HCA’s Revised Regulatory Framework from April 2015

Background
The Homes and Communities Agency (HCA) in May 2014 launched a consultation on key changes to the Regulatory Framework in order to protect social housing assets. At the time Julian Ashby, Chair of the HCA pointed out that this was necessary due to the profound changes the sector was facing in terms of finance and that it is the job of the HCA ‘to protect social housing assets and their public value... for the benefits of tenants, taxpayers and lenders.’ Also such changes provide ‘the preconditions for further investment and asset growth... and are needed to keep the Regulatory Framework “fit for purpose.”’ In January 2015, the HCA published the results of the consultation regarding the revision of the Regulatory Framework. At the Forbes Solicitors “Diversify or Die? Funding Affordable Housing After 2018” event at which risk management was a key theme, Bronwen Rapley of the HCA’s investigation and enforcement division stressed that the regulator will expect RPs up to and including board level to have a clear understanding of the risks being taken within the organisation and their potential to effect its value and viability. That priority is evident in the changes to the Regulatory Framework documents.

The role of the HCA
While the HCA has a range of responsibilities for the purpose of the social housing sector, as the Social Housing Regulator (the Regulator) its main responsibility is to regulate social housing providers so that they are well managed, remain financially secure, which in turn maintains investor confidence and protects homes for tenants. In this regard, it is a key priority for the Regulator to have a developed Regulatory Framework and be able to regulate the sector effectively, which is becoming more complex and risky. The Regulator is under a statutory obligation to perform its functions with a view to achieving (as far as is possible), the economic regulation and consumer regulation objectives. In doing so it is also under an obligation to minimise interference and as far as possible its approach should be proportionate, consistent, transparent and accountable.

Aims of the revised Regulatory Framework
According to the Consultation and the Decision statement, the Regulator has specified that changes to the Regulatory Framework aim to:

- Built on the existing co-regulatory approach under which the decision-makers in RPs should be aware of the HCA’s sector specific regulation and also the
general legal rules that apply to companies or registered societies whatever they do,
- Strengthen requirements for RPs to **manage risks** in their business **effectively** and
- From a good governance perspective require that RPs have the **appropriate skills and capabilities** to meet their objectives.

**What has changed?**
The key changes to the Regulatory Framework include:

- Changes to the **Governance and Financial Viability Standard (G & FVS)**,
- Introduction of the **Code of Practice,**
- Changes to the **Rent Standard** and
- Changes to **General Consent.**

**The Governance and Financial Viability Standard**

- **All relevant law**

According to the existing **G & FVS**, RPs are under an obligation to ensure effective governance arrangements that deliver their aims, objectives and intended outcomes for tenants (current or future) in an effective, transparent and accountable manner. In doing so, RPs must now ensure that they **adhere to all relevant law** (previously this part of the Standard only referred to legislation). This means that RPs are under an obligation to adhere not only to **legislation** but also **case law, common law and statutory guidance.** For the latter, the HCA provides the example of Charity Commission guidance. It is for this reason that we often refer to there being at least a tri-regulatory regime for most RPs which are registered or exempt charities. The HCA is now officially accepting it is often not the only regulator in town.

While this may be burdensome for some RPs, the Regulator has explained that this is an important requirement. It has also stated that non-compliance with law will not automatically result in breach of the Standard provided that the RP is able to show **all reasonable measures** were taken to comply with all relevant law in line with the Regulator’s **proportionate** approach to regulation. The Regulator also has said that this approach will be reflected in a new version of **Regulating the Standards** in March 2015.

- **Protect social housing assets**

The revised G & FVS also incorporates the additional element to **‘protect social housing assets’**, which RPs shall ensure in their governance arrangement. The Regulator has explained that this element reflects the role of RPs as **‘custodians of social housing assets’** and aims to ensure **‘ongoing viability of social housing’**
providers’. This is further supplemented throughout the G & FVS and the **Code of Practice** through the approach of minimising undue risk. Through the Code of Practice in particular, the Regulator provides non-exhaustive examples that provide context to RPs of what the Regulator will consider unacceptable outcomes resulting from social housing assets being put at undue risk. These include:

- Loss of social housing assets and/or tenants losing their home or the benefits of being within the regulated sector due to **enforcement of security or insolvency**
- Loss of social housing assets where the sale is the result of **poor business planning and decisions** or where the sale is being made due to an **unplanned cash shortfall** (G & VFS Code of Practice para. B.2)

**Business planning, risk and control frameworks**

RPs obligation in relation to having business planning and a control framework in place has been expanded. From the 1st of April 2015 RPs are under an obligation within this framework to include **risk**, to **approve this framework** by the RPs board and its **effectiveness** in achieving the required outcomes is to be **reviewed at least once a year**.

The Regulator has indicated that this is necessary due to RPs’ operating environments and diversity of activities. As such, RPs are required to **fully understand their businesses**, the **operating environment**, the **risks** and the **recourse of funders to social housing assets**. The Code provides that boards as the **custodians of social housing assets** are responsible for **managing risk** including maintaining a long term perspective to ensure sustainability and security of their social housing assets. Such a regime assists the Regulator in “ensuring registered providers of social housing are **financially viable** and properly managed” and “to guard against the **misuse of public funds**”. As risk management is a core business activity, the Regulator also considers that placing this requirement on RPs is ‘**reasonable and proportionate**’ in a regulated market.

**Stress Testing**

RPs are also to have a specific obligation to ‘**carry out detailed and robust stress testing**’ in relation to identified risks and combinations of risks with regard to a range of scenarios, as well as placing mitigation strategies in place. Similarly, prior to taking on new liabilities, RP’s must to ensure that they ‘**understand and manage the likely impact on current and future business and regulatory compliance**’.

The Code provides that RPs should test their plans using **different scenarios** going beyond ‘simple sensitive testing and include **multi-variate testing**, which tests against potential economic and business risks’. Further such testing should utilise scenarios which would assess **resilience**.

This would in the case of many RPs include for example assessing potential changes in income brought about by welfare reforms and the impact of any volatility in the private rental and sale markets if the RP is running any market rental or buy to sell schemes.
The HCA’s guidance is that testing should be used by RPs to establish which risks are capable of causing serious or fatal damage to the organisation.

- **Skill and capability to perform**

The Regulator has also expanded RPs governance arrangements by requiring RPs to ensure that they manage their affairs ‘with an appropriate degree of skill, independence, diligence, effectiveness, prudence and foresight’. This is because the Regulator considers having the requisite skills and capabilities are key elements of a well-run organisation where risk is managed effectively. Additionally, it seeks to point out that RPs need to have the right skills and capabilities, as well as to recognise that such skills may come from outside the organisation. Through the Code, this requirement is elaborated further where it is stated that the Regulator would expect the RP to have the following:

- an **appropriate skill strategy** addressing the needs of the business;
- **regularly assess** the competencies, experience and technical knowledge of the board and management in relation to the size, scale and risk profile of the organisation;
- ensure all material decisions are made with appropriate **internal/external expertise/advice** and that such support or advice is **impartial**;
- **Have plans to address skills gaps** including utilising external skills, which are monitored to ensure implementation;
- The level of **independence** should be determined in accordance with adopted code of governance and other legal requirements such as Charity law. Additionally, board members should exercise ‘**independence of judgment and act at all times in the best interests**’ of the RP. It is also specified as good practice to have an appropriate mechanism in place to deal with any conflicts of interest.

It is a common theme adopted by regulators including the HCA and the Information Commissioner’s Office that appropriate and regular training is essential. The lack of training is now an aggravating factor in regulatory cases and having a sound training scheme to which the organisation gives appropriate priority serves as mitigation of things to go wrong.

- **Asset/liability registers**

Another new element added to the G & FVS is the obligation on RPs to ‘**maintain a thorough, accurate and up to date record of their assets and liabilities**’ (emphasis added). According to the Code the purpose of this requirement is to ensure that RPs ‘**understand their assets and liabilities** and have **swift access** to such information in decision making and risk management’. While the Regulator **does not prescribe a format** for such records, it does expect such a register to ‘contain **sufficient information** to enable a potential buyer to accurately price the value of the business and/or value of the social housing assets in the event of distress’.

However, the Code does illustrate the **type of assets** that a RP might record including:
• Treasury arrangements;
• Key contracts;
• Title information (and any applicable restrictions such as planning obligations, charitable endowments etc.);
• Valuations;
• Stock condition;
• Lender covenants.

Similarly, the Code also provides an illustration of the type of liabilities (in the widest context) that a RP might record including:

• Loans (incl. borrowing from other group companies or related undertakings);
• Guarantees, indemnities etc. (incl. those provided to subsidiaries and SPVs whether secured/unsecured);
• Leases, sale/lease and leaseback transactions;
• Mark-to-market exposures on derivative positions;
• Cross default provisions;
• A duty or responsibility that obligates the entity to another;
• The potential for any impairment particularly in relation to investments in non-core activities.

As such RPs are under an obligation to maintain such a register and regularly update it, with the board having a full understanding of the liabilities that exist between all the entities and how a failure within one part of the group may affect another.

The approach taken by a particular RP will vary according to its size and complexity. In keeping a register though, an RP may consider how swift access is ensured. This raises questions in relation to the format of the register that the RP may keep, for example it may an electronic register or a physical one to complement the online version in order to ensure swift access even when online services are not available.

The RP may also want to consider how it goes about compiling the information needed to set up and maintain the register.

One example is how best to show land in the asset register where the title is already registered with the Land Registry. At one end of the scale just recording the title number does not include any immediately available information although it does allow for rapid searches which will produce current results. Using office copy entries as the register will provide more information within the register itself but will have to be updated and replaced as they will not reflect changes in the Land Registry records after the initial search.

Similarly, not all titles are in fact registered with the Land Registry such as leases less than 7 years or longstanding unregistered property assets.

As a result RPs would need to consider their own records and interpret them in order to produce parts of the asset register. Having a central asset register may also be beneficial to RPs apart from satisfying the requirements of the Regulator because it will allow different teams working in different areas within an RP to have access to it, use the information in their work and update it centrally as changes take place. Additionally, RPs may consider a wide range of sources that could be deemed to be assets and
included in the register such as plant machinery and other tangible assets, key contracts, proceeds of insurance and litigation, as well as intellectual property rights among others.

As with assets when determining its liabilities, RPs should do so in the widest context. This may also include debt, guarantees, unavoidable obligations, bonds, TUPE costs and litigation costs. RPs may also consider whether any of these have an impact on the social housing assets, since this is one of the main aspects on which the Regulator is focusing.

- **Communicating with the Regulator**

The obligation to communicate with the Regulator has been widened. Under the revised Regulatory Framework, RPs are now under an obligation to communicate in *a timely and accurate manner*. According to the Code, RPs should inform the Regulator of *any material issue* which indicates that there has been or may be a breach of the Standards. The examples provided include material frauds, liquidity issues, and breaches of lenders’ covenants or failures of governance.

The Regulator will continue with the Quarterly Survey, which functions as an early warning system of RPs short term viability. Additionally, it will directly engage with RPs through the In-Depth Assessments, which are described as being ‘bespoke to each provider’ focusing on the providers risk profile, its exposure and quality of governance to manage risks, its viability, stress testing and asset and liability registers. The Regulator will also conduct Stability Checks, which focus on gap analysis to ensure that no material changes have occurred since the In-Depth Assessment.

- **Boards to certify compliance with G & FVS**

RPs at least once a year are also required to assess their compliance with the G & FVS and the board is under an obligation to certify in the annual accounts their compliance with the standard. According to the Code, the board certifies the narrative report, which accompanies their financial statement. The Regulator has indicated that through this approach, RPs are *providing a transparent statement to their stakeholders* as well as the Regulator, without the need for a specific regulatory report on this issue.

RP boards will have to get used to interrogating and challenging proposals brought forward for approval to make sure they understand how a new scheme will change the overall picture or at least affect existing parts of it. This requirement might also lead to some reassessment of the degree of delegated authority extended to officers and managers. Setting authorisation by reference to document or transaction types may not be sophisticated enough.

The increased onus on Boards to assess compliance with the Standard and certify it in the accounts each year is a key part of the Standard and officers should consider how proposals are presented to their Boards for approval. The Standard indicates the
questions that Boards should be asking and their task will be easier if proposals are presented with suitable analysis where that information is available.

**Code of Practice (the Code)**

The Regulator using its powers under the Act has introduced the Code of Practice in relation to the Standards and in order to ‘amplify the requirements’ in the G & FVS. The aim of the Code is to help RPs ‘understand what the Regulator is looking for when seeking assurance on compliance with the Standard’.

Within the co-regulatory regime, it is the responsibility of RPs to understand the content of the Code and use it in meeting the Standards. Therefore, the Code is a useful tool as it explains and elaborates the content of the Standards, in some cases with illustrative examples. While the Regulator will have regard to the Code when assessing whether Standards have been met, it is the Standards that the Regulator will enforce rather than the Code. In practice this means that each RP has to determine for itself what effective compliance with the G & FVS looks like in the context of its activities and risk profile. There is not a standardised solution that will fit all RPs the same way.

**The Rent Standard**

The rent standard requires that RPs ‘shall charge rents in accordance with the Government’s direction to the regulator of May 2014’. In this regard, the Regulator does not have control over the rent policy as this is driven by the Rent Regulation to the Regulator from the Department for Communities and Local Government. Nevertheless, the revised Regulatory Framework has brought two key changes regarding the rent standard including:

- **Indexation basis from RPI to CPI**

  RPs are under an obligation to meet the requirements from the Government to the Regulator and the ‘key requirements’ set in the Rent Standard Guidance. According to the Rent Standard, weekly rent increases each year by an amount of no more than CPI + 1%. At the same time, the rent cap also increases annually by CPI + 1.5%.

- **Ending upward convergence of rents**

  RPs are under an obligation to keep rent increases within the guideline limit. As such upward convergence through rent increases, which go beyond the guideline limit are no longer permitted. This change may have an impact on the financial viability of a RP, in which case it is able to seek a waiver of a requirement of the Rent Standard for a specific period of time. According to the Rent Standard Guidance an example of such
a case could be where a RP receives a reduction in the overall rental income due to the ending of the rent convergence uplift, which would cause the RP to risk failing to meet existing commitments to banks or other covenants.

Changes to General Consent

For most disposals of social housing by private RP consent is required by the Regulator (s. 172 of the Act). This can be burdensome for the Regulator and the regulated and so the General Consent has been developed to permit certain disposals without reference being made to the Regulator. Nevertheless the Regulator indicated in the Consultation conducted in 2014 that a balance needed to be struck in light of other changes between ‘protection of social housing and flexibility for providers’. As such it has introduced the following changes:

- Number of consents have been reduced from 39 to 34;
- Category 6 Consent is no longer available for a RP (private or non-profit), which is a subsidiary of an unregistered parent and
- Category 6 Consent is also not available if the grant of a security interest over a social housing dwelling secures or it may in the future secure Index Linked Finance (ILF).

To supplement bank debt, RPs are looking to the bond market and through ILF, which is rooted in sale and leaseback or lease and leaseback structures. RPs have secured and are considering this type of finance in order to meet their growth ambitions and due to the lower initial start costs and the lower asset cover requirement. However, in the Sector Risk Profile 2013 and 2014 the Regulator points out that this may lead to higher risks overall and that this poses different risks to the more traditional funding that RPs are used to.

The Regulator has indicated that changes in relation to Category 6 Consent are necessary because allowing access to an unregistered parent and ILF poses a greater level of risk, as well as loss of control.

The General Consent has always been the HCA’s unofficial definition of lower risk activities which RPs could undertake without prior permission. It is worth noting that on top of all the additional risk management changes being bought in from the start of April the HCA has also changed the General Consent to call in these higher risk users of social housing stock for prior approval.

Summary

The changes to the Regulatory Framework taking effect in April 2015 will require different degrees of change for different RPs. Some may only have to package existing information as the asset and liability registers on top of existing risk analysis and management arrangements. For some RPs there will have to be a change of approach
from the Board downwards to enable the organisation to demonstrate to the HCA that it is meeting the high standards the Regulator expects the entire sector to maintain.

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