately £2m

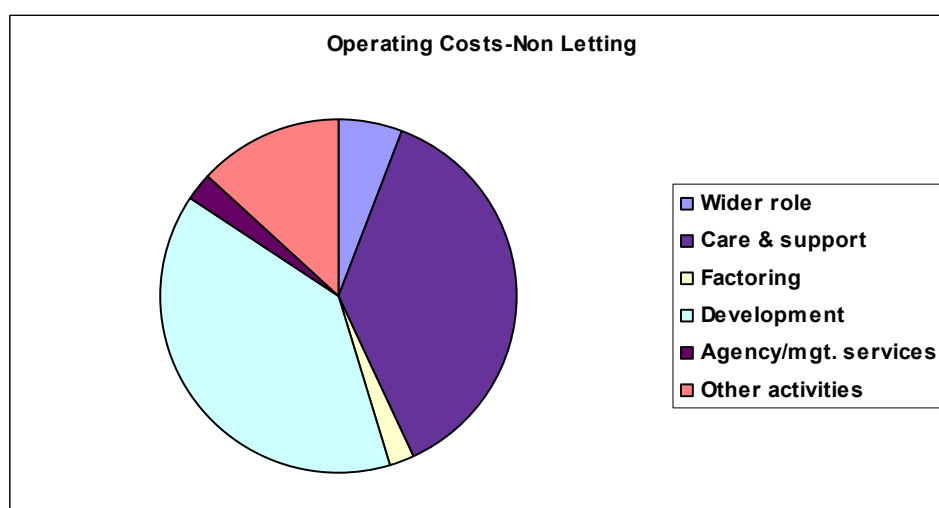
Fig. 7: Operating costs – Letting Activities 2009/10



Source: SHR – Accounts Consolidation System

Operating costs not directly attributable to letting activities were up to £263.9m from £245m in 2008/09. Fig. 8 below shows that care & support and development accounted for around 76.5% of this sub-total between them. RSLs have again allocated approximately £34m (13%) as ‘other’ activities as they did not fit under any of the standard headings the 2007 Accounting Order. However our analysis shows that more than half of that (£19.2m or 56%) is attributable to GHA alone, and almost 70% (£23.5m or 69.9%) is accounted for by only three RSLs.

Fig. 8: Operating Costs - Non letting activities 2009/10



Source: SHR – Accounts Consolidation System

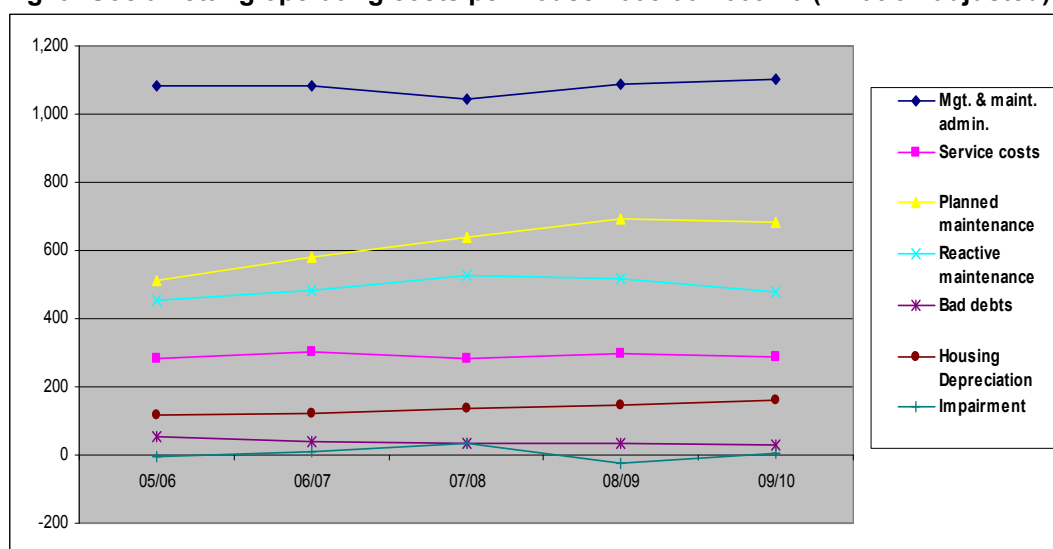
Social letting management and maintenance costs

Any analysis of operating costs is affected by capitalisation policies for major repair costs; this is where landlords add the cost of improvements to their houses to their

balance sheets. RSLs can have significantly different policies on the capitalisation of major repairs and they have only had to disclose the amount of any capitalised major repairs since the 2008 Statement of Recommended Practice (SORP) came into effect on 1 April 2008. In 2009/10 RSLs reported capitalised major repairs of £169.7m, marginally down on £177m for 2008/09. The anticipated wider adoption of component accounting will have a major impact on this (see 3.7 below).

Fig. 6 above showed that the total cost of lettings activities has risen by 36% over the last five years. However, when those figures are displayed in unit costs, and adjusted for inflation (see Fig. 9) this illustrates that management and maintenance costs have remained relatively constant and planned maintenance expenditure (excluding any capitalised costs), while clearly up across the five years actually rose very little in 2009/10, despite RSLs continuing to work towards meeting the requirements of the Scottish Housing Quality Standard. (SHQS).

Fig. 9: Social letting operating costs per house 2005/06-2009/10 (inflation adjusted)



Source: SHR – Accounts Consolidation System

Expenditure can vary considerably from RSL to RSL and from classification to classification. In 2009/10 the median management and maintenance administration cost per house was £958. This represents a 0.7% drop from 2008/09's £965 per house.²

In 2009/10 a quarter of all RSLs spent more than £1,126 per house (2008/09, £1,123) and a quarter spent less than £821 per house (2008/09, £819). Predictably,

² . We use medians in this report as an average or mean is sometimes not appropriate for our data. This is because the distribution of RSL stock is very skewed: a small number of organisations account for a large proportion of the total stock.

Care and Support RSLs had the highest unit expenditure on management and maintenance administration with a median spend of £1,250 per house, and this figure was some way clear of the General RSL group with a median of £957 per house.

On direct maintenance costs the sector medians in 2009/10 were £574 per house (2008/09, £505) for planned maintenance and £402 per house (2008/09, £416) for reactive maintenance. Although at £192.1m total planned maintenance across the sector is up around 3.0% from the 2008/09 level (£186.6m) the per house increase is very small (0.88% from 2008/09 when adjusted for inflation).

The costs shown here are influenced by:

- the size and quality of landlords' stock and therefore how much they invest in their stock, including work required to meet the Scottish Housing Quality Standard;
- landlords' asset management practices, including where landlords set the boundaries between planned and routine maintenance and their capitalisation policies; and
- the tender prices landlords can achieve.

As the quality of the housing stock has improved at a steady pace (we will report on this later in the financial year in the context of SHQS monitoring) we conclude that some landlords may have been able to take advantage of falling tender prices during the period

However, reactive maintenance costs are down, both in total across the sector where a drop of around 3.6% took spend in 2009/10 down to £133.9m from £138.9m in 2008/09, and per house where a slightly bigger drop of 5.2% took the spend down to £477 from £503 in 2008/09.

Staff and Non Staff Costs

In addition to the accounting order analysis we also analyse costs between staff and non-staff. Fig. 10 shows the five year trend in relation to these.

Fig. 10: Total Sector Expenditure, 2005/06–2009/10

| | 05/06 | 06/07 | 07/08 | 08/09 | 09/10 |
|------------------------------|----------------|----------------|----------------|----------------|------------------|
| | £000's | £000's | £000's | £000's | £000's |
| Non Staff Costs | 556,798 | 523,068 | 592,777 | 656,442 | 690,576 |
| Staff Costs | 266,695 | 283,446 | 306,995 | 327,466 | 345,332 |
| Total Operating Costs | 823,493 | 806,514 | 899,742 | 983,908 | 1,035,908 |

Source: SHR Accounts Consolidation System

Non-staff costs increased by £34.1m or 5.2% in 2009/10, approximately half of the increase in the previous year (£63.7m or 10.7%).

Staff Costs

In 2009/10, staff costs rose by £17.9m (or 5.4%) to £345.3m (2008/09 £20.5m and 6.7%). The number of staff employed in the sector fell to 11,518 (full time equivalent posts) from 11,600 in 2008/09, a drop of less than 1.0%. This means that the cost per member of staff increased from £28,230 to £29,982, an increase of 6.2%. This includes overheads such as employers' national insurance contributions and pension contributions (where applicable). The increase in RPI for the same period was 4.4%.

Sector staffing levels relative to stock numbers fell in the past year. But over the period from 2005 to 2010 staff numbers increased by 12% compared to an increase in stock of 7%.

The biggest increases were in direct labour and concierge staff (29%) and office-based staff (18%). Care and support staff numbers increased by only 1%. As a result, the ratio of staff to stock has decreased from 1:24 in 2005 to 1:23 in 2009.

Between 2005/06 and 2009/10:

- total staff costs rose by 29%;
- staff costs per house rose by 17%;
- staff costs per full time equivalent member of staff rose by 20%; and
- EVH salary scales³ have risen by 14%.

After adjusting for inflation, between 2005/06 and 2009/10:

- total staff costs rose by 16%;
- staff costs per house rose by 5%; and
- staff costs per full time equivalent member of staff rose by 7%.

³ A number of RSLs use the Employers in Voluntary Housing (EVH) salary scales,

So, while the sector has halted the growth in the number of staff it employs, its staff costs continue to grow. This will partly be the result of staff progression through salary scales, but annual pay increases also impact. This is a cost area that RSLs will need to keep tight control of to help them meet the other cost pressures they face.

Interest Payable

RSLs continue to attract private funding on good terms. Our loan portfolio analysis indicates that at 31 March 2010, RSLs had outstanding borrowings of £2.36bn (2008/09, £2.12bn), up 11% on the previous year. By contrast, the cost of servicing the debt decreased significantly by almost £19.5m or 19%, to £84.2m from £103.6m. As Fig.11 indicates interest payments in 2009/10 were lower than in the equivalent period five years ago although the amount outstanding was some 63% higher. So, despite the rise in outstanding loan balances, only 24 RSLs actually reported an increased cost of debt servicing in 2009/10 and of those 18 reported increases of less than £100k.

Another indication of the reduction of the cost of finance can be seen in the accounts of individual RSLs. When assessing financial risk one useful measure is interest cover (operating surplus net of accounting adjustments as a proportion of interest costs). This gives a measure of the affordability of an RSL's debt servicing costs. In 2009/10 only 13 RSLs recorded interest cover below 110%, a marked improvement on 2008/09 (35 RSLs).

At the end of 2004/05 the proportion of RSLs net housing assets that was funded from Housing Association Grant (HAG) and other capital grants was 73.1%. By the end of 2009/10 this had fallen to 68.0% (2008/09, 69.4%). This illustrates the increasing extent to which RSLs have utilised private borrowings, as well as their own internally generated reserves, to continue to grow their asset base. The recently announced budget proposed by the Scottish Government has a reduced total amount of funding to support provision of new build by RSLs. So it is clear that any significant new build programme will need to have a greater proportion of funding from RSLs' own reserves or borrowing capacity or some combination of both. This has the potential to increase the financial risk attaching to the sector as a whole as well as to individual RSLs, should they choose to continue to build in this new context.

In 2007/08 for every pound that RSLs earned in turnover some 10.2p was spent in servicing debt. This fell to 9.3p in 2008/09 and has fallen further in 2009/10 to 7.0p. The variation over the period from 2005/06 to 2009/10 is illustrated in Fig.11 below:

Fig.11 Interest Payments, Turnover & Borrowing 2005/06 to 2009/10

| | 05/06 | 06/07 | 07/08 | 08/09 | 09/10 |
|--------------------------|-----------|-----------|-----------|-----------|-----------|
| Interest Payments (£000) | 85,180 | 89,360 | 103,284 | 103,656 | 84,160 |
| % of Turnover | 9.9 | 9.6 | 10.2 | 9.3 | 7.0 |
| Total Borrowing | 1,444,632 | 1,606,039 | 1,792,254 | 2,122,166 | 2,357,459 |
| Average Interest Rate | 6.06 | 5.86 | 6.08 | 5.30 | 3.76 |

Source: SHR Accounts Consolidation System

The average rate of interest paid by RSLs in 2009/10 was 3.76%, a significant reduction on the 2008/09 level of 5.30%.

It is clear that RSLs continue to be able to borrow money at very favourable rates relative to their commercial counterparts. This is welcome, and demonstrates that lenders continue to have a strong view of the creditworthiness of the sector. It does, however, remain the case that many organisations within the sector will be vulnerable to increased charges for borrowing (see also 3.9 below).

We have in the past stressed the importance of treasury management in the governance, risk management and business planning of RSLs. The emergence of new risks, the likelihood of an increase in the average cost of borrowing for RSLs and a greater focus on covenant compliance by lenders means that this would be an opportune time for RSLs to review their treasury management arrangements in order to manage future exposure to higher rates and to ensure sufficient access to private finance at affordable rates.

Pensions

Our review of the 2009/10 accounts illustrates the extent of the challenge faced in relation to the provision of pensions for staff. Overwhelmingly the pension schemes within the sector are based on defined benefits and are multi-employer. In defined benefit schemes the benefit on retirement is determined by a set formula, usually related to the employee's final salary, rather than depending on investment returns. This means that the risk attaching to any shortfall on return on investment is that of

the employer - or in the case of multi-employer schemes the employers collectively - rather than the employee.

The accounting treatment for pension assets and liabilities is set out in Financial Reporting Standard 17 (FRS17). For defined benefit schemes any deficit (the difference between the estimated value of the assets and the actuarial estimate of scheme liabilities) should be shown on the balance sheet of the organisation. However FRS 17 also states that where more than one employer participates in a defined benefit scheme each employer should not account for the scheme as a defined benefit scheme unless they are able to identify their share of the underlying assets and liabilities in the scheme on a consistent and reasonable basis. Where employers are unable to do so, they should account for the contributions to the scheme as if it were a defined contribution scheme. For defined contribution schemes accounting entries are limited to contributions payable during the year (in the revenue account) with no recognition (in the balance sheet) of pension liabilities arising from actuarial estimates.

Despite the concession in FRS17 for multi-employer schemes there has been a substantial increase in the pension liability reported on RSLs' balance sheets. 18 RSLs reported a liability in their accounts for 2008/09, an aggregate liability of £11.5m. For 2009/10 the reported liability of these same RSLs had risen to £91.2m, an increase of 793%. In addition a further six recognised a liability (totalling £4.3m) for the first time. The aggregate recognised pension liability of all 25 organisations was therefore £95.8m.

Therefore an increasing number of employers are managing to identify their share of assets and liabilities on a consistent and reasonable basis such that they can report a pension liability. But the majority continue to account for multi-employer defined benefit schemes as if they were defined contribution schemes. This means that the sector's aggregate balance sheet under-estimates the true liability. It is likely that more employers will recognise pension liabilities in future years. And it is probable that changes in accounting treatment, including the future convergence with International Financial Reporting Standards (IFRS), will increase reported liabilities over the next few years. Not only will this affect the sector's aggregate balance sheet but it may also have implications for covenant compliance for those RSLs directly affected. This is an issue that we will continue to monitor and we expect governing

bodies to do the same. A useful metric in comparing the RSLs position with other RSLs and over time is the relationship between total pension liability and net assets.

Actual estimates of liabilities may also increase or decrease as a result of changes in actuarial estimates relating to mortality as well as predicted returns on investment. New pensions legislation means that employers will be required to automatically enrol eligible job holders into a qualifying pension scheme over a period of four years from October 2012. While the majority of RSLs already provide workplace pensions, the introduction of an auto-enrolment scheme will bring an added administrative and financial burden to some. There will be particular risks for those RSLs where a relatively small proportion of staff currently belong to a pension scheme.

A factor in mitigation concerns the UK Government's intention to move to using the CPI as the measure of price inflation for the purposes of regulating occupational pension schemes. This is likely to reduce RSLs' future pension liabilities and is discussed further at 3.5 and 3.11 below.

Impairment of Assets

RSLs continue to be relatively unaffected by the issue of impairment. The total charged in 2008/09 was a little over £2m. In 2009/10 this fell to £1.2m. The relatively small amounts and the small number of RSLs booking impairment charges (5 RSLs in each of the past two years) might be considered surprising in the current economic conditions. We will continue to monitor this area.

2.4 Borrowing and Asset Values

Borrowing

2009/10 saw RSLs continue to use external financing to deliver new build programmes and other capital expenditure.

Long term borrowing over the period from 2005/06 to 2009/10 has increased by approximately 63% from £1.61bn to £2.36bn. During 2009/10 available loan facilities increased by 5.8% (£207.3m) to more than £3.8bn. Amounts owed by RSLs to lenders increased by 11.0% (£235.3m) to £2.36bn.

Fig.12: Change in Borrowing in Year Ended 31 March 2010

| | Total Loan Facility £000's | Drawn Down £000's | Facility Undrawn £000's | Balance Outstanding £000's |
|------------------------------|---------------------------------------|------------------------------|------------------------------------|---------------------------------------|
| Year to 31 March 2010 | 3,801,692 | 2,587,391 | 1,214,301 | 2,357,459 |
| Year to 31 March 2009 | 3,594,416 | 2,309,077 | 1,285,339 | 2,122,167 |
| Increase (Decrease) | 207,276 | 278,314 | (71,038) | 235,292 |
| % Increase (Decrease) | 5.77 | 12.05 | (5.53) | 11.01 |

Source: SHR Loan Portfolio System

The amount drawn down by RSLs increased at a faster rate (£278.3m or 12.05%) than the growth in the overall loan facilities available to the sector (£207.3m or 5.77%). This means that, for the second successive year, the aggregate undrawn facility available to the sector fell. The reduction of around £71m or 5.5% is almost twice the reduction that was recorded in the previous year (£32.5m or 2.5%). We do not believe that this indicates a lack of available finance for viable projects, but we will continue to monitor this trend.

We have previously commented on the level of market concentration amongst lenders to the sector. In *Number Crunching*, published in March last year, we noted that, as at 31 March 2009, the sectors three largest lenders had 70.4% and 72.5% of market share in relation to total loan facility and balance outstanding respectively. On both measures there has been a marginal increase in market concentration during 2009/10, and Fig.13 illustrates this.

Fig. 13: Top 3 Lenders to the Sector 08/09 & 09/10

| | 2009 | | | | 2010 | | | |
|------------|-------------------------------|---------------------------|------------------------|---------------------------|-------------------------------|---------------------------|------------------------|---------------------------|
| | Total Facility £bn | Market Share % | Bal O/S £bn | Market Share % | Total Facility £bn | Market Share % | Bal O/S £bn | Market Share % |
| RBS | 0.940 | 26.16 | 0.597 | 28.12 | 1.052 | 27.69 | 0.693 | 29.36 |
| Nationwide | 0.870 | 24.19 | 0.563 | 26.51 | 0.907 | 23.87 | 0.616 | 26.14 |
| Lloyds | 0.720 | 20.03 | 0.379 | 17.85 | 0.730 | 19.21 | 0.413 | 17.50 |
| | 2.493 | 70.38 | 1.538 | 72.48 | 2.690 | 70.78 | 1.722 | 73.06 |

Source: SHR Loan Portfolio System

Asset Values

There has been a substantial increase in housing asset values during 2009/10. The value of housing assets (net of accumulated depreciation) rose to £9,692m to March 2010 (March 2009, £8,830m). After accounting for HAG and other capital grant funding, the aggregate balance sheet for the sector reported net housing assets of £3,102m (March 2009, £2,701m). These figures compare to £6,784m and £1,838m for 2005/06 and represent increases of 42.9% and 68.8% respectively. This difference in the growth rates between government funding and other funding means that, during 2009/10, the proportion of grant funded net housing assets fell to 68.0% from 69.4%. This illustrates the increased reliance on private borrowings and RSLs own internally generated reserves.

3. Uncertainty & Risk - Emerging Issues

In maintaining and developing Scotland's social housing stock, RSLs have benefited from access to considerable public funding as well as relatively cheap, long-term finance. At 31 March 2010 more than £6.5bn had been advanced to Scottish RSLs in the form of grants with a further £2.4bn from private lenders.

To ensure continued bank funding on as favourable a rate as possible, lenders will expect RSLs to provide robust and comprehensive business plans. Our business planning guidance issued in October 2009 sets out how we expect RSLs to carry out effective business planning; this guidance also reflects our understanding of lenders' expectations.

Inevitably, the credit crunch has increased competition amongst borrowers for access to increasingly scarce bank funds. While RSLs have continued to be able to access private finance, we are seeing more stringent banking covenants. Notwithstanding the drop last year in the costs of borrowing for RSLs, it is likely that this will result in higher margins in future and, depending upon the level of interest rates, an increase in the overall cost of borrowing. It is also likely that the amount of capital available to banks will be affected by the end of the Special Liquidity Scheme (SLS), which was introduced in April 2008 to improve the liquidity position of the banking system. (see 3.9 below)

Governing bodies will need to provide adequate assurances that they are and will remain credit-worthy throughout the term of any lending arrangements and have the forecast cashflows to ensure full repayment of debt within the term. In a more difficult lending climate some RSLs may find this challenging.

This section highlights the key issues arising during 2009/10 that we believe have or will have significant implications for the operations and viability of the sector. This is to help RSLs with their own assessment of risk and with their business planning that will flow from that. We first drew attention to these matters in the regulatory advisory note that we issued in August 2010. Our assessment of these factors at sector level will inform our view of risk and what this means for our engagement with individual RSLs. In some instances, we will be seeking assurances from RSLs about how they are responding to these particular issues.

We are aware that many landlords are already considering some or all of these issues. We expect some of these risks to have significant implications for a number of RSLs and we would restate the importance of good forward planning, governance and risk management in the current environment.

3.1 Business Planning

We have now reviewed more than 30 business plans since issuing our Business Planning guidance in October 2009. The results are encouraging and, given these early plans were developed just after the guidance was issued, we anticipate further improvement as good practice becomes increasingly embedded in RSLs' governance and business planning.

A well-governed RSL will be able to demonstrate that its management and governing body have collectively developed a strategy based on a clear understanding of the general business direction it wishes to follow. And we - and lenders - will expect an explicit statement of the risks that require to be monitored and managed. Management and governing bodies then need to expand on this strategy statement by outlining a suitably detailed operational plan.

Improvements in Business Planning

Some RSLs have presented plans with a more clearly articulated understanding of their key partners. This gives a fuller understanding of an RSL's operating environment and how it is engaging with those organisations that have influence over the RSL's success in meeting its objectives. Such an insight is essential for RSLs not only to understand who their key stakeholders are but also what risks some of these may be facing should they experience their own financial difficulties.

We have also seen evidence of more rigorous risk management underpinned by regular monitoring and review and, in some cases, greater integration of financial plans. A growing number of plans have also included more explicit reference to bank covenants and performance against the minimum/maximum targets set by their banks. Finally, evidence of closer working relationships between RSLs and their lenders and more detailed work on sensitivities are a growing feature of the more recently submitted business plans.

Business plans: areas of concern

Our engagement around business planning has illustrated some positive developments but areas of concern still remain.

Firstly, many plans do not readily link the internal business plan objectives with the wider economic environment within which an RSL operates. Given the downturn in the wider economy and the large and prolonged public sector budget cuts facing the Scottish and UK economies, we would expect to see such factors being fully addressed in these plans. RSL governing bodies need to explicitly take these wider factors into account to give assurance that they fully understand the potential impact on their business and to what extent the

stated objectives remain both relevant and achievable. Our Regulatory Code of Governance (SHR16) outlines how RSLs need to challenge themselves to ensure they remain focussed on setting and delivering such objectives.

Secondly, the risk assessment many RSLs have presented in business plans does not always readily link to the sensitivity analysis they have undertaken on the forecast cashflows. Testing the impact of higher or lower interest rates and inflation rates is sensible, and a sensitivity most RSLs undertake, but these may actually be of only limited value in terms of knowing what actions you need to take to keep your business on track. For example, illustrating the effects of losing a key contractor (an emerging and potentially growing risk as we have seen recently) will be a sensible sensitivity to assess if the RSL's risk assessment highlights such a scenario as a key business risk.

Isolating the business critical risks is essential as is undertaking suitable sensitivity analysis (including combining the impact of a number of independent events). This is what risk assessment and sensitivity analysis should comprise so that meaningful contingency plans can be developed.

3.2 Treasury Management & Derivatives

For those RSLs with large private debt obligations, managing and minimising the cost of finance is increasingly important in these financially constrained times. When we published *Shaping Up for Improvement* in July 2009 we emphasised the importance of treasury management. We would re-iterate that message in view of the continuing risks attaching to managing and minimising the cost of finance.

There are particular risks attaching to the use of financial derivatives. Our Treasury Management guidance (SHR 24) states that RSL senior officers need to be suitably qualified to ensure they understand the associated risks and rewards of any particular derivative product that forms part of the RSL's financial strategy. Being suitably qualified may mean executive staff having relevant qualifications as well as actively undertaking relevant continuing professional development to ensure they keep up to date with market changes and requirements.

In addition to having suitably qualified senior staff, RSLs should also consider whether they need the advice of an independent financial adviser to understand fully the associated risks and rewards of any derivatives strategy or related product. It may be that making use of such an independent adviser will be an essential element for most lenders to meet the FSA's regulatory requirements of the suitability of any derivative's counterparty.

Each RSL's governing body is responsible for understanding the risks inherent in its business strategy. This applies to treasury management and the use of derivatives as much as to other aspects of business strategy. The risk arising from a treasury management strategy that incorporates the use of derivatives may be of a magnitude that, in certain circumstances, might present a threat to future financial viability. It is therefore essential that the governing body takes advice to ensure that it fully understands the costs, benefits and importantly the risks of any derivative product or policy in the short and longer-terms. We would expect to see evidence of a full governing body discussion around any decision about entering into such products.

Financial derivatives aim to reduce the risks associated with the uncertainty of key financial variables such as interest rates. However, the pricing and suitability of such derivatives depend on what the projected value for interest rates will be over the relevant forecast period. Even with the best information possible, forecasts can be wrong. When they are marginally wrong this does not usually cause problems. However, a small number of RSLs suffered as a result of the most recent significant drop in the Base Rate, having entered into free-standing derivatives that assumed that UK interest rates were likely to rise. This does not necessarily mean that, in these instances, the decision to base treasury management on complex derivative arrangements was wrong. But this illustrates how important it is for governing bodies to understand the nature and significance of the risk before entering into this type of transaction and to make decisions based on the best advice and information available at the time.

3.3 New Forms of Finance

The changes in the UK banking market have triggered an increased interest across the sector in the use of what might be classified as less traditional or innovative forms of private finance.

Examples of new funding arrangements include bonds and other capital market solutions, either directly or via aggregating bodies such as The Housing Finance Corporation and the European Investment Bank. Local authority funding has also become an option for some RSLs, allowing them access to cheaper public debt (eg, Public Works Loan Board) again either directly or indirectly via the Scottish Government's National Housing Trust initiative or potentially via the emerging Tax Incremental Financing (TIF) arrangement.

When considering whether to secure new, non-traditional debt options, RSLs should consider how the organisation would cope with the associated risks and uncertainties.

Factors worth reviewing in advance of decisions on borrowing via any of these new approaches would include, although will not be limited to, the following:

- the potential requirement to accept a minimum amount of financing;
- the costs, including lenders' fees and charges and any necessary professional fees, compared to traditional bank debt costs;
- the level of exposure to joint obligations if RSLs are required to group together to secure the finance;
- limitations on how much and when the new sources of funding can be drawn down; ,
- the level of front-funding that may be required;
- exposure to significant refinancing risks, for example the potential for the repayment as a single payment at the end of the debt term or for a shorter period than traditionally would be possible with bank debt;
- associated financial covenants; and
- are Security Trustees in place that might limit funders' ability to waive any covenant breaches?

Experience to date suggests those RSLs entering into more complex funding structures may require an increased level of regulatory engagement. The extent of this additional engagement would depend on factors such as the size of the financial risk being carried and the financial capabilities of the individual RSL involved. There can be an issue in relation to flexibility where bond financing is used. For example if there is a requirement to alter a term then the consent of all of the bondholders may be required.

3.4 Scottish Housing Quality Standard (SHQS) & Climate Change

In 2009 RSLs estimated that they would need to invest on average £500 per house per annum to meet the Scottish Government's target of achieving the SHQS by 2015 (see SHQS Progress update 2008/09).

Traditional funding sources such as house sales have decreased faster than many anticipated, and it seems likely that a significant and increased share of the resources required to meet SHQS and climate change obligations will need to come from new borrowing. In addition, all landlords will need to maximise available resources through effective management of costs and some landlords will have to make hard choices about the use of their borrowing capacity, i.e. for improvement or for development.

The Climate Change Act commits the Scottish Government to achieve a 42% reduction in greenhouse gas emissions by 2020, from a 1990 base. The exact contribution to this saving

by social housing has yet to be determined, but it is clear that housing will need to make substantial investments to reduce energy use.

To meet these SHQS and climate change obligations, careful planning of both cyclical and planned maintenance activities will be of great importance not only to ensure that tenants benefit but also so RSLs remain financially viable and housing remains affordable.

We will be publishing a separate SHQS report on or before 31 March 2011.

While there is – understandably – an emphasis on meeting SHQS we know that some RSLs are looking at the issue of stock quality beyond SHQS and 2015. It is important that all RSLs embed SHQS into a clear and funded asset management strategy that looks beyond SHQS and is linked into business plans.

3.5 Inflation

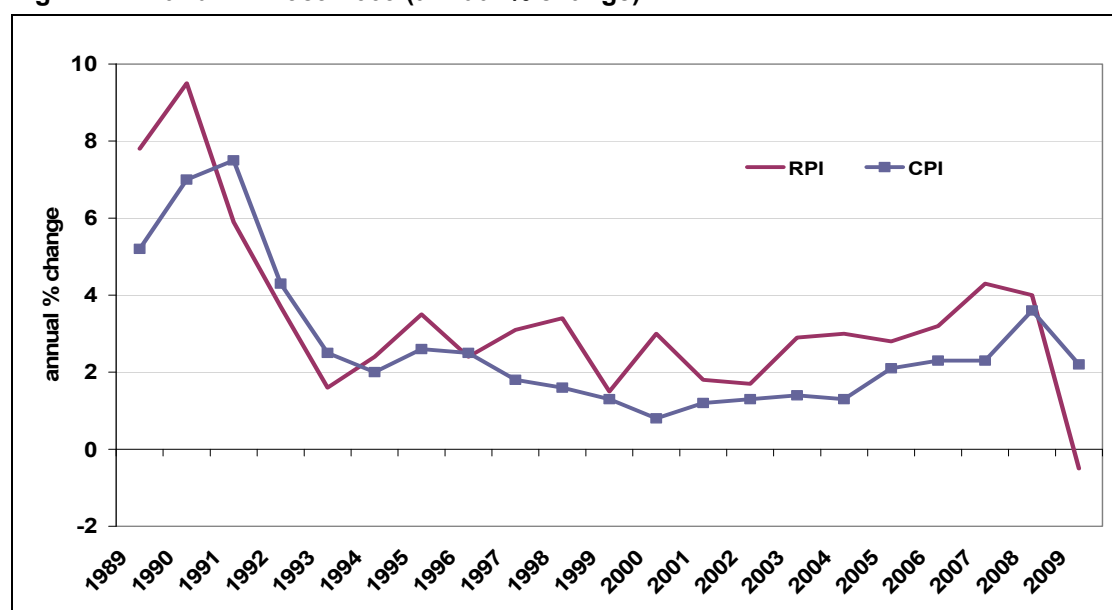
Rents account for approximately 71% of the sector's income. We previously highlighted that other income sources (service charges, sale of assets, interest receivable) had increased in significance in recent years but, even at their recent peak (2008/09), they still accounted for less than one third of the sector's total income. As set out at 2.2 above, the recession has limited the extent to which RSLs have been able to achieve asset sales, and other sources of income such as payments from local authorities for residential care costs may come under pressure given the planned reductions in public expenditure in the next four years. Therefore it is likely that rental income will be even more critical to an RSL over the next few years.

The UK Government's budget measures in June 2010 signalled its intention to increase benefit payments in line with CPI rather than RPI, and although the two indices are similar, they are not exactly the same.

RSL rental increases currently tend to be linked to RPI. However, with more than half of rents funded by housing benefit, RSLs will need to assess the potential financial implications of this change to ensure they understand any additional financial risks as a consequence of this policy.

Figure 14 illustrates how the two indices have varied over the 20 year period 1989 to 2009.

Fig. 14: RPI and CPI 1989-2009 (annual % change)

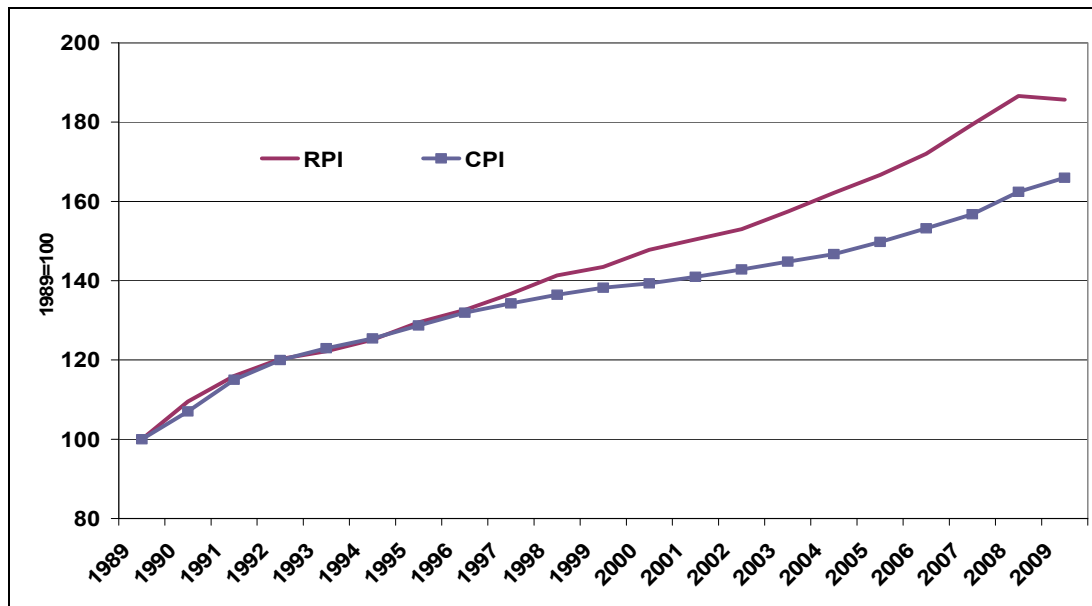


Source: ONS

In the main, the two rates track one another fairly closely except when the Bank of England's Monetary Policy Committee (MPC) changes the base rate as a means of affecting inflationary pressures in the economy. In such circumstances, RPI (which directly reflects the resulting change to mortgage interest costs) will move more rapidly (up or down) compared to CPI. That said, CPI has tended to be lower than RPI.

Perhaps of greater interest is the compound effect of these annual average changes that can be seen from Figure 15. In the 20 years to 2009, RPI rose 86% compared to only 66% for CPI; a 20 percentage points differential.

Fig. 15: RPI and CPI 1989-2009 (1989=100)



Source: ONS

In s.2.1 above we comment on the risks arising for those RSLs that do not manage to maintain a sustainable relationship between costs and revenues. The inflation change from RPI to CPI may heighten this risk for some RSLs. But, from the RSL perspective, there is at least one potential positive to the CPI/RPI debate. Should pension schemes adopt CPI in their valuations, this would have the potential to limit to a certain extent the increases in pension liabilities in future and so potentially help mitigate some of the other more financially damaging effects of this change.

3.6 Housing Benefits

A further development that could have significant implications for RSLs is the proposal from the Department of Work and Pensions (DWP) to put a ceiling on its housing benefit obligations. For private landlords, the DWP will pay Local Housing Allowance (LHA) rates set at the 30th percentile of local (i.e., the Broad Rental Market Area or local authority area) rents with these allowances being increased annually in line with CPI. LHA rates will nonetheless, be capped at £250 per week for a one bedroom property, £290 per week for a two bedroom property, £340 per week for a three bedroom property and £400 per week for four bedrooms or more.

This could have an impact on those RSLs developing mid-market rental properties; with the possible effect of reducing cashflow surpluses and so may have an adverse impact upon the underlying strength of RSL cashflows. There is a range of proposed measures that may

affect RSL tenants, for example the introduction of a household size factor and reductions in benefit for claimants who have been out of work for more than twelve months.

Currently the LHA applies only to private sector tenants, but changes to the rates may add pressure on the social sector. If less financial support is going to be provided for private rented accommodation, the demand for social rented houses may rise. However, if rents in the social rented sector continue to rise in line with RPI and not CPI, this will increase social rent levels relative to private rented. This may mean DWP has to consider what level of rent it can afford to support in this sector.

We know that several RSLs are already working towards delivering challenging efficiency targets. For some, this is mainly in response to reductions in development funding opportunities while, for others it is because private finance costs have or are expected to rise. We also know that a number of governing bodies held rents steady last year (in response to a fall in RPI in the benchmark rent-setting month) despite costs continuing to rise. We will continue to monitor operating costs and rent levels across the sector and we will publish information on this. This will help us to identify those with greatest financial stress and will also allow tenants to compare their landlord's performance against others.

On 11 November 2010 the UK Government published a White Paper (Universal Credit: Welfare that Works) that set out plans to introduce legislation to reform the welfare system by creating a new Universal Credit. As far as housing benefit is concerned the intention is to add an appropriate amount to the universal credit award to help meet the cost of rent. This amount will be similar to the support currently provided through housing benefit. RSLs will require to keep abreast of developments in this area and adapt administrative systems as required.

3.7 Component Accounting

For some time it has been recognised that very few RSLs fully adopt the principles of component accounting despite it being required under Financial Reporting Standard (FRS) 15. The 2010 SORP update incorporated a technical note designed to help RSLs better decide whether component accounting is applicable to their own organisation and the impact of this is that RSLs will have to more actively consider the adoption of component accounting – accounting separately for the component parts of assets such as kitchens, roofs and bathrooms capable of being allocated different useful lives for depreciation purposes. The SORP update is effective for accounting periods beginning on or after 1 April 2011.

Component accounting is likely to reduce variation in results between years as fluctuations in major repairs work from year to year will have much less of an impact on the income and expenditure account. This is because costs will be capitalised and depreciated over the lifespan of the component as opposed to being fully charged as a cost in a single year and having an immediate effect on the Income & Expenditure Account.

We are aware that many RSLs are considering the impact of this and that, for most, depreciation charges are likely to rise with consequences for business plans and potential consequences for covenant compliance. RSLs will have to ensure these changes do not trigger a default on any or (due to cross-default clauses contained in loan agreements) all of their bank covenants. In relation to certain loan agreements this type of change may fall within the definition of events which must be notified to lenders. RSLs should determine whether they have any such obligation and contact lenders where this is required.

3.8 VAT

From 4 January 2011 the standard rate of VAT increased from 17.5% to 20%. The impact of this will vary between RSLs as some can secure VAT refunds. However the ability of many to absorb a 2.5% increase in relevant costs is likely to be limited, and so this is likely to add to the financial pressures in the sector and reinforce the need for tight operating cost control.

A feasible and attractive option for some may be to seek to bring some services such as repairs and maintenance in-house thus saving the full 20% on significant cost activities. We would expect governing bodies to fully assess all the related costs and benefits and risks and uncertainties before embarking on such a route.

3.9 Banking Margins & Interest Rates

We have noted a considerable change in lending practice to RSLs since the onset of the credit crunch. Overwhelmingly (92% of 60) the most recently negotiated facilities are priced with reference to LIBOR, rather than Base Rate. This indicates the sector's increased exposure to the wholesale money markets as distinct from the monthly rate set by the Bank of England's Monetary Policy Committee.

While we note at s.2.3 the lower interest costs on RSLs in the last year, we are seeing increases in the average margin now being charged, at 155 basis points above LIBOR up from an average of 110 basis points for the five year period to December 2008. Whilst the average margins have increased there is still a wide variation.

Despite the reduction in the cost of finance and in the average interest rates, we believe it prudent for RSLs, particularly those with variable rate financing, to plan for higher interest

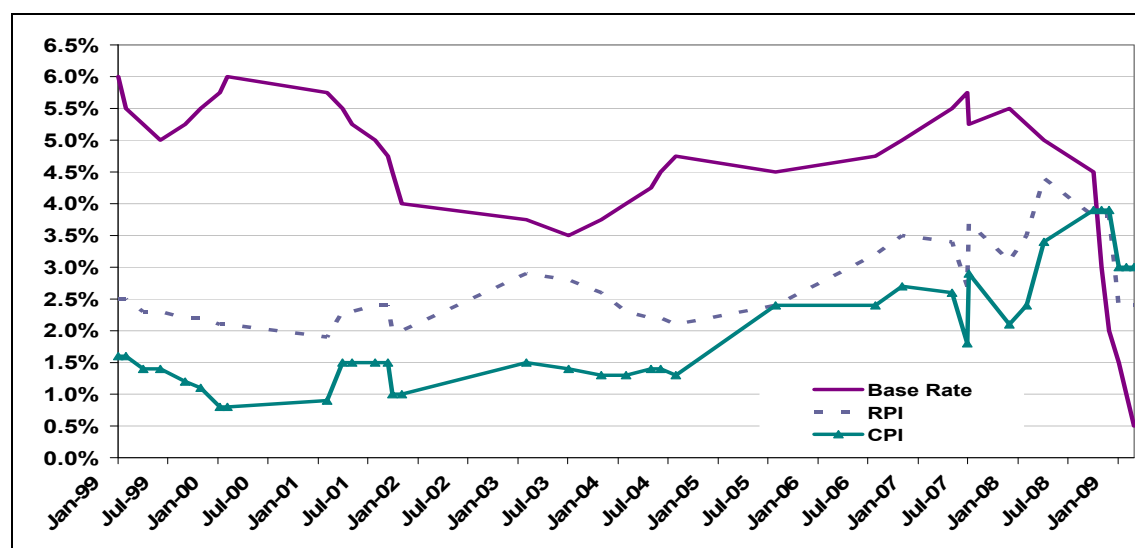
rates in future. As we note earlier, it is likely that the amount of capital available to banks will be affected by the end of the Special Liquidity Scheme (SLS), which was introduced in April 2008 to improve the liquidity position of the banking system. The drawdown period for the SLS closed on 30 January 2009 but the Scheme will remain in place for three years to provide participating institutions with continuing liquidity support and certainty. This means that repayments will begin in 2011/12 and will carry on for a period of three years. This will raise issues for banks and may affect their customers, including RSLs, in two ways:

- any reduction in funds available to banks has the potential to increase the cost of finance although lenders have indicated that they have factored in the repayment of these facilities and therefore this should not impact on the pricing of facilities which have already been granted. If however facilities are up for renegotiation or new facilities are being sought then it may result in higher pricing if repayment of the SLS impacts on the availability of supply; and
- banks may be more vigilant in monitoring covenant compliance and more willing to seek repayment and penalties in the event of any breach.

One third of new term loans in 2010/11 were for periods of less than 30 years. This could become increasingly common as competition for bank funding across the economy increases and banks need to more closely match their lending and borrowing terms. As a consequence, RSLs may find they are still able to get access to finance, but only by accepting refinancing risk, i.e., they have to fund unpaid debt at the end of the term of their original loans by securing additional new loans, which may be at more expensive and onerous terms.

The Bank of England believes the outlook for inflation remains uncertain and it may be forced into raising the Base Rate even if economic growth remains sluggish. Given the historic low levels for Base Rate and the increase in bank margins, governing bodies need to assess the impact on their cashflows should interest rates and margins begin to rise.

Fig. 16: Bank of England Base Rate, RPI & CPI (%)



Note: The RPI excludes mortgage payments; the RPI & CPI figures are the average quarterly rates at the date when the Bank of England Base Rate was adjusted.

Sources: Bank of England; ONS

3.10 RSLs with subsidiaries

Some RSLs have established subsidiary companies. Reasons for this vary and include mid-market rental, care services activities, housing maintenance, community regeneration, property letting and, architectural business activities. Some of these activities are funded by the Government’s Wider Role funding, the future of which is uncertain given the anticipated reductions in Scotland’s public sector budget.

The 2008/09 APSR showed that 41% of the 165 mainstream RSLs had at least one subsidiary. Eighteen RSLs had established two or more subsidiaries and there are two RSLs that both have five subsidiaries.

Although the SHR does not have a direct regulatory role in respect of unregistered subsidiaries, we are interested in how the relationship with subsidiary companies affects the parent RSL. In the course of our regulatory engagement we may look to understand how the subsidiary helps the RSL to achieve its strategic objectives and to understand any risks that the subsidiary might present to the parent RSL. Subsidiaries may require support from the parent RSL or, conversely, the parent may rely on forecast surpluses from such subsidiaries to support its social housing activities.

In establishing subsidiaries it is essential that governing bodies understand the business model that underpins the business opportunity and is assured about any risks presented to the RSL’s main social housing activities. The creation of a subsidiary may require consent

from lenders. In addition lenders' consent will normally be required, in advance, for any on-lending to a subsidiary. The terms of such on-lending should be on an arm's length basis and, in some instances, be supported by a separate business case that needs SHR approval by the SHR. Additional considerations apply to charitable RSLs. HMRC rules mean that on-lending must be on sound commercial terms in order to demonstrate that the transaction is for the benefit of the charity. There is no single test of commercial soundness and HMRC will judge each case on its merits taking account of factors such as the rate of interest charged, security offered and the repayment term.

Without such arrangements, RSLs face being in breach of their loan arrangements, and could face having to absorb the costs of rectifying any such breaches. If the original business case is not rigorously tested, establishing subsidiaries could undermine the financial strength of the parent rather than provide it with an additional source of income.

With public funding becoming more scarce and the general housing sector remaining subdued, safe additional income derived from subsidiary activities needs to be carefully considered, supported with robust risk assessment and suitable contingency planning.

A key element of the risk assessment an RSL needs to undertake prior to establishing any subsidiary activities is the extent to which it has or can get access to the skills required for the business of the subsidiary. In addition, the governing body needs to assure itself that it too has sufficient knowledge of the business activity amongst its own members to hold such staff and management to account.

3.11 Pension Liabilities

The interim report of the Independent Public Service Pension Commission was published in October 2010. It indicated the scale of the challenge that exists for all organisations providing pensions to employees on the basis of defined benefits. Lord Hutton, the Commission Chairman, summarised his conclusion:

"It is my clear view that the figures in this report make it plain that the status quo is not tenable. I believe we need to adopt a more prudent approach to meeting the cost of public service pensions in order to strike a fairer balance not just between current taxpayers and public service employees but also between current and future generations."

In s.2.3 above we note the significant rise in reported pension liabilities in the past year, and the fact that such liabilities remain understated as a consequence of the current accounting treatment and we comment on the risk to RSLs of a further deterioration in the pension position as well as the possible consequences of a change in accounting policy.

Some 80% of Scottish RSLs belong to the SFHA pension scheme, 7% belong to the Strathclyde pension fund and others belong to one of around 20 other smaller schemes. Some RSLs have employees in more than one scheme.

The most recent (2009) valuation of the SFHA scheme highlights the additional liabilities and cash costs that will now have to be absorbed by participating RSLs (see Table 6).

Fig. 17: SFHA 2009 valuation results

| | @ 30/9/09 | @ 30/9/06 |
|--|--------------------------------|-------------------------------|
| Triennial Scheme valuation | -£160.1 million | -£53.6 million |
| % liabilities funded | 65% | 83% |
| Cost of closing gap (over next 15 years) | +10.4% of pensionable earnings | +5.3% of pensionable earnings |

Source: SFHA Pension Scheme Valuation, 2009

As a consequence of this pension challenge, our assessment of the financial strength of the sector means we will be looking more closely at how well RSLs are assessing their pension obligations and how they intend to manage any associated cashflow issues. All RSLs that are members of multi-employer defined benefit schemes need to incorporate explicit consideration of the risks attaching to this form of pension provision in their business planning processes.

Governing bodies also need to be aware that there is potential for a conflict of interest where advice is provided by staff members who may be members of the pension scheme.

One mitigating factor in relation to projected pension deficits concerns the linkage of future pension increases to CPI rather than RPI. This is likely to have the effect of limiting increases in future balance sheet liabilities for organisations providing defined benefits pension schemes. It may also have a favourable effect on the Income and Expenditure Accounts of the affected organisations in the first set of accounts to be prepared following the change.

3.12 Future Scottish Government Expenditure

In its proposed 2011/12 budget announced in November 2010 the Scottish Government has set out the first real terms reduction in its budget since devolution.

This will have an impact on some RSLs plans for development. It may also affect other areas. RSLs that provide care and support services to people in need may have particular concerns. There will be budgetary pressures on all areas of local authority activity including the resources available for supported living and wider action activities. RSLs involved in the

provision of care and support services should ensure that their risk management and contingency planning takes account of the risks in this area.

As RSLs plan their budgets for the next few years, they will have to consider this new funding reality. Developing RSLs in particular will have to consider whether and how they stay involved in this activity. Entering into partnering arrangements may offer access to funding on a consortia basis, but can bring challenges in terms of management and governance.

Given the additional development challenges, our regulatory process will pay closer attention to those RSLs whose finances incorporate assumptions about high levels of public subsidy. While these may have been realistic at the time the business plan was approved the real terms reduction in public expenditure is likely to signal a need for such assumptions to be revisited and revised.

3.13 Shared Services

In Shaping Up for Improvement we encouraged RSLs and their governing bodies to consider whether sharing services with other organisations offered the prospect of improving efficiency and effectiveness. Like the option of bringing previously out-sourced services in-house (discussed at s.3.8 above) this might in the current economic climate be attractive for some RSLs. Its important that in any option appraisal RSLs make an accurate estimate of the costs and benefits of any shared services project and consider the governance arrangements that will apply. Common concerns are how will disputes between the sharing parties be resolved and will the RSL retain an option (either to in-source or out-source) if the shared services arrangement does not work in a satisfactory manner?

**Registered Social Landlords in Scotland
Summary Facts and Figures 2009/10**

Introduction

Registered Social Landlords (RSLs) are non-profit distributing organisations (mainly housing associations), governed by volunteers and managed by professional staff. We regulate 202 RSLs and 26 local authority landlords. This report gives you summary information about 163 RSLs that gave us returns for the period up to March 2010. You will find references to more detailed information at the end.

Governance and management

There are 1,990 volunteers serving on the sector's governing bodies, 58% of whom are tenants or other service users. Four fifths of RSLs have charitable status, which brings additional duties for governing body members as charitable trustees. As noted in 'Beyond the Crunch', more than two-fifths of RSLs have subsidiary organisations that carry out a range of activities.

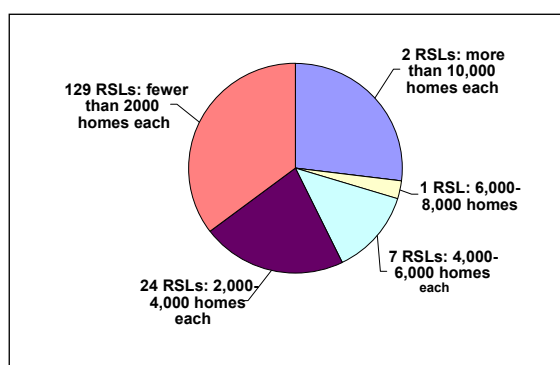
The Scottish Public Services Ombudsman received 337 enquiries and complaints about RSLs. The largest proportion (26%) related to general policy and administration.

RSLs employ 11,518 full-time equivalent staff. This represents one staff member for every 24 properties and marks a break from the declining staff to stock ratio trend.

Stock profile

The sector owns just over 272,000 homes, 5,000 bedspaces⁴ and 5,000 shared ownership units: 11% of all Scotland's homes. Almost 80% of RSLs own fewer than 2,000 homes each. Figure 1 shows that these smaller organisations own over a third of all RSL stock. But the four largest RSLs alone own a further third.

Figure 1 : Stock holdings



⁴ There are differences between the numbers of units reported to us in APSR (282,936) and in the Accounts (282,409). Although when aggregated the difference is not large, we are working with landlords to bring the figures they report closer together in the future.

Figure 2 shows the movement of homes that entered or left the sector last year. The result was a net gain of 3,539 homes. The biggest influence was the creation of 4,987 new homes through new build or rehabilitation programmes.

Figure 2 : Stock movements in the sector

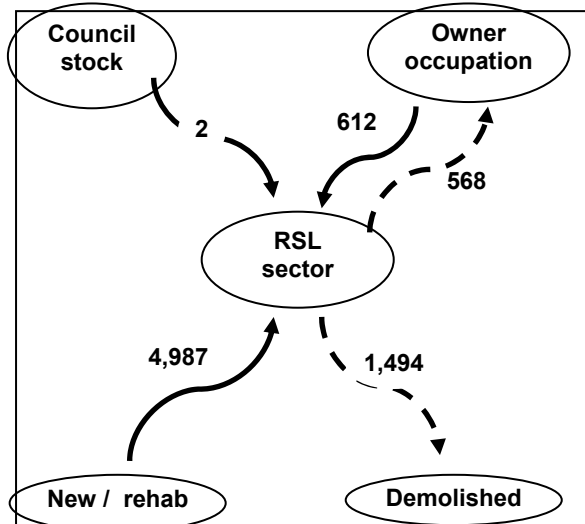
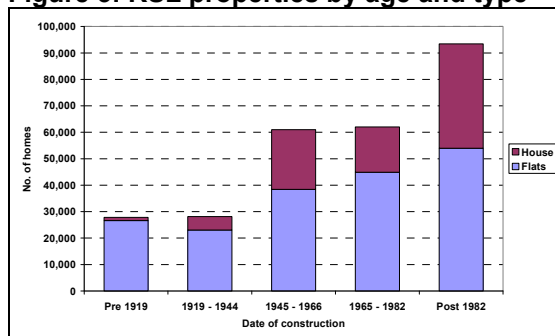


Figure 3 shows that RSL properties are predominantly (69%) flats and a third of all properties were built after 1982.

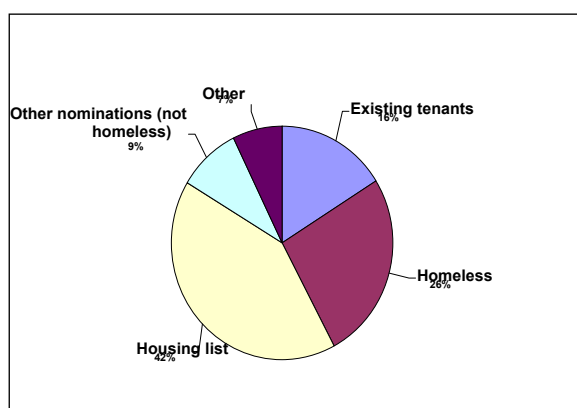
Figure 3: RSL properties by age and type



Access

RSLs made 29,559 lets last year. As figure 4 shows, the largest proportion of these lets were to applicants on RSLs' housing lists. A further 26% were to households assessed as homeless by local authorities. Another 16% of lets were made to existing tenants who wanted to change their home. Of all households housed last year, 8% had a minority ethnic background, and a further 11% were recorded as of 'unknown' origin.

Figure 4: Lets by source of applicant



Managing tenancy turnover

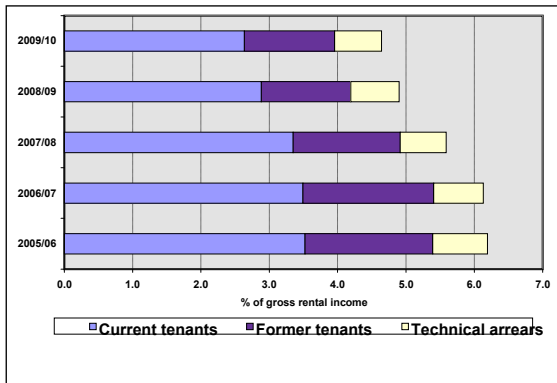
RSLs managed tenancy turnover rates (the number of houses that became empty as a percentage of lettable homes) of between 3% and 35% last year. This is a slight increase on the range of figures for last year but the sector's overall turnover of 10% is the same. The 4% drop in potential rent lost due to empty homes in the sector (as reported in 'Beyond the Crunch') is therefore attributable to faster relet times. The median performance of RSLs to relet a house is 18 calendar days.

Last year, 668 tenancies ended with eviction and 274 ended through abandonment following granting of decree. This equates in total to 0.4% of all tenancies in the sector, but ranged between 0% and 2.2% for individual RSLs.

Managing rent arrears

On average, tenants pay a weekly rent of £59.73. Over 60% of all tenants get Housing Benefit (administered by local authorities) to help pay rent. The sector's total rent arrears have decreased over the past four years by 15% (£7.5 million) in 2010 prices. As figure 5 shows, this was mainly due to reductions in former tenants' arrears (partly the result of RSLs writing these off as bad debts). 'Technical' arrears (delays in Housing Benefit) also declined slightly but steadily over this period, and rent arrears owed by current tenants have also shown a slow but steady decrease since 2005/06.

Figure 5: Rent arrears as % gross rental income



Looking more closely at rent arrears we find that:

- 4.6% of all tenants have more than 13 weeks’ arrears; this ranges from 0 – 18% for individual RSLs;
- RSLs typically report that just over two-fifths of all tenants that gave up their tenancies were in arrears, with debts of 8.8 weeks’ equivalent rent; and
- 8% of all RSLs’ former tenants’ arrears are collected (up to 70% for individual RSLs), whilst 34% of them are written off.

Managing repairs and investment

RSLs completed 853,925 reactive repairs to their houses last year. This is an average of three repairs per property, compared to fewer than two in 2002/03. Over four-fifths of RSLs reported that they completed more than 93% of repairs on target.

RSLs have told us that 25,292 properties were brought up to the physical Scottish Housing Quality Standard last year. And they report collectively that 70% of the sector’s stock now meets the standard.

Finding more detailed information about RSLs:

- [The RSL Register](#) – provides a range of information, including RSL Performance Profiles – individual RSLs’ statistics with comparative figures for their peer groups and the sector overall.
- [Statistical tables](#) – a set of excel spreadsheets covering all RSLs’ profile and performance statistics, grouped by peer groups or council areas, and showing totals and descriptive statistics for the sector overall.
- [The Scottish Housing Quality Standard Progress Report](#) – a summary of the progress RSLs and local authority landlords are making towards meeting the physical quality standard set by the Scottish Government.

About the Scottish Housing Regulator

The Scottish Housing Regulator (SHR) is an executive agency of the Scottish Government. We exercise independently the regulatory powers of Scottish Ministers in the Housing (Scotland) Act 2001. We [register](#) and [regulate](#) independent social landlords. These are usually housing associations, but they can also be housing co-operatives or companies limited by guarantee. We also [inspect](#) the housing and homeless services provided by local authorities.

We operate independently and impartially, while remaining accountable to Scottish Ministers for the standard of our work and for inspecting and reporting within the overall context of Scottish Ministers' strategic objectives for the social housing sector and tackling homelessness. A code of practice sets out what Ministers expect from us in delegating their regulatory powers to us.

Our independence is further safeguarded by a Regulation Board that supports the Chief Executive to manage and direct the organisation.

Our purpose is to:

- protect the interests of current and future tenants and other service users;
- ensure the continuing provision of good quality social housing in terms of decent homes, good services, value for money, and financial viability; and
- maintain the confidence of funders.

Our work supports the principles of public service reform by promoting good services that are organised around the needs of the people who use them. We encourage registered social landlords (RSLs) and local authorities to be open, accountable, efficient and well governed. And we expect them to provide equal opportunity and open access to their services.

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