Analysis of the finances of Registered Social Landlords

Technical report

March 2018

About us

We are the independent regulator of social landlords in Scotland.

We protect:

nearly
610,000 tenants
who receive services of social landlords

over
123,000 owners
who receive services of social landlords

around
40,000 people & their families
who may be homeless and seek help from local authorities

over
2,000 Gypsy/Travellers
who can use official sites provided by social landlords

We regulate:

around
200
Social landlords

160
Registered Social Landlords

32
Local Authorities

Our role is to:

monitor, assess and report on social landlords' performance of housing activities and RSLs' financial well-being and standards of governance. We intervene where we need to, to protect the interests of tenants and service users.

About this report

Section 3 of the Housing (Scotland) Act 2010 sets out our regulatory functions and these include a requirement to report upon the financial well-being of Registered Social Landlords.

Regulatory Standard Number 3 requires each RSL to manage its resources to ensure its financial well-being and economic effectiveness.

Our reports on the finances of RSLs provide an analysis of the information reported to us by RSLs on their financial performance.

We base our overall analysis of the sector on the most up-to-date information available to us as provided to us by RSLs. This report is our analysis of information provided by RSLs for the financial year to 31 March 2017. We present the information at the aggregate level for the RSL sector as a whole.

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Highlights

The sector's financial position continues to be strong

Rents & Inflation
Rental increase is below inflation in 2017/18 but forecast to be above inflation.

Pensions
Continued movement from defined benefit schemes to defined contribution schemes which offer RSLs greater certainty around future liabilities.

Cash Generated
Strong financial position remains but reduced cash generated and higher interest paid on debt. This means that overall, landlords have less scope when it comes to managing unexpected events.

Turnover
Rental income went up by 2.4% but Care & Support income is expected to reduce in future years.

Housing Investment
RSLs are investing more in new and existing homes. Investment increased by 24.5% to £807m during 2016/17.

Voids, Arrears & Bad Debts
Lower levels despite changes from Welfare Reform.

Borrowing
Borrowing is set to increase sharply with RSLs forecasting that they will borrow an additional £1.4bn in the next 5 years to fund investment in new and existing homes.

Executive Summary

Rents & Inflation

Our review of the projections indicate that during the period 2019 to 2022, average rents are expected to track the increase in RPI but be around 1% above the increase in CPI. It is likely that over this period, any indexation of welfare benefits will be based on CPI. Where welfare caps are applied, it is possible that benefit uplifts will not be available at all.

Any rent increase, particularly one which is in excess of CPI, may create issues around affordability for tenants in receipt of benefits as well as for those in work who may not receive pay rises.

Given RSLs' planning assumptions around rent increases, we expect all RSLs to look constructively and creatively at ways in which they can reduce costs without detriment to the interests of tenants and minimise the risk to tenants that their rent becomes unaffordable.

Pensions

The movement away from Final Salary and Defined Benefit to Defined Contribution is clear. Defined Contribution gives the RSLs much more certainty about the future cost of pensions.

- 57 RSLs currently provide only Defined Contribution pensions for employees. From discussions with these landlords, we conclude that they have looked at the risks associated with Defined Benefit provision and judged that they cannot justify the risk that it poses to their longer-term solvency and tenants interests.

- 64 RSLs provide both Defined Benefit and Defined Contribution pensions. This normally takes the form of a Defined Contribution offering for new employees with existing staff being able to retain Defined Benefit should they wish.

- 33 RSLs provide only Defined Benefit pensions, of which 8 provide only Final Salary Schemes and a further 25 providing pensions on the basis of average earnings or a combination of final salary and average earnings, with new employees only having the option of average earnings.

Notwithstanding the recent shift away from final salary and defined benefit schemes, more than half of all RSLs still have some exposure to Defined Benefit schemes. This means that they are incurring future liabilities that they cannot control and the eventual liability borne by the RSL is uncertain.

Cash Generated from Operations

For many years we have used cash generated from operations to interest paid as a measure of financial health. This ratio is essentially a cash-based version of interest cover. It is a much simpler and more accessible measure than most widely used measures such as EBITDA MRI (Earnings Before Interest & Taxation Depreciation & Amortisation, Major Repairs Included) but it does not take account of amounts outstanding at the beginning and the end of the year.

For some years this ratio has been around 3 but in 2016/17 it reduced to 2.70.

The reduction is due to a fall in cash generated from operations and an increase in interest paid. The fall in cash generated by operations is due in part to rents rising by less than inflation while Management & Administration Costs rose by more than inflation.

Analysis of the five-year financial projection returns indicates that this ratio will continue to fall and by 2020/21 will fall to 2.58.

We do not view the reduction of interest cover as a long term weakening in the financial strength of the sector. Rather it reflects a sector that is using its assets more intensively in order to invest in its housing stock for both existing and new tenants.

But the fact that RSLs will be generating less cash from operations relative to interest payments means that many RSLs will have less headroom.

In terms of how we view financial risk, these RSLs will have less financial capacity available to meet potential adverse scenarios. So they will need to manage more material risk in order to comply with Regulatory Standard Number 3. It is important that this is understood by policy makers in considering how housing need will be met in future.

Turnover

Turnover has two main components – Social Lettings and Other Activities.

There is modest growth in Social Lettings of 1.0% but a reduction of 8.1% in Other Activities. Within social lettings, turnover comprises income generating activities (rents & service charges) and also grants received. Most RSLs release grants over the lifespan of the related assets. This accounting treatment was introduced with the change in accounting standards to Financial Reporting Standards. As an alternative, RSLs are permitted to credit all of the grant receivable in a single year to the accounts in that year and 15 RSLs opted for that approach, known as the "performance method".

In 2016/17, such grants accounted for 8.9% of the turnover so it is a significant change to the results.

Net income from rents & service charges increased by 2.4%. However, within this overall increase, service charges fell for the second successive year. Voids remained static, indicating that RSLs continue to manage voids reasonably effectively.

Care and Support activities declined. This is likely to fall further in succeeding years as we are aware of a number of RSLs who are planning to disengage from care and support as they consider that continuing to operate in these areas presents an unacceptable risk to their future solvency.

Investment in New & Existing Properties

There has been a substantial increase in the amount spent by RSLs on the acquisition and construction of properties and investment in existing properties.

In 2016/17 RSLs invested £807m, an increase of almost one quarter on the previous year. Capital grants received increased by around a third to £330m while loan advances received (excluding re-financing of existing loans) increased by 47% to more than £307m.

The proportion of development financed by RSL's own reserves fell to 14.8%, whilst there was an increase of 23.1% in cash receipts from property sales. This was anticipated due to the end of the statutory right to buy in August 2016.

Our initial analysis of RSL projections indicated that they were planning to complete around 29,500 new houses over the next five years. Work carried out during the course of our risk assessment has resulted in a revised estimate of approximately 32,500.

Borrowing

The total interest payable in 2016/17 was £166.7m, an increase of 5.9% on the prior year. Capitalised interest also increased by £0.6m or 17.6% to £4.0m.

For the first time, RSL's required on average 10.7% of turnover to service existing debt. This is not unexpected due to the volume of development under way and with the level of planned development increasing, this is likely to rise further. We expect RSLs to include modelling the risks of increased debt and interest payable as part of their sensitivity analysis.

The undrawn facility reduced by £79m or 11.2% to £628.0m whilst the total facilities only grew by £90.9m or 1.9% to £4.9bn. There were a number of re-financing exercises during the period including bond finance, with the latter normally requiring full drawdown at the start.

Our analysis of the annual returns anticipates that interest will rise to £260.5m by 2021/22, an increase of about 60% on the 2016/17 figure. Some key points are:

- 39 RSLs will see their interest payments more than double over the period
- 33 RSLs will see interest payable reduce, some of which are developers

In 2017 systemically important RSLs paid total interest of £101.3m, some 62.3% of the total payable. By 2022 the amount of interest payable by RSLs which are currently designated as systemically important will increase to £175.4m, or 67.4% of the total payable.

Arrears & Voids

Throughout the past few years, RSLs have worked hard to manage and mitigate the effects of changes in the welfare system upon tenants and the RSL itself.

Lenders have made it clear that they will monitor arrears and voids closely in view of the sensitivity of these measures to changes in the welfare system.

Our latest analysis shows that RSLs are continuing to work hard in this area. All of the measures which we consider have either remained around levels seen in previous years or shown a slight improvement in absolute terms.

Introduction

This is the second report to use financial statements prepared under Financial Reporting Standard 102 ("FRS 102"). Last year, the change to FRS 102 made it virtually impossible for us to provide the same level of analysis and commentary as in prior years. We now have three years of FRS 102 compliant financial statements and have expanded our commentary to include some elements of trend and projection analysis. Due to the flexibility that FRS 102 provides with some aspects of reporting, comparisons can still be difficult but we have highlighted areas where conclusions can be hard to determine.

This report presents our view on the finances of the sector based on the most up to date information that is currently available to us. This includes the annual returns and our engagement with the sector and key stakeholders.

We also carry out a detailed risk assessment on the financial health of each RSL. The decision on who to engage with and how depends upon our assessment of the risks in each case. In November 2017 we published what risks we would look at in our 2017/18 risk assessment for RSLs. This can be read in more detail here.

Following the 2016/17 risk assessment we published 56 regulation plans and 33 (approximately 21% of all RSLs) had financial health as a principal driver for our engagement. We engage with RSLs on the grounds of financial health to seek appropriate assurance about their finances and viability. We expect to publish broadly the same number of regulation plans following the 2017/18 risk assessment.

Financial Review

Financial Performance

Annual turnover	*Operating surplus*	*Interest payable*	*Aggregate net surplus*
Down by 1.6% to:	*Up by 37.7% to:*	*Up 5.9% to:*	*Up 46.4% to:*
1,560.0m	***409.8m***	***166.7m***	***250.7m***

In 2016/17, there were a number of very significant movements which impacted both the operating surplus and net operating surplus. Overall, both turnover and operating costs reduced by 1.6% with the major factors including reduced development sales and support income.

Other key points impacting the results include:

- The impact of the revaluation of pension schemes and a change by one RSL to amalgamate and reduce its group structure resulted in an exceptional £111.8m increase to the operating surplus.
- Increased level of borrowings combined with historical loans being replaced with higher interest rates caused interest payable to rise by £9.3m to £166.7m.
- Total comprehensive income was adversely by changed actuarial assumptions underlying pension schemes plus market conditions including continued low interest rates

Table 1 below summarises the results:

Table 1: Statement of Comprehensive Income

	2015/16 £000	2016/17 £000	Change %
Turnover	1,585,899	1,559,994	(1.6)
Operating Costs	(1,282,666)	(1,262,059)	(1.6)
Exceptional Items	(5,633)	111,818	2,085.0
Operating Surplus	**297,600**	**409,753**	**37.7**
Gain on non-current Assets	11,570	13,890	20.1
Surplus/(Loss) from Joint Ventures & Associates	1,663	(826)	(149.7)
Interest Receivable	10,045	9,018	(10.2)
Interest Payable	(157,458)	(166,737)	5.9
Other Financing Costs	(7,057)	(6,814)	(3.4)
Release of Negative Goodwill	782	779	(0.5)
Movement in Fair Value of Financial Instruments	10,190	3,293	(67.7)
Movement in Valuation of Housing Properties	4,077	(11,623)	(385.1)
Surplus Before Tax	**171,412**	**250,733**	**46.3**
Tax Payable/Receivable	(140)	(49)	(65.0)
Net Surplus	**171,272**	**250,684**	**46.4**

Revaluation of Housing Properties	(9,235)	15,651	269.5
Actuarial (Loss)/Gain on Pension Schemes	52,239	(42,346)	(181.1)
Change in Fair Value of Hedged Instruments	(137)	(290)	(111.5)
Total Comprehensive Income	**214,139**	**223,699**	**4.5**

Analysis of operating surplus

The operating surplus for 2016/17 was £409.8m and was heavily influenced by exceptional items of £111.8m, an increase of 37.7% or £117.4m on the prior year.

Under FRS 102 there is no definition of exceptional items and leaves it to the RSL to decide what should be shown, based on materiality. This introduces a considerable amount of flexibility as to what is shown on the statements and can make comparison and analysis across the sector more difficult. In 2016/17, there is a reasonable level of consistency with £90.0m being the release in the SHAPS pension deficit recovery provision. The balance of £21.8m is due to one RSL with registered subsidiaries completing a transfer of engagements.

Excluding the exceptional items, the adjusted operating surplus for the year is £297.7m compared with £303.2m in 2015/16, a small reduction of 1.7%.

A total of 5 RSLs generated operating deficits during the year and is broadly unchanged from the previous two years, as summarised in Table 2 below.

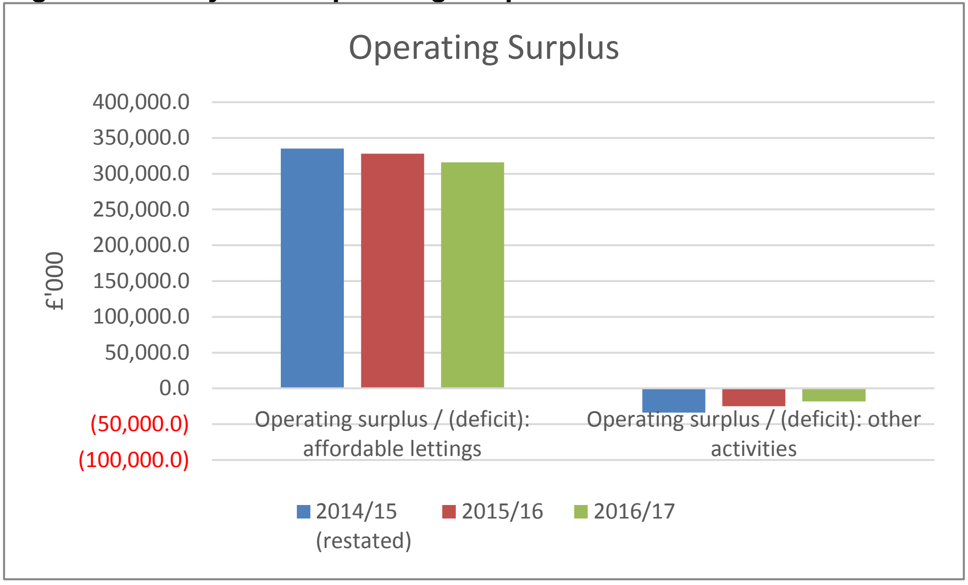
Table 2: Operating Surplus/(Deficit) by RSL

Operating surplus/(deficit)	2014/15 (restated)	2015/16	2016/17
Below 0	5	4	5
0 - 2,500.0	123	121	111
2,500.0 - 5,000.0	21	23	25
5,000.0 - 7,500.0	7	10	9
7,500.0 - 10,000.0	2	1	4
Above 10,000.0	4	3	7
	162	**162**	**161**

The deficits, however, are not necessarily generated by the same RSLs each year. The analysis does indicate a general trend of improving operating surpluses across the board but the drivers are not necessarily improved letting margins.

The adjusted operating surplus analysis sub-divided into social letting and other activities shows the continuing trend of other activities being loss making, albeit reducing year on year, and is summarised in Figure 1 below:

Figure 1: Analysis of Operating Surplus



Social Lettings

In 2016/17, the operating surplus decreased by 3.6% to £316.0m. The last three years has shown a slow but steady decline from the £335.2m recorded in 2014/15. This is primarily due to costs growing faster than income i.e. turnover has grown by 3.1% since 2014/15 whilst operating costs are almost double the rate at 6.1%.

The gross income from rents rose by 2.6% to £1,161.0m but this was offset by a modest reduction in service charges to tenants of 1.9% to £66.6m. Void income lost remained relatively static at £14.9m. Over the last three years, the void rate has reduced from 1.3% of gross income to 1.2%, indicating that RSLs on the whole are continuing to effectively manage lost income from empty properties.

Due to FRS 102, turnover is sensitive to changes in the deferred income released (primarily housing grants released to income over the lifetime of the property), which reduced by 10.8% to £129.1m during the year. A total of 15 RSLs have opted, under FRS 102, to credit all the grant receivable in one year within the audited accounts. This approach, known as the performance method, can have a material impact on the turnover year on year. In 2016/17, such grants accounted for 8.3% of the turnover compared to 9.1% in the previous year, so it is a significant change to the results.

Care and Support activities declined. This is likely to fall further in succeeding years as we are aware of a number of RSLs who are planning to disengage from care and support, as they consider that continuing to operate in these areas presents an unacceptable risk to their future solvency

Operating costs are sensitive to the planned & reactive maintenance costs that cannot be capitalised, but interestingly this cost reduced by £6.8m from the 2015/16 level. The key contributor to the 3.5% rise in operating costs was the 4.7% rise in management & maintenance administration costs to £351.5m. This will include costs of interventions with a small number of RSLs. Housing impairment costs more than doubled to £2.8m and the depreciation increase of 5.4% to £296.9m reflects the increased development and capital maintenance programmes during the year.

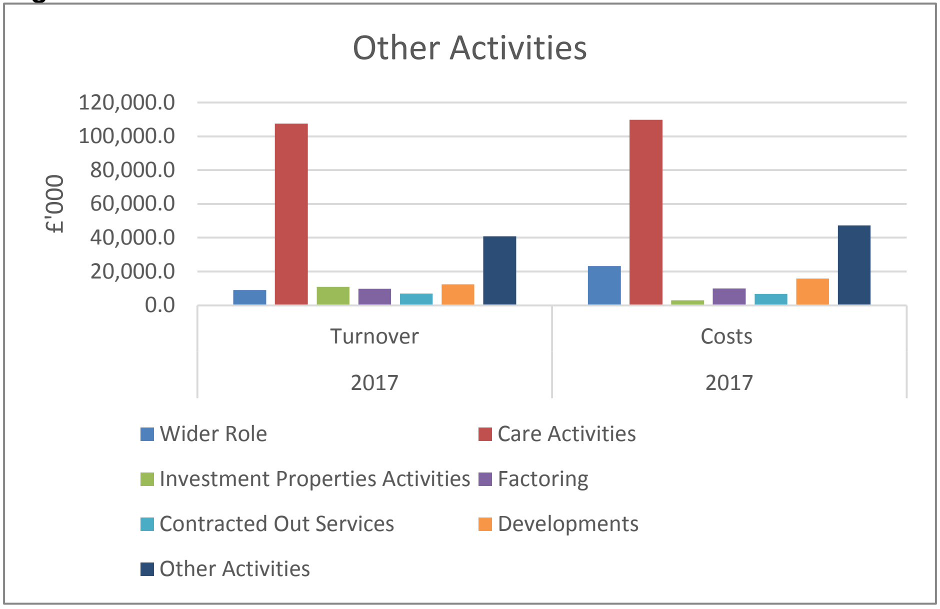
The number of RSLs with affordable lettings deficits has reduced from 3 in 2014/15 to 2 in 2016/17. There is no particular trend in respect of this, although 1 RSL has generated deficits in all three years and we are aware, through our engagement with the RSL, of the operational reasons for this.

Other Activities

Over the last three years, both turnover and operating costs have fluctuated but despite this the operating deficit has progressively reduced in value and in 2016/17 was £18.1m compared with £33.6m in 2014/15.

A summary of the activities turnover and operating costs is shown in Figure 2 below:

Figure 2: Other Activities – Turnover & Costs



Overall, most of the categories generate deficits, but assumptions on what the results infer should be treated with caution. An RSL will have a policy on how to allocate the overhead costs to each activity, but this is not necessarily the same for each RSL. This is perfectly legitimate but it does mean there is unlikely to be a consistent approach across the sector, so you cannot easily compare the costs allocated to each activity. In 2016/17, a total of 78 RSLs generated other activities deficits.

The 2016/17 results show that only Investment Property Activities and Contracted Out Services were in surplus. As in prior years, Care constitutes the bulk of the activities with 54.5% and 50.9% of turnover and costs respectively.

Wider Role is often considered a key activity for many RSLs, but turnover reduced by £2.9m to £9.1m in 2016/17, almost a quarter below the previous year's value. Overall the deficit for Wider Role was £18.7m compared with a £19.5m deficit the prior year, so costs have fallen almost in line with turnover.

Developments is primarily developments for sale and associated administration costs which cannot be capitalised as part of the total cost of the new housing. This means that both turnover and costs can be vastly different year on year. Deficits tend to be the norm (due to the administration costs) but overall the deficits generated are relatively low.

Analysis of Net Surplus

The net surplus after tax for 2016/17 was £250.7m, a rise of 46.4% on the prior year. The impact of the £111.8m exceptional items has been offset to a degree by additional costs and losses.

Interest payable has risen by 5.9% to £166.7m, continuing the trend of increased levels of borrowing combined with historical loans on very advantageous interest rates being replaced by new loans at the current, higher rates. As a percentage of turnover, the trend over the last three years is a steady rise from 9.5% to 10.7% whilst net social lettings income has grown by 5.7% over the same period.

Movements in housing valuations can fluctuate significantly year on year and in 2016/17 was a reduction of £12.6m compared with an increase of £3.4m the previous year.

Looking at individual RSL performance in Table 3 below, there has been a slight increase in the number of RSLs recording net deficits in 2016/17, but it is not necessarily the same RSLs each year. Despite this, there has been slightly improved performance overall with 32 RSLs generating a net surplus in excess of £2.5m. The median value has also improved from £536k in 2014/15 to £785k in 2016/17.

Table 3: Net Surplus/(Deficit) by RSL

Net surplus/(deficit) £'000	2014/15 (restated)	2015/16	2016/17
Below 0	18	10	13
0 - 2,500.0	125	136	116
2,500.0 - 5,000.0	15	14	21
5,000.0 - 7,500.0	2	0	5
7,500.0 - 10,000.0	1	0	2
Above 10,000.0	1	2	4
	162	**162**	**161**

Analysis of Total Comprehensive Income

Total comprehensive income includes those items not included in the net surplus/(deficit) calculation as they have not been realised i.e. the underlying transactions have not been completed. For example, if the RSL invests in property and the value of the property changes, the difference is shown as gain or loss on valuation. When the property is sold, the RSL realises the gain or loss associated with the property and it gets moved into a gain or loss line higher up the statement and is included in the net surplus/(deficit) calculation.

For RSLs, these transactions tend to fall into property revaluation, pensions and hedging instruments. By far the most significant impact of the three transaction types is the revaluation of pensions. Both 2014/15 and 2015/16 recorded major aggregated surpluses of between £41m and £52m, but in 2016/17 the situation radically changed to a £42.4m loss.

This has been in part due to market conditions with low interest rates and the changing the underlying actuarial assumptions used e.g. increased life expectancy, RPI/CPI increases, salary & pension increases etc. This impacted 44 RSLs in total with 40 recording an aggregated loss of £46.7m and 4 RSLs with an aggregated gain of £4.3m.

Financial Position

The aggregated net assets as at 31 March 2017 continued to grow in line with previous years at approximately 9% per annum. The major factors for the continued growth include:

- Reducing value of deferred grant income released annually
- Improved cash position (see table 5 below in cash generation section)
- Significant levels of new debt with deferred capital payments (see interest and borrowing section)

Table 4 below shows the continued steady investment in housing assets, both new build and housing improvements, with net housing assets growing by 4.6% in 2016/17. The proportion of deferred grant income to net housing assets reduced marginally to 43.0% from 45.4% over the period, further illustrating the importance of private finance for RSLs businesses.

Table 4: Aggregated Statement of Financial Position

	AS at 31/3/2015 (restated) £'000	As at 31/3/2016 £'000	As at 31/3/2017 £'000
Net housing assets	10,477,096	10,800,402	11,296,434
Other non-current assets	328,029	346,931	359,042
Total non-current assets	**10,805,125**	**11,147,333**	**11,655,476**
Receivables due after more than 1 year	157,068	141,249	112,083
Net rental receivables	33,244	37,879	34,975
Other current assets	201,441	182,767	213,646
Cash and cash equivalents	557,509	624,020	648,038
Loans falling due within 1 year	(107,061)	(104,228)	(135,496)
Other payables due within 1 year	(320,074)	(350,146)	(356,035)
Deferred income due within 1 year	(331,883)	(200,285)	(129,747)
Net current assets	33,176	190,007	275,381
Total assets less current liabilities	**10,995,369**	**11,478,589**	**12,042,940**
Loans due after more than 1 year	(3,475,610)	(3,607,106)	(3,814,576)
Other payables due after more than 1 year	(271,945)	(211,442)	(197,535)
Provisions	(341,607)	(309,223)	(381,651)
Pension asset / (liability)	(65,741)	(18,167)	(60,124)
Deferred income due after more than 1 year	(4,444,544)	(4,720,487)	(4,738,520)
Total long term liabilities	**(8,599,447)**	**(8,866,425)**	**(9,192,406)**
Net assets	**2,395,922**	**2,612,164**	**2,850,534**

Net rental receivables fell by 7.7% during the year to £35.0m, which is equivalent to 9.4 days as a ratio of total affordable lettings turnover. This is a modest improvement on the previous year which had jumped from 9.2 days in 2014/15 to 10.2 days and is in part due to increased bad debt provisions. With continuing pressure on tenants' ability to pay combined with the impending rollout of Universal Credit, arrears and debt management will remain a critical function within all RSLs.

Provisions increased to £381.7m and largely reflects the changes to the SHAPS pension deficit requirements which were not consistently treated in the 2015/16 AFS form. The pension liability is largely local government pension schemes and the increase reflects the deteriorating position in some schemes and the actuarial loss for the year.

Cash Generation

Cash generation is crucial to the financial viability of any organisation, in particular the cash generated from operations. This is the cash that is used to fund new housing, housing improvements and repay loan capital and interest.

In the year to 31 March 2017, total cash increased by 4.3% or £26.5m to £648.0m and Table 5 below summarise the annual movement:

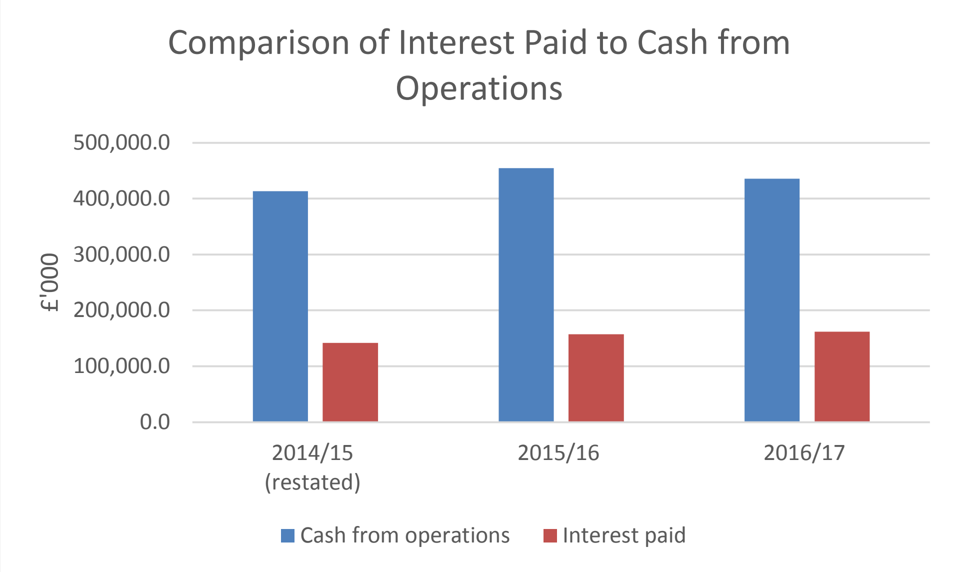
Table 5: Aggregated Statement of Cash Flows

	2014/15 (restated) £'000	2015/16 £'000	2016/17 £'000
Cash and cash equivalents at the beginning of the year	592,025	554,712	621,518
Net cash flow from operating activities	413,194	454,219	435,829
Tax (paid)/refunded	(145)	(38)	(54)
Net cash flow from investing activities	(394,834)	(378,564)	(464,213)
Net cash flow from financing	(52,730)	(6,309)	54,958
Net change in cash and cash equivalents	(34,515)	69,308	26,520
Cash and cash equivalents at the end of the year	**557,510**	**624,020**	**648,038**

Cash generated from operations fell by 4.0% to £435.8m, a reduction of £18.4m from the previous year. This has a direct impact on the ability of RSLs to cover the costs of loan and interest repayments, whilst remaining committed to developing new and existing housing.

Interest payable increased to £161.5m, an increase of 2.9% from the prior year but this is almost £20m more than paid during 2014/15. The movements are summarised in Figure 3 below:

Figure 3: Comparison of Interest Payable and Cash from Operations



Of the £161.5m interest payable, systemically important RSLs accounted for £101.3m or some 62.2% of the total. From a regulatory point of view, we can take some comfort from the fact that the majority of interest payable is from such RSLs, which are subject to closer scrutiny than other landlords – even those landlords with which we are engaging.

The impact of the movements is that the amount of cash generated from operations for each £1 in interest paid has fallen to 2.70 during the year, as shown in Table 6. Although it has reduced, this remains a healthy interest cover margin and should continue to be a source of assurance to lenders and other key stakeholders. It also reflects the importance of RSLs continuing their efforts to seek and implement operational efficiencies throughout their organisations.

Table 6: Cash Generated per £1 of Interest Paid

	2014/15	2015/16	2016/17
Cash from Operations (£m)	413.2	454.2	435.8
Interest Paid (£m)	141.8	157.0	161.5
Ratio	**2.91**	**2.89**	**2.70**

Cash from investing activities is primarily the investment in new housing and improvements and 2016/17 saw a significant increase of almost 25%, reflecting the rise in development commitments noted last year. Much of this was funded by grants and loan drawdowns as well as property sales, but this was insufficient to cover the full cost as summarised in the Table 7 below:

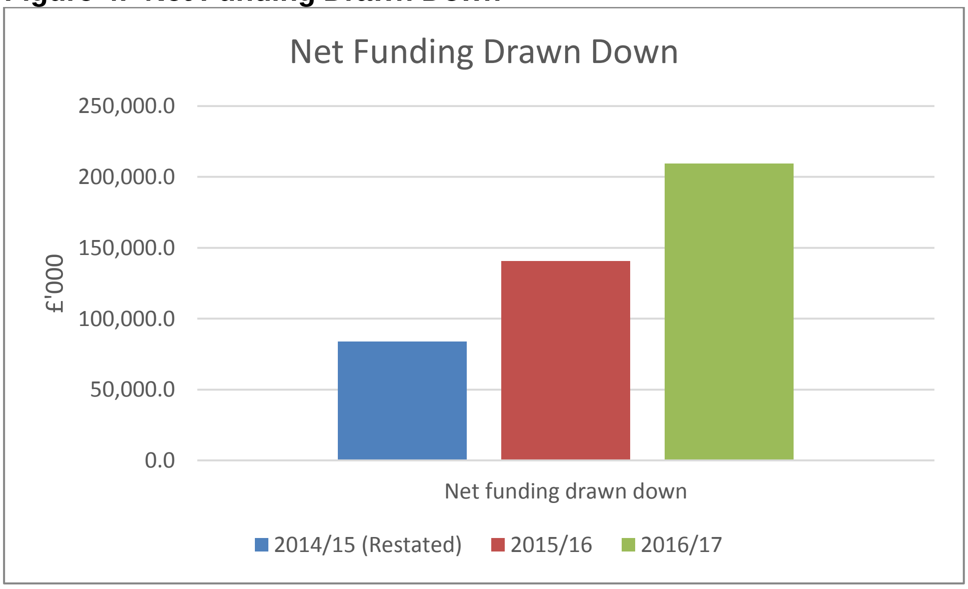
Table 7: Cash Outflow from Investing Activities

	2014/15 (restated) £'m	2015/16 £'m	2016/17 £'m
Acquisition and construction of properties	(694.8)	(648.2)	(807.0)
Purchase of other assets	(52.9)	(40.9)	(47.6)
Net capital grants received	294.6	248.4	329.9
Sales of properties	45.9	40.7	50.2
Sales of other assets	6.1	14.3	4.2
Interest received	6.3	7.1	6.1
Total	(394.8)	(378.6)	(464.2)
Loan advances received (excluding re-financing)	170.9	217.8	307.7

There was strong growth in development & capital maintenance programmes of 12.0% from the prior year to £807.0m. This was anticipated due to the volume of development programmes committed to in 2015/16. Capital grants also grew sharply with a rise of 32.2.% to £329.9m. Combined with £371.3m of loan advances, this offset the majority of the capital costs.

The net cash from financing activities in 2016/17 includes interest paid of £161.4m but this was more than offset by net £209.4m funding drawn down. Figure 4 below shows the rapid growth over the last three years:

Figure 4: Net Funding Drawn Down



Analysis of Costs per Unit & Ratios

Operational cost inflation rates often rise faster than rental income inflation, putting considerable pressure on RSLs to continuously look at ways to be as efficient and effective as possible. One measure that can be used to provide more information on this across the sector is cost per unit. Table 8 below summarises some of the key measures analysed using the data from the AFS returns:

Table 8: Breakdown of Cost per Unit

	2014/15 (restated) £	2015/16 £	2016/17 £	% Change 2014/15 to 2015/16	% Change 2015/16 to 2016/17	% Change 2014/15 to 2016/17
Management & maintenance administration	1,159	1,160	1,214	0.1	4.7	4.7
Planned maintenance	461	484	454	5.0	(6.2)	(1.5)
Reactive maintenance	553	568	574	2.7	1.1	3.8
Total direct maintenance	1,014	1,052	1,028	3.7	(2.3)	1.4
Total management and maintenance	**2,173**	**2,212**	**2,242**	**1.8**	**1.4**	**3.2**
Total staff cost	1,416	1,420	1,463	0.2	3.1	3.3
Key management personnel	100	104	120	4.1	15.0	19.8
Chief Executive (exc. pension contributions)	37	38	38	3.2	(1.2)	1.9
Rent receivable per unit	3,803	3,907	4,009	2.8	2.6	5.4

Total management & maintenance cost per unit has grown relatively slowly over the past three years, increasing by 1.4% to £2,242/unit in 2016/17. Over 50% of the unit cost is due to management & maintenance administration, which has increased by 4.7% from 2015/16 to £1,214/unit. There is not enough detail within the data, at this time, to identify the reasons behind the increase

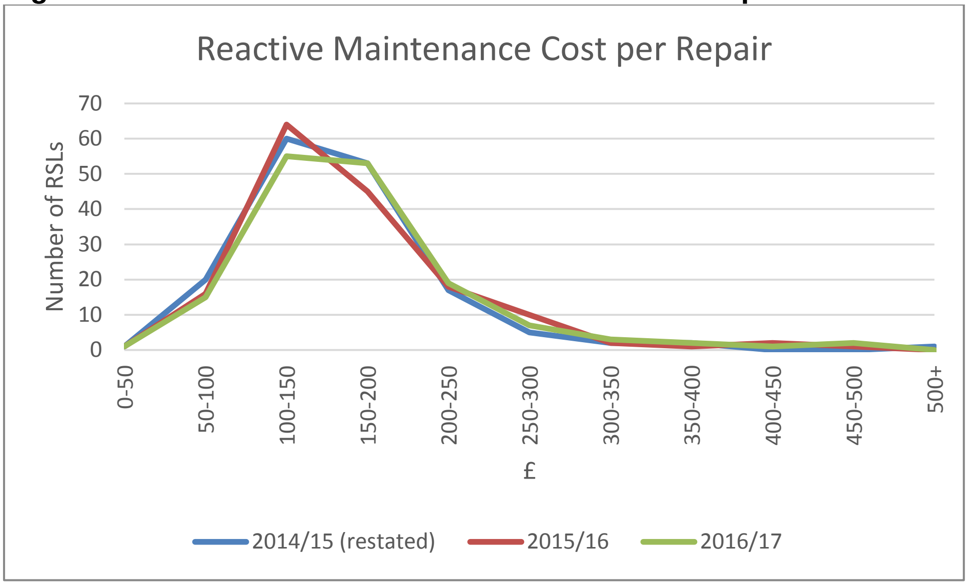
The fluctuation in planned maintenance cost per unit is not unexpected due to the nature of cyclical planning, effectively peaks and troughs over a period of years.

Planned & Reactive Costs per Unit

Reactive maintenance is more difficult to predict but effective stock management and up to date stock information should allow RSLs to control this to a degree. It has increased relatively slowly over the last three years, ranging from £553-£574 per unit.

A useful measure is the average cost per repair, using the repair data from the ARC return. Figure 5 below shows the distribution of the 161 RSLs for the last three years:

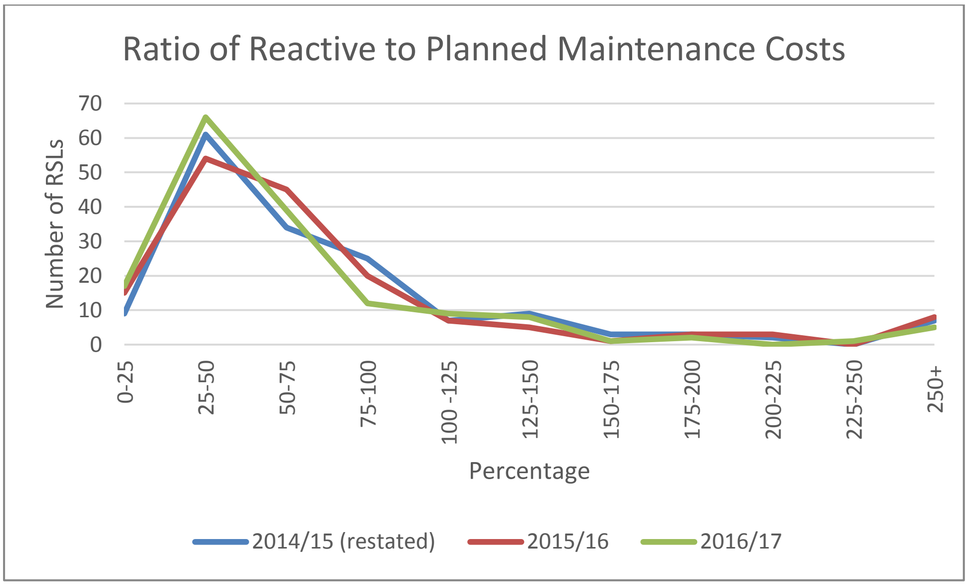
Figure 5: Distribution of Reactive Maintenance Cost per Unit



The median value, the middle value of the range as opposed to the average, for 2016/17 is £157/repair. This is a 5.4% rise on the prior year whereas in 2015/16 the value was virtually unchanged from 2014/15. The maximum value per repair has fluctuated over the last three years from £626 in 2014/15 to £459 in 2015/16 and then a slight rise to £468 in 2016/17. With only three years of data, it is difficult to draw a definite conclusion for the movement. The pre-2014/15 values have not been used due to the change in accounting treatments arising from FRS 102.

The ratio of reactive to planned maintenance costs per unit shows a very similar profile year on year. The majority of RSLs fall into the 25-50% range as summarise in Figure 6 below:

Figure 6: Ratio of Reactive to Planned Maintenance Costs



The key point to note is the number of RSLs where reactive cost exceeds the planned maintenance cost. A total of 6 RSLs spent over 200% more on reactive than planned maintenance during 2016/17 (compared to 11 the previous year). Although the maximum is broadly similar each year in the range 450%-490%, it is not the same RSL.

In 2016/17, 26 RSLs reported a value in excess of 100% compared to 27 in 2015/16 and 31 in 2014/15. Although not necessarily the same RSLs each year, a total of 14 out of the 26 RSLs reported values in excess of 100% in all three financial years. This is a possible trend which may be of concern, but there is insufficient data to determine the cause. We will discuss this with the RSLs to better understand their business model and seek assurance as to the business reasons for the trend as part of next year's risk assessment process.

We further analysed reactive cost per repair to determine what relationship, if any, could be determined when compared to the property age e.g. against the % of repairs on pre-2002 properties. Our analysis did not identify an obvious pattern, but we will be looking to refine and further develop this analysis for next year.

The above relationship has no particular pattern and we will be looking to refine and develop this analysis for next year.

Staff Costs per Unit

Staff costs increased by 2.9% to £423.9m, a significant increase from the 1.7% rise in the previous year. The FTE staff number also increased but by 283 or 2.2% to 13,133 resulting in a slight increase in average cost of an employee to £32,272.

Table 9: Staff Costs 2014/15 to 2016/17

	2014/15 (re-stated)	2015/16	2016/17	% Change in 2015/16	% Change in 2016/17
Staff Costs	£404.9m	£411.9m	£423.8m	1.7	2.9
Staff Number (FTE)	12,604	12,850	13,133	1.9	2.2
Average Cost per Employee	£32,124	£32,054	£32,272	(0.1)	0.7

As reported last year, our analysis indicated that 2014/15 and 2015/16 was skewed due to the way some RSLs reported pension deficits. The data entry significantly improved in the 2016/17 returns.

The FTE number employed by RSLs rose again to an all-time high of 13,133, a rise of 2.2% on 2015/16.

Table 10: Analysis of Staff FTE by Category

Year	Office	Care & Support	Concierge	Direct Labour	Total
2012	6,198	4,229	759	739	**11,925**
2013	6,217	4,340	815	810	**12,182**
2014	6,655	4,364	751	843	**12,613**
2015	6,612	4,331	760	901	**12,604**
2016	6,750	4,435	751	914	**12,850**
2017	6,859	4,385	910	979	**13,133**

Most categories of staff increased during the year, especially concierge staff which increased by 21.1% or 158.5 FTE to 909.8 FTE. This is primarily due to a 125 FTE increase in one RSL and excluding this, reduces the increase from 21.1% to 4.5%. Care staff decreased by 1.1% or 50.0 FTE to 4,384.7 FTE, an indication of the challenging environment and pressure on contract costs impacting service contract delivery and viability.

Office based staff, which includes senior management, increased by 16.1 FTE to 857.2 FTE, but the ratio of senior management to total staff fell marginally from 6.6% to 6.5%. Many RSLs had no change and some showed less senior staff than before.

A small number of organisations had noticeable senior staff increases and two RSLs had virtually no corresponding net increase in the other categories. This may indicate a changed business model and we will engage with individual RSLs to seek assurance on how they report on staff categories.

We will continue to engage with RSLs in respect of data entry accuracy around employment costs.

Key Management Personnel Cost per Unit

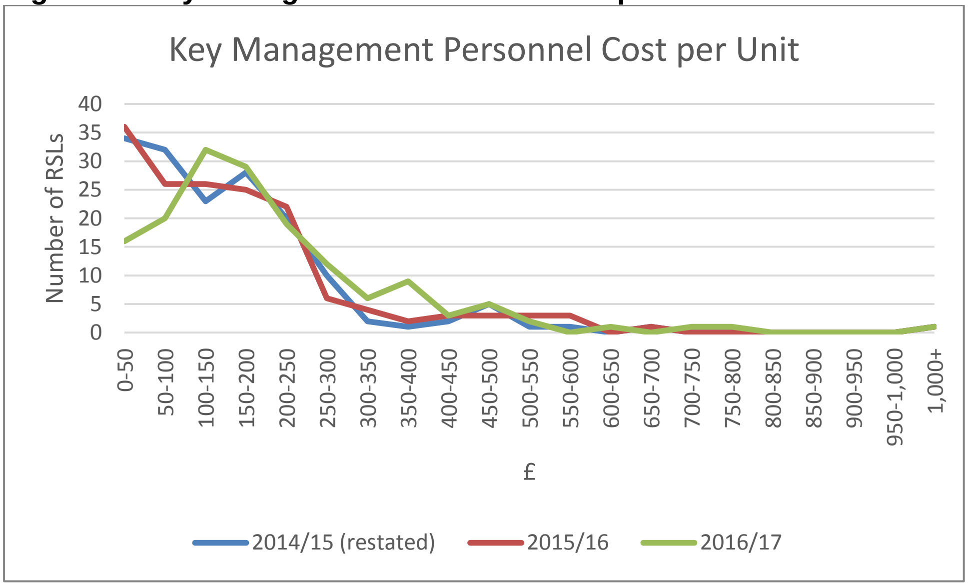
As with total staff costs, the data quality improved in 2016/17 compared to prior years with much more consistent reporting of pension deficit costs. Table 11 below shows the range of values reported:

Table 11: Key Management Personnel Cost per Unit

Key management personnel	2014/15 (restated) £	2015/16 £	2016/17 £
Minimum	0	0	0
Maximum	1,277	1,585	2,000
Median	132	132	164

A more detailed analysis of the data is shown in the table below. Despite inconsistent reporting in prior years, the last three years have broadly the same profile. The results have to be taken in the context that larger RSLs are likely to have a low cost per unit whilst smaller RSLs could have a much larger cost per unit.

Figure 7: Key Management Personnel Cost per Unit



The median value for 2016/17 was £164/unit, compared with £132/unit in both 2014/15 and 2015/16. All bar 11 RSLs had a value below £500/unit and only 1 is consistently above £1,000/unit. There is no definitive conclusion to be drawn at this time, but we will continue to develop our analysis in this area.

Chief Executive Emoluments per Unit

Table 12 and Figure 8 below show the range and median for the last three financial years:

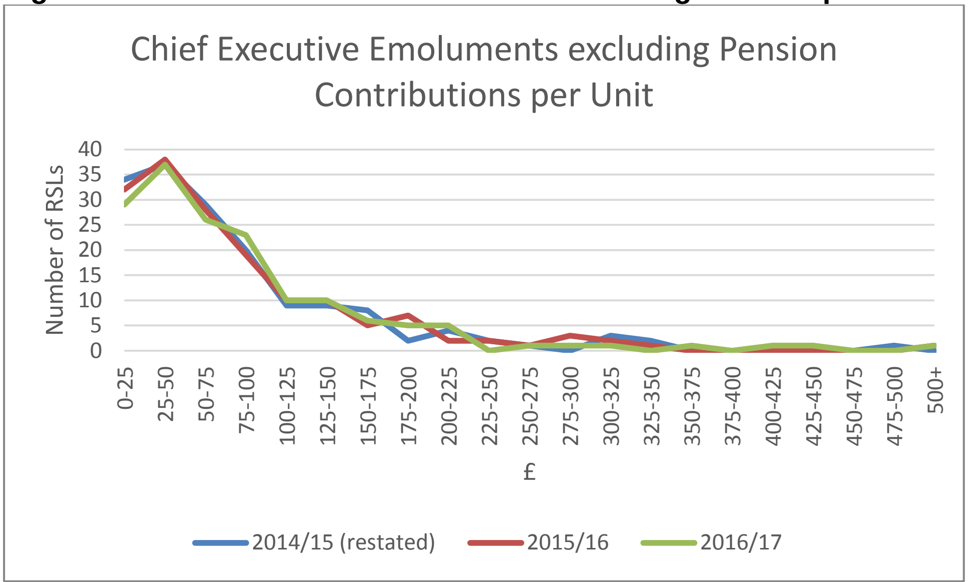
Table 12: Chief Executive Emoluments excluding Pension per Unit

Chief Executive emoluments exc pension	2014/15 (restated) £	2015/16 £	2016/17 £
Minimum	0	0	0
Maximum	481	593	622
Median	58	59	65

As with key management personnel costs, the analysis has to be taken in the context of the broad nature of the sector i.e. a mix of RSLs ranging from very small to very large. The analysis revealed no definitive trend but did identify some RSLs with significant variations year on year. We are aware from our engagement that some RSLs have changed their structure or the Chief Executive has changed, which impacted the values reported.

Although the maximum per unit has increased by 4.9% from £593/unit to £622/unit, the total costs actually reduced from £11.1m to £10.9m in 2016/17. The median value per unit has not significant changed over the last three years, increasing from £59 in 2015/16 to £54 in 2016/17. Although the maximum per unit has increased by 4.9% to £622/unit in 2016/17, the majority of RSLs show a relatively consistent value year on year. This can be seen from Figure 8 below which shows the last three years have produced very similar results.

Figure 8: Chief Executive Emoluments excluding Pension per Unit

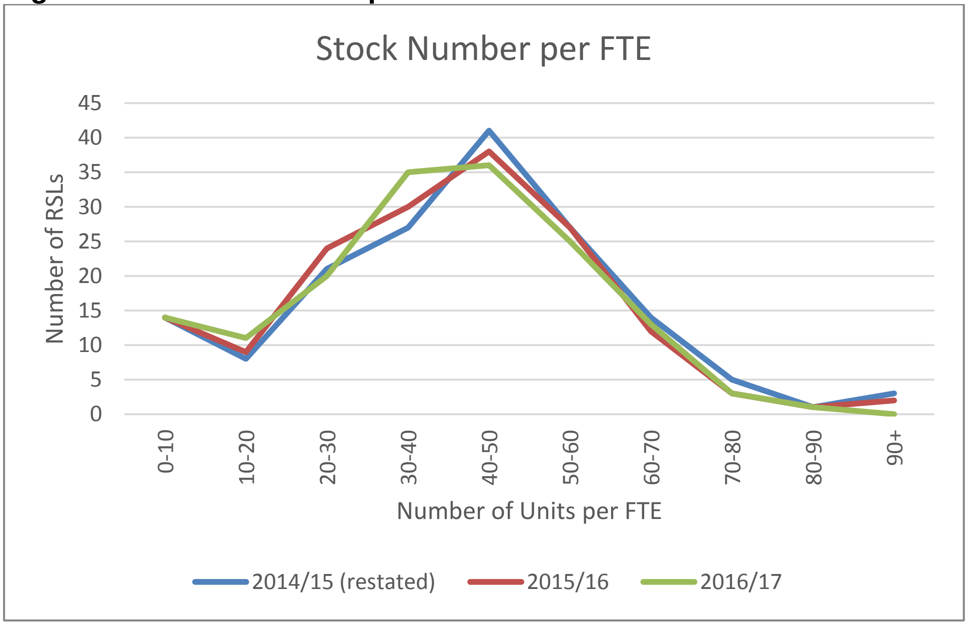


Stock Numbers to FTE

This measure could, along with other measures, be used to indicate how effectively an organisation is utilising its staff. RSLs such as care organisations have different business models requiring higher staff ratios, so care has to be taken at the aggregate level as to the conclusions drawn.

Figure 9 below, for all RSLs shows very similar profiles for all three financial years,

Figure 9: Stock Numbers per FTE



When Care organisations are excluded from the analysis, the profile is virtually unchanged where the ratio is 10-20 units per FTE. The main change is in the 0-10 range, which is as expected given the higher staffing ratios required for care activities.

The median has reduced steadily over the period from 42.44 to 39.03 units per FTE. The maximum however, has fluctuated more dramatically i.e. 95.7 in 2014/15, 359.6 in 2015/16 and 84.2 in 2016/17. The extremely high value in 2015/16 is due to a re-structure of an RSL group with RSL subsidiaries. Adjusting for this one-off event results in a revised maximum value of 95.2 in 2015/16.

The figure below shows the number of RSLs in each range. The analysis shows a trend of a reducing number of RSLs in the 40 and above categories but in most cases, the annual movements for each RSL is relatively small.

Table 13: Stock to FTE Ratio - Ranges

No. Units to FTE Staff Ratio	2014/15 (restated)	2015/16	2016/17
Minimum	0.00	0.00	0.00
Maximum	95.71	359.63	84.15
Median	42.44	40.89	39.03
0-10	14	14	14
10-20	8	9	11
20-30	21	24	20
30-40	27	30	35
40-50	41	38	36
50-60	27	27	25
60-70	14	12	13
70-80	5	3	3
80-90	1	1	1
90+	3	2	0

Pensions

The environment that pension schemes operate in continues to be very challenging. The outlook for interest rates shows only marginal increases over the next 24 months and life expectancy levels continue to increase. These things combine to make it more expensive to provide pensions in the long run.

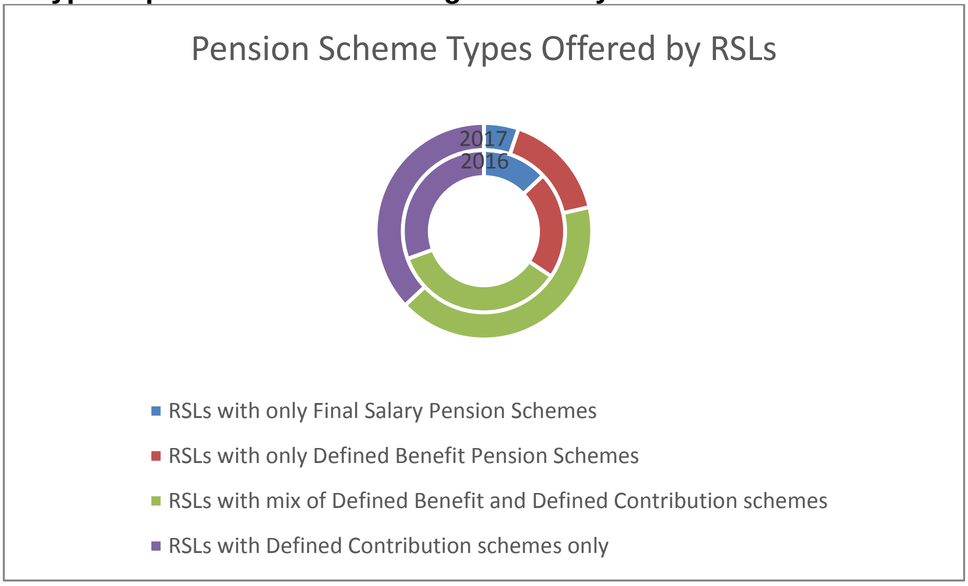
Against this backdrop, RSLs reported an overall actuarial loss of £42.3 million in 2016/17 compared to a gain of £52.2 million in 2015/16. This actuarial loss is against those pension schemes who have fully allocated the liability to individual employers and includes a small number of RSLs who have elected to make full disclosure of the Scottish Housing Association Pension Scheme (SHAPS) liability rather than applying the exemption under FRS102 where, for multi-employer schemes, if it is not possible to accurately define the liability for an individual employer, you can account for the scheme as if it were a defined contribution scheme. RSLs who have applied the exemption are required to include the net present value of future deficit contributions as a provision in the statement of financial position.

The impact of the actuarial loss has been to increase the pension liability on the statement of financial position from £18.2 million to £60.1 million. Within this, only 2 RSLs reported an overall pension asset compared to 40 who reported a liability with the maximum reported liability being £12.5 million.

Any RSL who continues to contribute to a defined benefit pension scheme, either final salary or career average re-valued earnings (CARE), is running the risk that the liability for servicing the past service element of the provision will increase. The triennial valuation of SHAPS is due at 30th September 2018 and whilst interim valuations have indicated that the funding position has improved since the last valuation at 30th September 2015, there is no guarantee that this will continue. The triennial valuation is likely to impact the level of deficit recovery payments being made by the RSLs and could also impact on the length of the recovery period that these payments will require to be made.

Figure 10 sets out what types of pension scheme RSLs were contributing to in 2016/17 compared to 2015/16. The number providing only a final salary scheme has dropped from 20 to 8, whilst the number who offer only defined benefit, either final salary or CARE, has fallen from 53 to 33. The number who offer a defined contribution scheme, either in conjunction with an active defined benefit scheme or on its own, has increased from 101 to 121. It is for each RSL to decide what pension provision they are going to offer, however, this decision-making should not be done in isolation and should form part of the wider value-for-money for tenants debate.

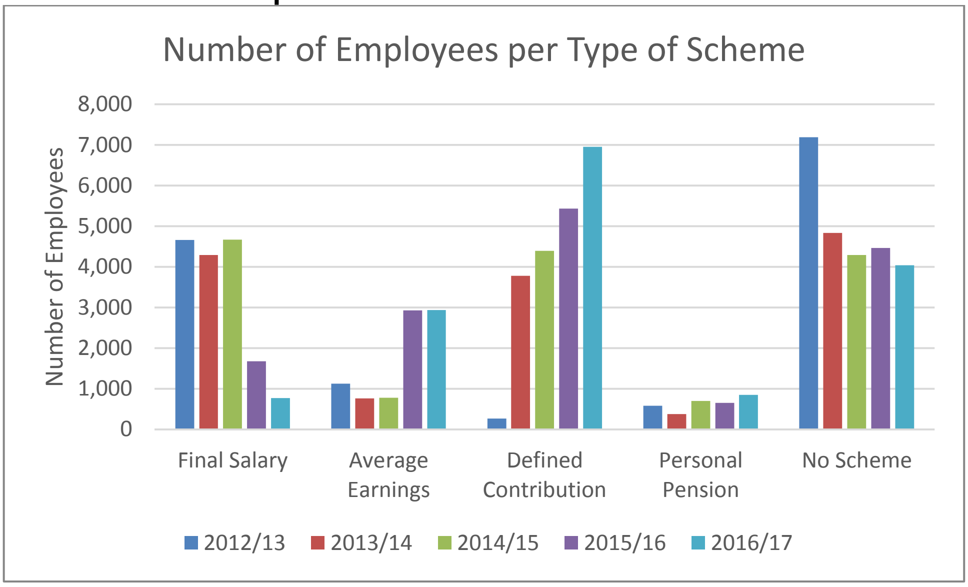
Figure 10: Type of pension scheme being offered by RSLs 2015/16 and 2016/17



Notwithstanding the recent shift away from final salary and defined benefit schemes, more than half of all RSLs still have some exposure to these types of schemes. This means that they are incurring future liabilities that they cannot control and cannot be reliably estimated in the longer term.

Figure 11 shows the pattern of pension scheme provision for the previous 5 years. For the first time, 2016/17 has seen the total number of current RSL employees contributing to a final salary fall below the 1,000 level whilst the level contributing to an occupational defined contribution scheme continues to increase rapidly and has now reached almost 7,000. The reason for this is the combination of RSLs choosing to close their final salary schemes along with auto-enrolment that has seen the non-participation rate falling from 52% in 2012/13 to 26% in 2016/17.

Figure 11: Pension scheme provision 2012/13 to 2016/17



SHAPS remains the single largest provider of pension scheme benefits to RSLs overall with almost 4,800 members. The Local Government Pension Scheme (LGPS) is responsible for just over 2,000 members and a number of RSLs do not allow new members of staff to join this scheme. Despite this, some RSLs who are in the LGPS have not made any provision in their projections to allow for a cessation event payment and have not included the relevant risk in their risk register.

Interest & Borrowing

The total interest payable in 2016/17 was £166.7m, an increase of 5.9% on the prior year, whilst the % increase in the loan balance outstanding at the year was 3.9%. Capitalised interest also increased by £0.6m or 17.6% to £4.0m.

The effective interest rate has risen steadily over the last three years from 4.34% to 4.63% as shown in Table 14 below.

Table 14: Effective Annual Interest Rates

	2014/15	2015/16	2016/17
Interest payable (£m)	146.6	157.5	166.7
Capitalised interest (£m)	3.2	3.4	4.0
Loans outstanding at year end	3,563.5	3,614.2	3,755.8
Effective interest rate	**4.34%**	**4.48%**	**4.63%**

The Bank of England base rate is expected to rise in the coming months to combat inflation and the resulting impact on interest payable is likely to be significant.

Table 15: Turnover Required to Service Interest Payments

	2014/15	2015/16	2016/17
Interest payable (£m)	146.6	157.5	166.7
Annual turnover	1,536.8	1,585.9	1,560.0
Percentage of turnover required to service debt	9.54%	9.93%	10.69%

The analysis indicates that RSLs are likely to be paying more for their borrowing and we anticipate this trend to continue in the short and medium term. More RSLs are seeking access to new funding for development and investment programmes. The average cost of borrowing and effective interest rate will likely rise as historical loans with relatively low interest rates become a steadily reducing proportion of an RSL's loan portfolio. More information on the interest rates can be found in our published analysis of the loan portfolio returns as at 31 March 2017. This can be found here

For the first time, RSL's required on average 10.69% of turnover to service existing debt. This is not unexpected due to the volume of development under way and with the level of planned development increasing, this is likely to rise further. We expect RSLs to include modelling the risks of increased debt and interest payable as part of their sensitivity analysis, as discussed in the Business Planning Best Practice publication.

The undrawn facility reduced by £79m or 11.2% to £628.0m whilst the total facilities only grew by £90.9m or 1.9% to £4.9bn. There were a number of re-financing exercises during the period along with bond finance, with the latter normally requiring full drawdown at the start. Further analysis on the debt movements can be found in the "Summary of the annual loan portfolio returns as at 31 March 2017" at here.

Table 16: Movement in Facilities

£m	Total loan facility	Amount drawn down	Facility un-drawn	Balance outstanding
As at 31 March 2017 - £'m	4,911.8	4,283.8	628.0	3,755.8
As at 31 March 2016 - £'m	4,820.9	4,113.9	707.0	3,614.2
Increase/(Decrease) - £'m	90.9	169.9	(79.0)	141.6
Increase/(Decrease) - %	1.9%	4.1%	(11.2)%	3.9%
Balance outstanding from financial statements				3,950.1

Care should be taken when comparing balances from the financial statements to the Loan Portfolio published data, as the values in the audited accounts can be different due to FRS 102 accounting treatment.

We meet with the major lenders on a regular basis to discuss a range of issues, including their appetite to continue lending to the sector. From our engagement with RSLs and lenders, it would appear that there remains a strong appetite to continue lending to the sector. As noted last year, there would appear to be adequate capital available to RSLs with viable and fundable projects.

The impact of the proposed Housing (Amendment) Scotland bill, which will remove the requirement for RSLs to seek consent from SHR for disposing of assets, is of concern to them, but they are familiar with changes as implemented by the HCA in England and are content with proposals to make equivalent changes in the Scottish regulatory environment. We will continue to work with lenders and potential lenders to enable RSLs to have access to funds at affordable rates.

Our analysis of the annual returns anticipates that interest will rise to £260.5m by 2021/22, an increase of about 60% on the 2016/17 figure. Some key points are:

- 39 RSLs will see their interest payments more than double over the period
- 33 RSLs will see interest payable reduce, some of which are developers

In 2017 systemically important RSLs paid total interest of £101.3m, some 62.3% of the total payable. By 2022 the amount of interest payable by RSLs which are currently designated as systemically important will increase to £175.4m, or 67.4% of the total payable.

Arrears & Voids

In 2018, various area will be rolling out the Universal Credit changes. Our engagement and discussions with RSLs has indicated that Discretionary Housing Payments ("DHP") has helped to offset some of the impact of the welfare changes. The Scottish Government report for the 6 months to 30 September 2017 showed the total value of awards spent or committed throughout Scotland was £52.6m, with an average award value of £537. More details can be found in their report here

Throughout the past few years RSLs have worked to manage and mitigate the effects of changes in the welfare system upon tenants and the RSL itself.

Out latest analysis shows that RSLs are continuing to work hard in this area. Arrears continues to follow the trend of prior years with total, current and former arrears all showing modest decreases during 2016/17. It is, however, much slower than in the previous years and bad debts increased by 3.8% or £0.3m to £7.9m as summarised in Table 17 below.

With the rollout of universal credit gathering momentum, there remains a possibility of increased tenant arrears in the near future. We remain aware through regulatory engagement of the resources and efforts made by RSLs to help minimise the impact of Welfare Reform on both tenants and the landlords. With a reduction in the proposed DHP budget to £50m in 2018/19, this will continue to be a challenging area for landlords to manage.

Table 17: Arrears & Voids

	2014 £m	2015 £m	2016 £m	2017 £m	% Change 2016/17	% Change 2015/16
Total Arrears	51.6	52.1	49.7	48.9	(1.6)	(4.6)
Current Tenant Arrears	33.9	32.8	31.8	31.2	(1.9)	(3.1)
Former Tenant Arrears	17.7	19.3	17.8	17.7	(0.6)	(7.7)
Voids	15.1	15.1	14.9	14.9	-	(1.3)
Bad Debts	9.5	8.4	7.6	7.9	3.8	(9.6)

Other measures to consider are the ratios of voids, arrears and bad debts as a percentage of turnover. This is possibly an even more positive story as it could be considered a more reliable indicator of performance in these areas. Table 18 below shows that this continues to decrease slowly and helps to reinforce the impact that the work done by RSLs to mitigate these continues to have an impact.

Table 18: Ratio of Voids, Bad Debts and Arrears to Turnover

% of Turnover	2015 %	Year 2016 %	2017 %
Voids	1.30	1.25	1.22
Bad Debts	0.74	0.82	0.78
Arrears	2.90	3.20	2.88

Lenders have made it clear that they will monitor arrears and voids very closely in view of the sensitivity of these measures to changes in the welfare system

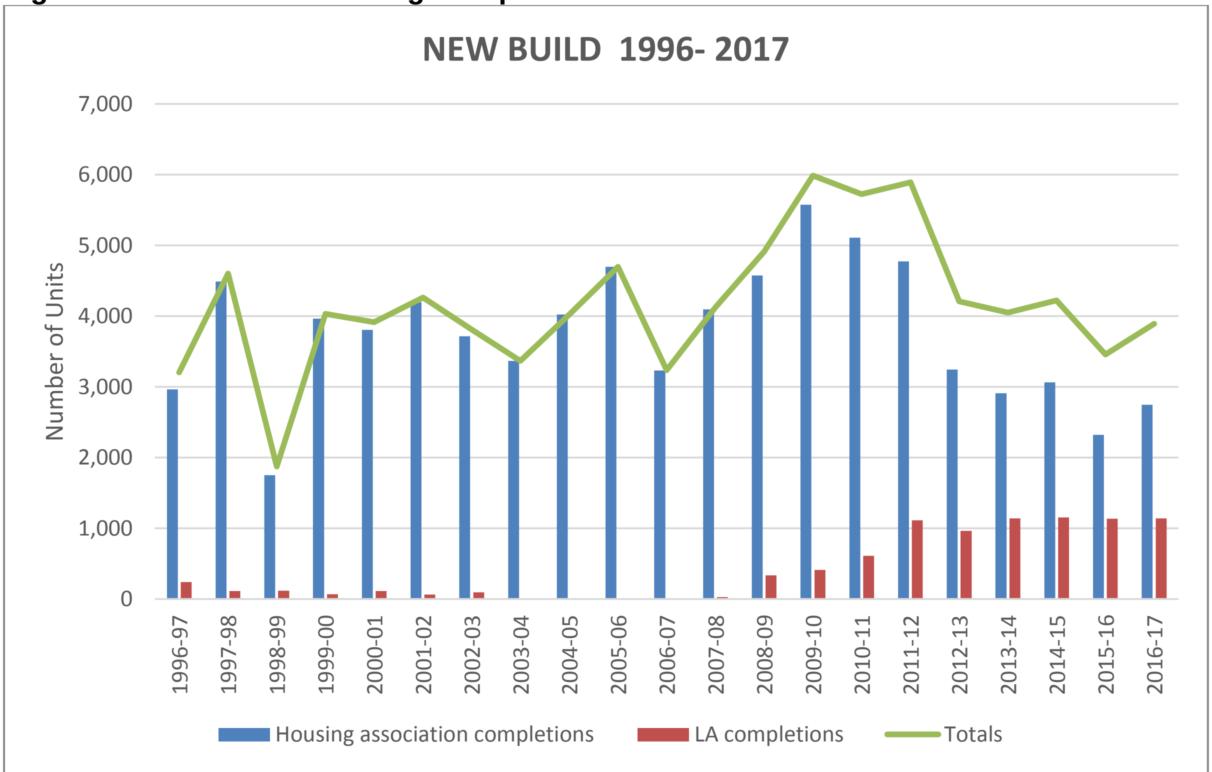
Investment in New & Existing Housing

The Scottish Government is committed to delivering 50,000 affordable homes in the period 2016-2021, of which 35,000 will be for social rent. This commitment requires a major increase in volume as in the period 2010-2015 just over 30,000 affordable homes were completed by both RSLs and local authorities.

In March 2017 we published the results of our thematic enquiry Development of Affordable Housing in Scotland. With some RSLs taking the decision to develop after a long break or for the first time, they will likely face significant risks associated with organisational capacity, procurement, contract management and funding. The thematic identified ten positive practice principles for development which aim to assist RSLs to comply with both the Business Planning Recommended Practice and the Regulatory Standards.

Figure 12 below shows the analysis of affordable housing completions in each of the last 21 years:

Figure 12: Affordable Housing Completions 1996-2017



Source: Scottish Government "Housing Statistics for Scotland – supply of new housing"

Total completions in 2016/17 were 3,891, of which RSLs completed 2,748 builds. Although up on the 3,458 builds in the previous year, it remains significantly short of the average 7,000 new builds per annum needed to achieve the Government's commitment.

Table 19: Development Finance

	2014/15 £m	2015/16 £m	2016/17 £m	%
Investment in New & Existing Properties	694.8	648.2	807.0	24.5
Capital Grants Received	294.6	248.4	329.8	32.8
Loan Advances Received (exc. re-financing)	170.9	217.8	307.7	46.9
Sales of Properties	45.8	40.7	50.2	23.3

We noted in last year's report of our expectation of increases in construction expenditure, capital grants and loan advances in future years. This is very obvious in 2016/17 with major increases in all three categories.

Capital grants and loan advances accounted for 40.1% and 46.0% respectively of the £807.0m construction costs. This is a significant increase on 2015/16 where these funding sources each accounted for approximately 38% of the costs. It is significant that the proportion of construction that was financed by loan advances was substantially more than the proportion financed by capital grants received. That this is happening at a time when government grant rates are much higher than they have been in preceding years illustrates the growing importance of private capital for RSLs in helping to deliver the government's target of 50,000 houses in the present parliament.

Other sources of finance such as property sales reduced to 13.9% of the total, of which 6% was from RSLs own reserves and is the lowest proportion we have recorded. In value terms this equates to a reduction from £141.4m to £105.8m.

Table 20: Sources of Finance in Year

	2014/15 %	2015/16 %	2015/16 %
Grant Funding	43.3	39.2	40.1
Loan Funding	32.3	39.0	46.0
Other (including own reserves)	24.4	21.8	13.9

Future Development & Debt Post-2017

To meet the Government target, not only will the scale of development have to increase significantly, but also the level of debt required to service it. RSLs also have to invest in their existing properties to ensure they continue to meet regulatory and statutory standards.

We have analysed the data supplied via the Five Year Financial Projections annual returns to see the aggregated impact of current development plans, debt levels and estimated new funding required from now to 2021.

In terms of volume, the FYFP shows that a total of 29,544 units across 106 RSLs are projected to be built and additional private finance of £1.4bn is to be secured. As part of our annual risk assessment process, we engaged with RSLs about their development plans and this highlighted identified a further 3,024 units to be developed that were not in the 2016/17 annual return i.e. 32,568 units in total over the next five years. Using an average debt per unit, we estimate these additional units may need approximately £160m of additional private finance, bringing the total new finance anticipated to just under £1.6bn.

This is significant growth and includes a relatively large number of RSLs developing for the first time after a long period or the first time ever, and is well above the 14,287 units completed in the five year period to 2016/17.

The scale of the growth in both units and projected debt has a major impact on the interest payable on cumulative debt over the period. The % of turnover required to service the interest payable increases from 10.69% in 2016/17 to 14.4% in 2021/22 as summarised in Table 21 below.

Table 21: Percentage of turnover required to cover interest payable

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Turnover (£m)	1,536.3	1,585.4	1,559.3	1,572.7	1,689.6	1,755.4	1,817.3	1,862.2
Interest payable (£m)	146.5	157.4	166.7	201.4	198.5	223.7	251.3	263.4
Percentage of turnover required to service debt	9.54%	9.93%	10.69%	12.81%	11.75%	12.74%	13.83%	14.14%

Whilst this is a major increase in a relatively short period of time, it is beneficial to put this into context by comparing the results published by the Homes England ("HE"), formally the Homes & Communities Agency, the social housing regulator in England. The % of turnover required to service interest payable was 17.3% in 2014/15, 15.0% in 2015/16 and 17.5% in 2016/17. Three key points to note from those results are:

- turnover remained flat at £20.0bn for the last two years due to providers implementing the 1% rent reduction on general needs units as required under the Welfare Reform & Work Act 2016. This is not a requirement in Scotland.
- Interest costs increased by 14% or £0.5bn to £3.5bn in 2016/17 due to loan breakage costs for a single provider
- Grant rates are significantly lower than those in Scotland and therefore have a much greater proportion of the housing investment funding is from private finance

HE concluded that underlying performance remained robust and that strong interest cover was needed to service the existing debt.

In respect of Scottish RSLs, our analysis indicates that strong interest cover will become even more important going forward, combined with robust cost control. We are aware through our engagement with RSLs that many are actively looking at ways to improve operational efficiencies and reduce the cost base.

The ratio of cash generated for every £1 of interest paid remains at a healthy level, despite some reduction from the 2016/17 level, as shown in Table 22 below:

Table 22: Ratio of interest paid to net cash from operations

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Net cash from operations (£m)	413.3	454.3	435.9	446.8	528.5	569.3	642.3	671.0
Interest paid (£m)	141.8	156.9	161.5	204.9	199.8	223.7	249.0	260.5
Ratio	2.91	2.90	2.72	2.18	2.65	2.55	2.58	2.58

Further consequences of additional debt and interest payable are summarised in Table 23 below:

Table 23: Financial Ratios - Aggregated

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Interest cover	292.01%	291.92%	275.73%	220.28%	267.00%	256.83%	260.34%	260.03%
Gearing	126.33%	118.23%	115.84%	130.57%	140.35%	145.25%	141.15%	134.31%
Debt burden	2.33	2.34	2.53	2.74	2.81	2.95	2.92	2.88
Debt per unit	12,530	12,814	13,638	14,730	15,813	16,770	16,939	16,954
Net debt per unit	10,581	10,660	11,401	12,939	14,291	15,268	15,441	15,455

Interest cover, using the definition per the AFS annual return, remains at a healthy level. Many RSLs have interest cover as a covenant with their lenders and the calculations can vary from RSL to RSL, so we are aware that our calculation may not be comparable with what RSLS reports to their boards and lenders.

Although interest cover has reduced, this is not considered to be a long term weakening of the financial strength of the sector. Rather it reflects a sector that is using its assets more intensively in order to invest in its housing stock for both existing and new tenants.

But the fact that RSLs will be generating less cash from operations relative to interest payments means that many RSLs will have less headroom than before.

We expect all RSLs to plan their treasury requirements well in advance. At a time when more RSLs are looking for more finance than ever before this has heightened importance. For any RSL, the supplier of private finance is an important stakeholder. It is important for RSLs to be clear on what the lender is seeking and what type of relationship they will look to have with their client. Clearly price is an important consideration, but it is not the only consideration. RSLs are required to closely monitor compliance with loan agreements and covenants and to inform SHR of potential or actual breaches.

Gearing, also using the AFS return definition, increases over the period with a peak of 145.2% in 2019/20 before slowly reducing over the next two years. This is despite the peak debt level being in 2021/22. Debt burden follows a similar patter with a peak of 2.95 in 2019/20 before reducing marginally to 2.88 by 2021/22.

Business Planning

UK growth during 2017 has slowed but inflation has risen sharply, further squeezing household spending power. The Office of Budget Responsibility ("OBR") last year expected CPI to peak a 2.8% during 2018, but the actual peak in 2017 was 2.6%. Their latest projection is for inflation to fall steadily to 2.9% by 2020, with CPI rates on average 0.9% lower. The Bank of England also raised interest rates by 0.25% and many commentators anticipate that future increases will modest and gradual due to the continued uncertainty surrounding Brexit. Combined with continued uncertainty about the full impact of welfare reform and how Scottish Government social security powers will work in practice, the risk for future tenant rent affordability remains a very high and credible risk for RSLs.

We expect RSLs to carry out sensitivity analysis to understand the impact on the business and to put in place mitigations for rising and/or high inflation. We also expect covenant compliance to be tested. We will engage directly with those RSLs who are not fully analysing their risks to seek assurance on how they gain assurance on the viability of their business models.

We commented last year that some RSLs found it useful to combine several different sensitivities to test robustness of the projections, particularly around cash reserves. Over the last year we have seen some more RSLs using this methodology and considering what sensitivities would effectively break the organisation. Going forward, expect to see RSLs consider a wider range of sensitivities and in particular those that are pertinent to their specific business model. We consider this to be an appropriate response to the increasing level of uncertainty in the operating environment.

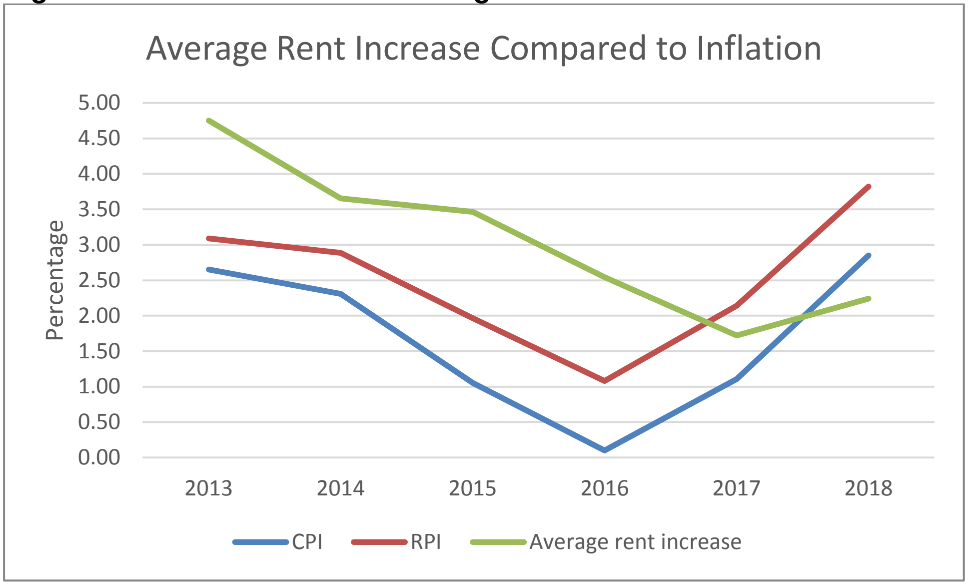
Rent Increases & Inflation

In June 2016 the inflationary outlook changed markedly as a consequence of the devaluation of Sterling which followed the result of the referendum on the United Kingdom's membership of the European Union.

The substantial increase in inflation from June 2016 means that, during the year ended 31 March 2017, the average increase in rents charged by RSLs was less than inflation, whether measured by RPI or CPI.

Inflation assumptions and projected future rent levels remain, from our perspective, two of the most important assumptions used in financial forecasts.

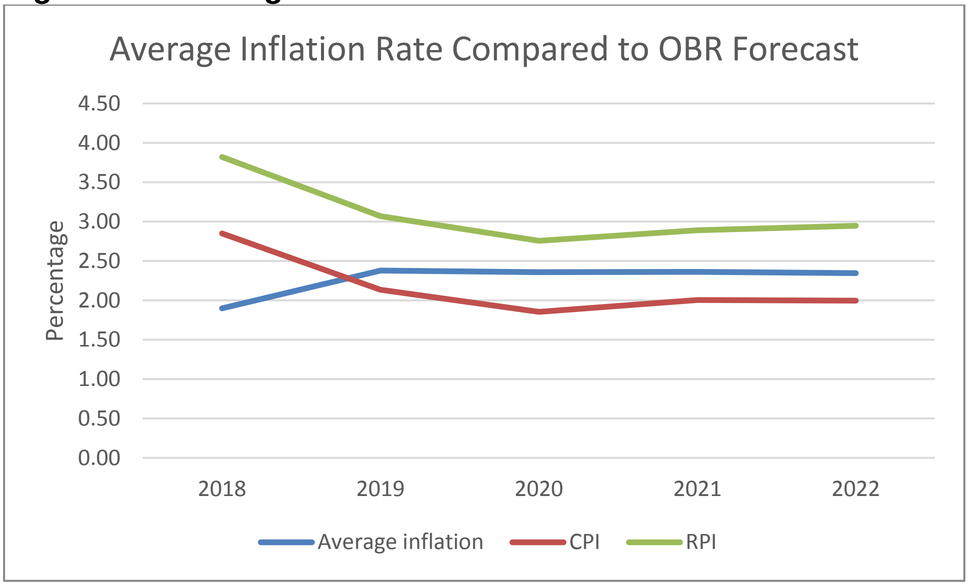
Figure 13: Inflation Rates & Average RSL Rent Increase



With inflation forecast to keep rising in 2018, the average sector rent increase per ARC return data shows a modest rise but for the first time it is expected to fall below CPI.

Our analysis of the financial forecasts in respect of inflation assumptions combined with the projections from the Office of Budget Responsibility ("OBR") show that RSLs have assumed inflation increases from 2018 onwards. After 2019 the rate will lie between CPI and RPI until at least 2022. The OBR projections show that RPI remains at broadly CPI plus 1% over the period.

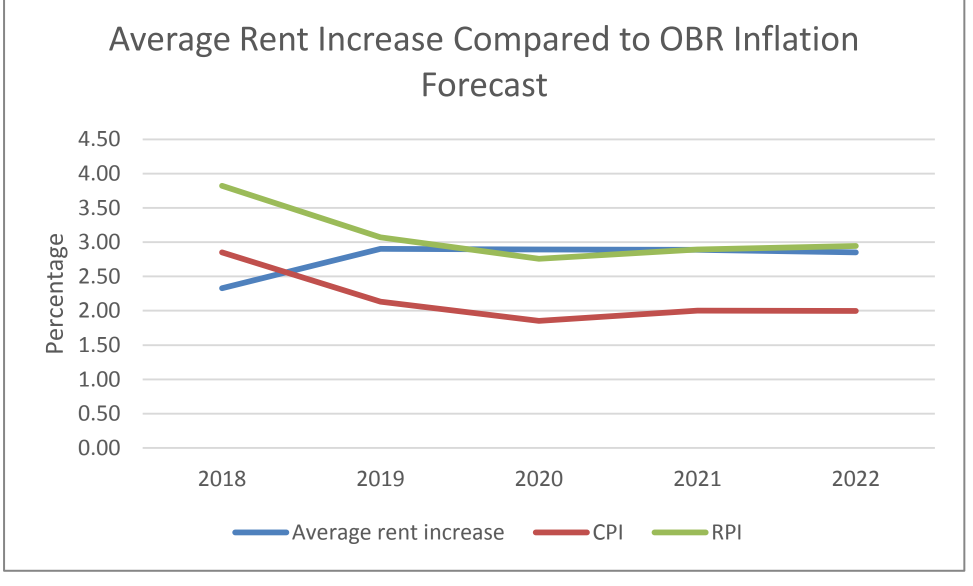
Figure 14: Average Inflation Rates v OBR Forecasts



Comparing the OBR rates to the average rent increases shows that the majority of RSLs plan to increase rents by more than CPI over the next five years, to such an extent that it almost mirrors the RPI rates from 2019 onwards.

It is likely that, over this period, any indexation of welfare benefits will be based on CPI. Where welfare caps are applied, it is possible that benefit uplifts will not be available at all. Therefore any rent increase, particularly one which is in excess of CPI, may create issues around affordability for tenants in receipt of benefits as well as for those in work who may not receive pay rises.

Figure 15: Average Rent Increase v OBR Inflation Rates



The analysis also shows that from 2019 to 2022 a total of 15 RSLs are using inflation rates above the OBR RPI rate in 2019 and this rises to 31 by 2022.

The average rent margin above inflation assumed in RSL forecasts for 2018 is 0.43%, or a total average of 2.33%. This is below both CPI and RPI for the year. But a total of 46 RSLs forecast margins in excess of 1%.

Table 24: Analysis of Average Rent Increase above Inflation

	2018	2019	2020	2021	2022
Average rent increase above (%)	0.43	0.52	0.54	0.52	0.50
0 or lower	69	51	50	52	57
0-0.5	9	5	5	4	3
0.5-1	25	33	34	34	32
1 +	46	60	60	59	57

It is likely that over this period any indexation of welfare benefits will be based on CPI. And where welfare caps are applied it is possible that benefit uplifts will not be available at all.

So, any rent increase, particularly one which is in excess of CPI, may create issues around affordability for tenants in receipt of benefits as well as for those in work who may not receive pay rises.

We set out our expectations on rent affordability in our Business Planning Recommended Practice which was published in December 2015.

Glossary

Care Organisations	This is defined as any organisation that employs greater than 50% of their FTE in a care role.
Career average revalued earnings pension scheme	A form of defined benefit pension scheme based on the average salary across each year of scheme membership.
CPI	Consumer Price Inflation is the benchmark inflation rate calculated by the Office of National Statistics and is utilised by the Bank of England to determine monetary policy.
Defined benefit pension scheme	A pension scheme that pays benefits based on a link with the employee's salary and where the risk lies with the employer.
Defined contribution pension scheme	A pension scheme that pays benefits based on the level of contributions that have been paid into a fund and where the risk lies with the employee.
Final salary pension scheme	A form of defined benefit pension scheme based on the highest salary within the last 3 years of scheme membership.
FYFP	This is the annual return that collates 5 year financial projections from RSLs.
Gearing	The calculation is (total outstanding debt – cash and cash equivalents) / net assets. The ratio is commonly used as a loan covenant. The calculation utilised by SHR cannot generally be compared to the covenant calculations as it does not adjust for grants held as deferred income in the statement of financial position.
Interest cover	The calculation is (net cash from operating activities + interest received) / interest paid. The ratio is commonly used as a loan covenant. The calculation utilised by SHR cannot generally be compared to the covenant calculations as it is based on figures from the statement of cash flows rather than the statement of comprehensive income.
Key management personnel	Those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity. This will include governing body members.
Local Government Pension Scheme	This is the common name applied to all the pension schemes offered by Local Authorities. An example is the Strathclyde Pension Fund.
Performance method	Accounting policy choice that allows capital grants to be released as deferred income when the performance criteria related to the grant have been fulfilled. Can only be used where housing assets are valued using a revaluation method.
RPI	Retail Prices Index Is a method of inflation calculated by the Office of National Statistics which includes housing costs.
RSL	An RSL is an organisation registered under the Housing (Scotland) Act 2010 to provide Scottish Secure Tenancies. This does not include Local Authorities.
Stock / unit numbers	This is the unit numbers entered into the Annual Financial Statements return that we require each RSL to complete.
Systemically important RSLs	We refer to a small number of RSLs as systemically important because of their stock size, turnover or level of debt or because of their significance within their area of operation. We need to maintain a comprehensive understanding of how their business models operate, and how they manage the risks they face and the impact these may have. We seek some additional assurance through our regulation plans as a result of this.
Total staff costs	The total staff costs for the organisation including any payments made in respect of pension deficit recovery programmes.

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