

Viability

A discussion paper

July 2009



TSA

**TENANT
SERVICES
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Viability

A discussion paper

We consider in our discussion paper, *Building a New Regulatory Framework*, published in early June, the potential range of standards and objectives for those, within six themes. This paper expands on the discussion of a standard relating to viability.

Fundamental objectives of the TSA include that we ensure the financial viability of registered providers. In support of this, the 2008 Housing and Regeneration Act allows the regulator to set standards in matters relating to the management of their financial and other affairs.

The sound financial performance of a provider is fundamental to its ability to deliver excellent quality services to its residents, maintain good quality housing and to maximise its ability to attract external finance to grow its stock of social housing. Financial performance results from the effectiveness of the control environment within the organisation and the quality of the strategy pursued by the board. Hence financial performance and the effectiveness of governance are inextricably linked.

Any standards relating to financial management must require providers to plan and manage their affairs effectively to ensure viability. However, viability, as a minimum standard, does not

necessarily ensure that providers are using resources available to them effectively. Whilst a more viable organisation may be one which uses its resources effectively organisations do not necessarily need to maximise the effective use of resources to ensure viability. Our discussion paper, published in June, therefore introduces a further potential standard on value for money.

We have set out some key questions below, but stakeholders should not be constrained by them. You may choose not to answer them all. We are open to any other thoughts or considerations you might have and would welcome views on any issues within this paper.

Application of the standard across the domain

We expect that a national viability standard will not apply to local authorities. However, given the strong link between sound finances and service delivery, we will want to work closely with bodies such as the Audit Commission that are concerned with financial issues for local authorities, where service delivery performance may warrant it.

The Act specifies (section 194) that standards in relation to the management of financial and other affairs are applicable to profit-making providers only in so far as relating to the provision of social housing. In essence this means that the financial performance for social housing provision will need to be defined and reported in some way for profit-making registered providers. Fundamental to this is capturing what social housing activity relates to and this is explored as part of our work on registration.

Existing approach to financial regulation

The inherited system of viability regulation is centred on part one of the Regulatory Code, which requires that:

“Housing associations must operate viable businesses, with adequate recourse to financial resources to meet their current and future business and financial commitments:

- based on a coherent and robust business plan
- fulfilling their loan-agreement covenants”

However, to supplement that regulation, the Housing Corporation developed specific tools to focus on the use of resources. Two key themes included encouraging the more efficient use of financial capacity to meet new build targets and encourage greater operational efficiency. These two initiatives were introduced outside the framework of the Code via focused conversations with landlords and through the introduction of the operating cost index.

In addition to the Regulatory Code viability requirements, the Housing Corporation set out requirements relating to the management of financial matters (in broadest sense) in Circulars

and associated Good Practice Guides. In summary, these relate to:

- Treasury management – Circular and Good Practice Guide
- diversification (of activities) – Circular and Good Practice Guide
- internal controls assurance – Circular and Good Practice Guide
- rent influencing – Circulars and guidance
- accounting requirements – Determination

The process of assessment of viability has been based on analysis of financial forecast information, usually through the standardised 30-year capacity model. This model was developed for the HC, in conjunction with the NHF, with a small group of associations that volunteered to help its development. The model enables the TSA to collect financial planning data of providers in a standardised format.

Output from the assessment is an Annual Viability Review (AVR) concluding on the analysis and providing a TSA judgement summarised under one of four straplines. The AVR is not published openly but the executive summary forms the basis of the viability assessment in the Regulatory Judgement. The AVR is usually made available to associations' funders (by the association) under the terms of loan agreements.

Throughout 2008 and early 2009, the Housing Corporation and, latterly, the TSA refined the approach to financial regulation in response to the changing risk profile of the sector, due to the finance and housing markets. The refinements have included gathering quarterly sector information on the key risks materialising in the year (refinancing risk, impact of reduction in sales) and the review of internal association information to address specific risks identified through the AVR process (including covenant monitoring reports, regular cashflow reports and management accounts).

The experience from the past 12 months has highlighted the importance of short-term solvency issues as compared with medium-term viability

concerns, often highly influenced by aspirational plans for growth and diversification or medium-term maintenance issues. It has also highlighted the need to tailor regulatory engagement to ensure we have sufficient assurance to arrive at a sound Regulatory Judgement, based on proportionate regulation.

We have developed the approach to regulation of financial viability in response to the changing market environment and in such demanding economic times we suggest it is appropriate to build on the current approach, rather than attempt a wholesale revision. However, we are committed to ensuring that the regulatory approach is sufficiently flexible to respond to any change in risk profile of registered providers, minimises regulatory burden and is consistent with the Principles of Better Regulation.

Question 1

What, if any, elements of the existing approach to the regulation of viability should the TSA carry forward and develop?

New legislative basis

The TSA has flexibility over the design of the standard(s) relating to the management of financial affairs and standards may point to codes of practice, encouraging a co-regulatory and self-assessment approach.

In line with our statutory objectives, we believe there needs to be a standard that refers to providers' viability. Experience within the TSA strongly suggests the need for a viability standard with a sufficiently flexible process of assessment to allow for a tailored, timely and proportionate response to risk.

However, in addition to viability, financially robust providers can influence the achievement of other TSA objectives, including:

- to ensure services to tenants are delivered economically, efficiently and effectively
- to encourage and support a supply of well-managed social housing, of appropriate quality, sufficient to meet reasonable demands
- to encourage investment in social housing

Fundamentally, the more efficiently and effectively organisations provide services and operate, the

more financially robust they will be, with greater opportunity to attract and apply resource to both enhance service delivery to tenants and increase the supply of housing.

Options for financial standards might therefore encapsulate elements across all TSA objectives set out above and include a broad requirement on the management of financial matters to ensure viability and to ensure resources are applied effectively to deliver cost-effective and efficient services and homes.

However, such a standard is wide ranging and crucially will have many parts to its assessment, making scrutiny of performance against it more difficult. Also, on balance, a discrete standard requirement on viability as a minimum is attractive. Funders to the sector and other stakeholders currently gain assurance from our assessment of viability and this will facilitate a smooth transition. Through informal discussions with Finance Directors in the sector they have told us that a 'clean' viability standard is helpful for clarity in their relationships with funders and other stakeholders;

viability being such a fundamental objective underpinning their ability to deliver their plans. We therefore consider the alternative – to split a wide ranging financial management standard into two discrete standards covering viability and economy, efficiency and effectiveness, (or value for money) – a preferential option.

Our discussion paper suggests a discrete standard on viability on this basis, which may have its objectives expressed as:

Landlords manage their resources effectively to ensure their viability is maintained. Financial planning is based on a robust business plan that demonstrates current and future financial obligations can be met.

A standard on viability lends itself to a national standard. All providers should be required as a minimum to ensure their organisational viability. Whilst it will be appropriate for a range of standards to reflect local deals, and whilst that may impact on the costs and processes for different providers in differing ways, that will not affect the need to maintain viability.

The Act provides for the TSA to adopt or point to codes of practice to amplify standards, providing more detail on what is expected from providers to be compliant. However, the concept of financial viability and the process to achieve that is well understood by those tasked with it in organisations.

To maintain viability, an organisation must develop financial plans based on robust information that identifies the resources required and available to fulfil its plans, with proper consideration of the risks to their achievement. An organisation must manage those resources effectively and monitor and report against plans.

Sound financial performance results from the effectiveness of the control within and strategy pursued by an organisation, under the direction of the board, hence structures and processes required to maintain viability are inherent within an organisation that has good governance arrangements.

We are, therefore, interested in views on whether a code of practice would be helpful to amplify what is meant by maintaining viability. Conversely, a viability standard may be set out sufficiently to be clear (and succinct) on what is required to meet the standard, without recourse to further amplification.

In considering the need or otherwise for a code we would be interested in your thoughts on the links between strong financial management to maintain viability and good governance.

Question 2

Is a discrete national standard focused on viability the most appropriate approach?

Question 3

What key elements do you think should be reflected in a viability standard to ensure clarity on what performance standard is required?

Question 4

Does maintaining viability lend itself to further amplification by way of a code? If so, what areas should such a code reflect?

How we will regulate

The TSA has to decide how it will regulate viability. We will need to set out our expectations on how providers demonstrate they are compliant and how we will monitor compliance (including in what circumstances we might take special measures).

Critical to successful delivery will be not only the approach to standards that we establish, but the way in which we regulate. The new Senior Risk and Assurance Managers will take a lead role in establishing and managing effective relationships with the largest registered providers. They will be supported by risk and assurance teams and regional standards advisors who will manage the day-to-day relationship, supporting registered providers and their tenants in the delivery of excellent services.

This approach reflects our initial high-level assessment of risk across social housing based primarily on the number of homes owned by a registered provider. This approach will be refined in due course.

We are considering applying a range of assessment including:

- self-assessment by registered providers' boards
- feedback/assessment from residents and stakeholders
- benchmarking and peer review
- independent validation/audit of particular functions
- the TSA's assessment of a provision of a small suite of information (financial and service delivery indicators) which may identify areas of concern
- the TSA's assessment of financial plans of an organisation with review of the assumptions and key risk areas within the plan (for viability)

An assessment of financial viability is one of judgement, not fact. It is necessarily a forward-looking assessment and financial plans involve assumptions which may produce a viable plan on paper, but which are potentially not achievable. Viability, although proposed as a national minimum standard to be passed (ie no concept of a maximum viability performance in the standard), will necessarily result in a range in viability dependent

on risk exposure, plans for growth and key assumptions on which future plans are based.

When a viability standard is failed, it is too late for the tenant, provider and regulator. It is vital, therefore, that we can understand the extent to which viability is at risk for an organisation and we would want to monitor the position. We propose, therefore, to continue with an independent assessment of viability, based on appropriate financial information returns and an informed assessment of risk exposure. The approach could be based on sector risk monitoring in combination with a regulatory risk-assessment process together with financial data comparison to identify outliers and those at risk. This risk-based approach to our regulation should underpin the monitoring and assessment process of our work on the national viability standard. Where necessary, regulators will gain additional assurance from a provider to demonstrate that the risks are being appropriately managed to ensure viability is maintained. These additional information requirements will vary, depending on the risks faced and management's response to those. However, any additional monitoring information would only be required in response to identification of specific risk to the achievement of the standard of viability.

Question 5

Do you agree we should continue with an independent assessment of viability, based on appropriate financial information returns and an informed assessment of risk exposure? If not, what role might the alternative methodologies suggested above play in the assessment of viability?

Publishing assessments and grading performance

Our intentions are set out in our overall discussion paper: it is our intention to be transparent about our views on registered providers' performance. Tenants and registered providers as well as other stakeholders will want to know how well they are performing, so we will publish our assessments. There are a number of options open to us in terms of grading systems:

- overall assessment of a registered provider's performance, ie an aggregate view of its performance across the full range of TSA standards
- judgements against each of the national standards
- judgement based on each of the six themes

There are also options for the type of grading system used, for example:

- pass/fail assessments
- poor, satisfactory, good and excellent

For viability, an analytical assessment would likely identify the risks to which the organisation is exposed and provide an assessment of the potential impact and likelihood (and timing) of those

risks affecting the viability of the organisation. This provides a continuum of assessment (if not published judgement) and it is sometimes challenging to fit an assessment into one or other of any published bandings.

If we are to introduce bandings of assessment, the options in relation to financial viability include the following:

a) Four bandings, as is now

This is generally viewed as too many bandings to provide a useful reference for users to understand the view of the regulator. There is particular concern that users of the information might naturally assume the first banding is an optimum, whereas the second assessment may, in certain circumstance be more favourable.

b) Simple pass/fail

Under this proposal at any time (based on experience of the Housing Corporation), the vast majority (if not all) would show a pass assessment. Only a handful of organisations have had a fail assessment previously and typically these have been recorded as such during the period where an alternative future is explored for the organisation, under our intervention powers.

c) Pass, pass with closer regulator monitoring, fail

This option is attractive in that it might provide the reader with a better reflection of the regulator's view of an organisation's position in relation to viability – that we will be more active with some than others, dependent on the risk exposure of that organisation. The fail assessment would necessarily be very short lived however, since a non-viable organisation will not have an independent future.

d) Pass, concern over viability (-borderline), fail

This option represents the first, third and fourth bandings we have currently. The assessment of concern is often problematic and has been interpreted as 'a loaded gun'. It potentially can lead to a detrimental change in the way stakeholders engage with the organisation, which might exaggerate the problem.

Question 6

What are your views on the range of grading system for assessing registered providers' compliance with all standards?

Question 7

What are your views on the additional 'banding' options for assessing registered providers' compliance with the viability standard?

Additional issues

Regulation of viability has adapted over the past year, largely in response to the changing economic environment and the degree of exposure of individual associations. This has flagged up a number of issues that we must consider. In addition, informal discussion meetings with a range of sector Finance Directors also provided comments about the existing approach and indicators for changes for the future. The following sets out some additional issues on which we welcome your feedback.

Annuality of approach

We inherited a system that largely focuses on an annual review of financial health and viability. Perhaps largely as a result of the fast changing environment the annuality of approach is viewed as a risk by some and potentially inefficient, where circumstance does not change so frequently. Whilst the inherited Housing Corporation approach does not discourage more frequent financial monitoring as required (and variability in what information may be required for monitoring), regulators and the regulated have grown used to the capacity model as being the reference for all monitoring.

Question 8

What are your views on the annuality of approach – would a more fluid approach be more appropriate?

Period of assessment

In general, it is felt that there is limited value in extending a period of viability assessment beyond five years. Plans after that period of time (in terms of growth) are usually aspirational and subject to significant change. Assumptions have little credibility. It is right that social housing businesses plan over the long term – to ensure planning for key maintenance peaks and debt refinancing/repayment and to demonstrate the cost of housing is repaid over the long term. However, it was felt that the regulator's assessment of viability should focus on the period up to around five years only.

Also, experience over the last 12-18 months has also caused us to focus on short-term solvency issues, where previously viability was the focus. The form of assessments therefore changed in response and emphasis moved away from the medium term assumptions to liquidity management in the shorter term. This raises the issue whether there is merit in distinguishing between short term and medium term in any assessment and judgement. In effect could

there reasonably be a two-part assessment and/or judgement process that separately considered solvency (perhaps referencing to current financial health, liquidity and immediate plans) and medium-term viability (perhaps referencing to the impact of plans for growth).

Question 9

What are your views on the period over which the TSA should focus its assessment of viability?

Question 10

Should an assessment differentiate between solvency and liquidity issues over the short term and viability over the medium to longer term?

Provision of financial data

There is, in general, support for the inherited capacity model, although to some degree this is influenced by familiarity with it now rather than whether it is the best tool for collecting financial information. We have received feedback that indicates the multi-function of the capacity model, enabling a high degree of sensitivity analysis, sometimes diverts attention and resource from what matters to individual organisations in terms of their

risk exposure and their own covenants. Whilst the capacity model provides and requires a high degree of financial detail, the way it calculates sensitivities is not necessarily consistent with the impact on a landlord's own plans.

Feedback we have received indicates that landlords would prefer engagement on individual relevant sensitivities rather than desktop analysis on a broader range of risk.

Similarly, recent events have highlighted the importance of covenant compliance and monitoring and we have sought assurances on that where necessary. The range of covenants varies between differing landlords and different funders and previously the TSA has not collected covenant information.

Question 11

What is your view on the capacity model as a means of collecting financial forecast information and in analysing that information? What alternatives are there?

Question 12

Does consideration of solvency require a different form of financial information for monitoring purposes and what might that be?

Question 13

Should the provision of covenant information be part of financial information submitted to the TSA across the sector or on an exceptions basis?

Many commentators refer to the number and range of ratios provided in the analysis tool, focusing on the fact they do not often add to the analysis and are confusing and superfluous for many. There is a degree of support for a sector-derived small suite of financial health indicators that could be adopted across the piece. These might be directly derived from financial statements and therefore could reasonably be added to the information required in the Accounts Direction. It was felt there would be value for external stakeholders, boards and tenants in seeing commonality across the piece and potentially how these indicators move in relation to planned financial performance.

Question 14

What is your view on the development of a suite of financial health indicators which are common across the (non-local authority) part of the sector? What are your suggestions for any indicators?

Treasury management

The TSA inherited Circular 01/07 Treasury Management by Housing Associations and published good practice, Treasury Management for Housing Associations: A Good Practice Guide (updated May 2009).

Proper management of treasury risk is a very live issue for the sector currently. A range of factors have heightened the issue: funding is not as readily available as it has been previously, significant associations are beginning again to look at alternative funding markets, the unusual financial environment of last year and resulting mark to market calls, the keener attitude of lenders to look at arrangements and new financing models.

The Circular discusses management of treasury risk in the context of associations' risk management frameworks. It sets out basic expectations on

treasury management and goes on to specific requirements in certain areas.

Basic expectations include:

- landlords must have skills, knowledge and experience necessary at board and officer level to properly manage treasury management risk
- landlords must use derivative instruments solely for the purpose of managing treasury risk – therefore a risk must be present against which the derivative can be matched
- financial transactions must be prescribed currencies

Circulars will not feature in the TSA's new framework and regulatory requirements need either be expressed within a standard or within a code of practice which amplifies a standard. Conversely, good practice publications may continue and it is possible that good practice published by the Housing Corporation will be equally relevant going forward.

We need, therefore, to consider whether similar requirements are still necessary and if so, how we achieve that.

Question 15

Should the TSA set specific requirements in relation to treasury management and if so what might they be, particularly by reference to Circular 01/07?

Question 16

If the TSA were to set specific requirements on this particular risk management area, do you think this is a matter for the financial viability standard or governance standard?

Comparative cost approaches

We have said we may have a role in publishing sector-wide cost information to enable comparison of cost across the sector. This is in line with recommendations within the Cave report. However, a key challenge in the provision of such information is to ensure like-for-like comparison and users of the information are clear about to what the varying cost information relates. Such information would provide a platform for landlords to challenge and be challenged by tenants and stakeholders to explain where and why significant differences may exist.

The Housing Corporation introduced the operating cost index (OCI) which provided a means of comparing costs between different landlords based on the identified drivers of cost in the sector. Whilst the OCI is a robust sophisticated statistical approach, it has been criticised for its technicality and its relevance is questioned particularly in relation to how a landlord might influence that result.

Alternatively, the Housing Corporation previously published a suite of financial performance indicators which were comparatively simple in their calculation (unit costs of management and maintenance, for example). Similarly these were criticised often for the impact of cost apportionment differences between organisations and that they did not fully reflect the impact of context (or cost drivers).

We are considering potential alternatives to the simple unit cost approach, which might include investigating the impact of overheads on unit management and maintenance costs. Any sector-wide cost information will need to be read across both local authorities and non-local authority landlords and must be derived on a materially consistent basis across the sector. We want to explore, therefore, whether there is a range of cost information that is relevant across the sector and

that, from sources available, can provide useful comparative data.

Question 17

What are your views on the suggestion that we should develop, in partnership with landlords, a consistent set of cost information indicators to enable stakeholders to compare and challenge landlords?

Question 18

What cost information might be most useful and what are the key challenges to obtaining robust comparative information?

Responses

We are keen to receive your views on any of the range of issues set out in this paper.

Please address your response to:

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Responses should arrive no later than
8 September 2009.

Alternatively please e-mail your response to althea.houghton@tsa.gsx.gov.uk

Responses may be placed on our website and therefore open to be viewed by all interested stakeholders. Respondents wishing to send a response in confidence should be aware that the TSA cannot guarantee to maintain confidentiality because of our responsibilities under the Freedom of Information Act.

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