

19 December 2008

Dear Chief Executive/Director

Financial risk and viability

Thank you for sending us your annual accounts and financial projections for the next five years. Given the current financial climate, I am writing to give you feedback from our analysis of the projections and our assessment of the key risks to the sector, and to highlight the need to discuss any emerging financial problems with us.

You will find a briefing paper attached. We expect this to inform your business planning assumptions and future financial projections, and the strategies you need to consider to deal with the risks your organisation may face in these challenging times. We may engage with your organisation about the information you gave us. This briefing is about the sector as a whole and general issues, rather than about your individual organisation or circumstances.

We look at the financial health of RSLs in order to protect the interests of current and future tenants, to make sure you are exercising good stewardship over the public subsidy embedded within the sector's housing assets, and to maintain the confidence of funders. As independent organisations it is for you and your governing bodies to decide how to deal with the competing demands on RSL resources – investing in existing stock to meet the Scottish Housing Quality Standard, delivering service improvements for tenants, contributing to wider regeneration activities, taking transfers from other RSLs, buying land or undertaking new developments. And it is for each RSL to identify, monitor and manage its exposure to risk.

The briefing paper sets out our expectations about the sort of activities and planning we expect RSLs to be undertaking in response to the current environment. In particular, we expect RSLs to be reviewing their financial forecasts; assessing any exposure to the prevailing housing and financial markets, managing short term liquidity; and monitoring compliance with financial covenants.

From our perspective, the sector overall is relatively stable financially, and continues to represent a good investment opportunity for lenders, and to provide good investment partners for government. In order to support this position we will continue to assess risk across the sector and act in a proportionate way with landlords to make sure risks are managed to protect the interests of tenants and maintain the confidence of lenders and funders. It is particularly important at this time that you tell us about financial or development problems as they emerge. We remain confident that, with good forward planning, governance and risk management, the RSL sector is well placed to deal with the current environment.

You should copy this letter and briefing paper to your chairperson and senior finance officer. If you would like to talk to us about this briefing, or any relevant issues that are emerging for your organisation, please contact Linda Scott, Senior Regulation Manager, on 0141 271 3766 or by email linda.scott@scottishhousingregulator.gsi.gov.uk in the first instance.

Yours sincerely

A handwritten signature in black ink, appearing to read 'KW Watt', written in a cursive style.

Karen Watt
Chief Executive

Financial Risk and Viability: A Briefing from the Regulator

1. Background

- 1.1 When we received the sector's financial projections at the end of June many registered social landlords (RSLs) had yet to factor the impact of a less benign economic and financial environment into their forecast cashflows. We know it is difficult to predict with certainty how broader factors may affect your business or how they will move in the medium to longer term. This makes it all the more important that you are stress-testing (or carrying out sensitivity analysis of) your assumptions and playing out a number of different scenarios to see how they may affect your organisation. We are not advocating a one-size-fits-all approach to how you should do this. You will need to decide what is relevant to your business.
- 1.2 We expect each RSL to assess how it is placed to withstand the combined effect of adverse changes in the macro-economic environment alongside more expensive private finance. Remaining solvent and having sufficient resources to meet the many calls on an RSL's funds is essential at this stage in the economic cycle but is even more so given the added uncertainties of the credit crunch. We recognise that, for some, the current situation and the tighter Housing Association Grant (HAG) regime may constrain ambitions for growth. For others, where your organisation is financially robust and has access to private funding, the current market conditions may present opportunities.

2. Testing assumptions

- 2.2 The evidence from the most recent set of five year cashflow forecasts submitted to us leads us to recommend that RSLs now test their assumptions in the following key areas, either because the projections look unrealistic in the current environment or optimistic given the sector's historic performance trends:
- a) **Rent arrears:** The collection of rent arrears has shown only modest improvement over time – and most of the improvement relates to the recovery of arrears caused by delays in housing benefit administration. But many RSLs are projecting continued improvement in the collection of rent arrears. Given the harsher economic climate, and the decisions households make about how they use their resources, the sector will need

to work harder if these projected arrears reductions are to be realised, without recourse to increased bad debt write-offs.

- b) **Operating costs:** Increases in operating costs are likely to pose one of the greatest threats to the viability of the sector going forward. Unless RSLs keep tight control over their cost base they will reduce their ability to deliver improved services or contribute to broader objectives, such as new homes at lower cost to the public purse. The sector's current predictions on cost control look ambitious given previous trends, unless RSLs are deciding now how to achieve business efficiencies to generate more capacity or remain viable.
- c) **Deflation:** As you know, general inflation can be beneficial to RSLs because, while recognising the need to remain affordable for current and future tenants, it links to higher rents. However, in a potentially deflationary environment, RSLs need to test the impact of different retail price index trends emerging. For example, with 56% of the sector's debt on fixed rates, the value of debt payments of many RSLs will not be declining in line with lower inflation adjusted rents.
- d) **Low cost home ownership:** Unlike many RSLs in the English sector, Scottish RSLs have not been reliant on low cost home ownership or open market sales to cross-subsidise their social rent development programmes or to support their business plans. However, given the state of the housing market and the fall in property values, we expect to see realistic assumptions feeding into the next round of projections in terms of income generated (and allowed to be retained) from right to buy sales receipts and any exposure to low cost home ownership.
- e) **Meeting the Scottish Housing Quality Standard:** By now, we expect all RSLs to have factored the requirement to meet the Scottish Housing Quality Standard into their financial projections.
- f) **New development:** RSLs told us in their projections that they planned to spend nearly £3.5bn on new houses, with a reduction in the amount of reserves going into new build and a very slight increase in private

borrowing from the year before. Largely because of the timing of the projections, RSLs have generally assumed similar HAG rates to the year before. Clearly, the reduction in HAG rates needs to be factored into the scenario testing RSLs carry out to construct their business plans. At the same time, you may also need to test discount rates, building costs, and valuation uncertainties. You will be aware that the Scottish Government has launched a consultation on proposals for investment reform, and the prospect of further change resulting from these proposals will also be relevant.

3. Private lending

- 3.1 In terms of the private finance market, at the end of March 2008, RSLs in Scotland had agreed borrowing facilities of £3.3 billion, including new facilities of £333 million. Around £1.3 billion of committed funding had not been drawn down at the end of March and was available to RSLs to support their plans.
- 3.2 The number of active lenders to the sector has fluctuated over the past year. Some of the most prominent lenders stopped new lending to RSLs during 2008 or concentrated on existing business and customers. At one point, there were only four lenders prepared to lend to new customers. However, we have recently seen some of the smaller lenders re-entering the market. Whilst a positive sign, they appear to be re-entering the market as a consequence of the increased lending margins now being quoted.
- 3.3 From our experience to date, we would offer these observations:
 - a) **Cost of funds:** Pricing has increased and money is more expensive to borrow (although it is still significantly cheaper for RSLs than the deals being secured by commercial and unregulated sectors). Ultimately pricing will be determined by the lenders' ability to raise funds to lend and their willingness or ability to rely on the wholesale money markets as a source of such funds. We have yet to see how the reduction in LIBOR and interest rates will play out for the sector, as lenders rebuild their capital base and compare risk and returns in the social housing sector with other commercial lending. This suggests that it would not be prudent to assume there will be a swift return to low-priced and freely available private funding for the foreseeable future.

- b) **Understanding lenders' view of risk:** While lenders still take an RSL sector-wide view of risk and return (and set great store by regulation), it is clear to us that lenders are looking ever more closely at the risks presented by individual organisations when determining pricing and availability of funds. This means you need to be more aware of the risks lenders will be interested in before you start negotiations, and the importance they will attach to standards of governance.
- c) **Covenant compliance:** We have seen a hardening attitude towards covenant compliance. Since we wrote to you in the summer, another RSL has been penalised by its lender for breaching lending covenants. We cannot emphasise enough the importance of monitoring covenant compliance and talking to your lender as early as possible if covenants are likely to be breached. It is better to discuss extensions or variations before a breach happens than a waiver after the event. Where you have loan facilities that were negotiated some time ago they may no longer bear any relation to the cost of funds for lenders or the risks lenders may perceive in certain RSLs going forward. So, if you breach a covenant lenders may seize the opportunity to renegotiate price and terms. If you need additional facilities, this may be accompanied by a condition that existing facilities should be reassessed.
- d) **Managing short term liquidity:** In general, if your loans are maturing and you need to refinance, or if your plans and projections require additional facilities, you should stress test the assumptions you are making around cost and availability of private finance. And you should factor in a longer period of time to secure new finance or to draw down against existing facilities. Clearly, the key risk you need to manage is the possibility of short-term liquidity problems.
- e) **Derivatives:** Some English RSLs that have entered into free-standing derivatives are being required to provide cash or additional property security to meet margin calls on those contracts. This is because long term interest rates have declined rapidly recently. We are not aware of any Scottish RSL in this position, but you must tell us immediately if you

are. Notwithstanding this additional risk factor, given the sharp reduction in interest rates, those with embedded derivatives will also need to ensure they fully understand the cashflow implications of their treasury arrangements.

f) **Impairment:** RSLs that hold land or other property or commercial assets may need to consider whether any fall in value needs to be reflected in annual accounts and whether this may cause breaches of financial covenants in loan agreements. Early discussions with your auditors would be prudent.

g) **Parent guarantees:** If you are the parent in a group you may have provided funding guarantees or carry contingent obligations for a non-registered subsidiary. Where such guarantees or obligations exist and they are presenting significant risk or are leading to financial pressures for the parent, it is important that you make us aware of them. We have set out our regulatory requirements about managing financial issues within a group structure in our guidance note SHR 20. We expect that any financial support or guarantee provided by the parent RSL should not threaten its financial viability or its ability to meet its obligations towards tenants and funders.

3.4 There is a trend towards greater centralisation within lending institutions. Some lenders have reviewed their Scottish operations and withdrawn local relationship managers. The council of mortgage lenders has been clear that this does not mean lenders are less committed to Scotland, simply that they will have to work harder to provide services from more centralised locations. But it also means that some RSLs will need to work harder to manage that crucial lending relationship.

4. RSL response

4.1 It is clear that the ability of the sector to withstand more challenging economic and financial conditions and to continue to contribute to a broad range of objectives (for example, developing new supply) will depend, in no small part, on the behaviour of RSLs in terms of:

- a) **Governance:** making sure you have the right people on your governing bodies who can bring a constructive challenge to executive teams and who understand enough about the business environment to support RSLs through tougher times and secure continued viability and value for money for tenants.
 - b) **Financial planning:** reviewing and updating your financial forecasts, business plan and financial assumptions on a regular and realistic basis, building in robust stress-testing and scenario planning.
 - c) **Securing efficiencies:** keeping cost growth in check and delivering core business efficiencies to secure continued viability.
 - d) **Risk management:** having a stronger focus on good risk and treasury management, and assessing your exposure to the housing and finance markets.
 - e) **Managing private lending requirements and liquidity:** managing effectively your existing loan covenants, conditions precedent and lending relationships, within a tougher financial climate and as the institutional landscape changes. This means making sure you are complying with all notification, information and financial covenants at all times. And putting the best foot forward in securing new private finance, through good quality advice and attractive and realistic funding prospectuses for lenders.
 - f) **Controlling development risk:** reviewing any unsold homes and keeping new development and contractor risks under close control.
- 4.2 In view of the combined uncertainties, challenges and opportunities the sector faces it may be appropriate for you to **review your business strategy and future plans**. This may involve deciding, with your governing bodies, what sort of business you want to be in, what role you need to play in your local communities, and how the RSL's resources should be used for the benefit of current and future tenants. This would also include a review of your future strategy for new social housing development, in light of the organisation's capacity, emerging opportunities, and the economic and financial context.
- 4.3 Such a review of strategy and plans could also be an important part of an RSL's response to the Scottish Government's investment reform agenda, should Scottish Ministers confirm their intention to encourage the formation of RSL consortia and to appoint a number of lead developers. The Scottish

Government is currently consulting on these proposals, and it is clear from the consultation paper that close attention to the issues set out in paragraph 4.1 above would be necessary for any RSL intending to seek pre-qualification or appointment as a lead developer under the proposed new arrangements.

5. Regulatory response

5.1 In response to the changing times, we anticipate needing greater assurance from some RSLs about their short term liquidity and financial planning. As you know, we conduct annual viability reviews based on your annual accounts and five year projections; and we get information about your loan portfolios. Over the rest of this financial year, we will be stepping up our focus on the financial health of the sector and individual RSLs, and plan to:

- a) review the financial information we require from RSLs;
- b) survey RSLs in the new year to bring us up to date about the impact of the current macroeconomic and lending environment on your financial position and response to the current situation;
- c) examine RSL business plans (particularly RSLs with whom we have high and medium engagement) to assess their quality and underpinning assumptions. We will develop guidance to the sector on business planning if our review suggests this is required; and
- d) undertake an exercise to test our powers and response to a hypothetical insolvency case.

5.2 We will continue to assess risk across the sector and act in a proportionate way with landlords to make sure risks are managed to protect the interests of tenants and maintain the confidence of lenders and funders. It is particularly important at this time that you tell us about financial or development problems as they emerge. We remain confident that, with good forward planning, governance and risk management, the RSL sector is well placed to deal with the current environment.