Analysis of the finances of Registered Social Landlords

Summary findings

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 a summary of 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. Our technical report provides more technical financial information for a specialist audience.

Highlights

The sector's financial performance 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

In last year's report we noted that the operating environment for RSLs was becoming more complex and challenging. The 2016/17 aggregate financial statements and the latest financial forecasts provide further evidence of this more challenging environment. RSLs are gearing up to increase the number of new houses that they are planning to build while managing a range of issues such as rent affordability, pension provision and welfare reform.

Our overall conclusion is that the sector's financial performance continues to be strong. This gives us confidence that the sector as a whole is well placed to respond to the increasingly complex and uncertain environment.

Across the sector there is evidence of a reduction in financial headroom. This means that there is less scope to manage unexpected new or additional costs or lower than expected levels of income. This is demonstrated by a number of key metrics. For example around a third of all RSLs have seen interest cover fall by 25% or more. In other words, interest on their loans has increased at a higher rate than the cash generated by their activities. Our analysis of financial projections indicates that this decline in headroom will continue over the next five years and beyond.

This reflects a sector that is using its assets more intensively in order to invest in its housing stock for both existing and future tenants and should not be seen as a weakening in the financial strength of the sector.

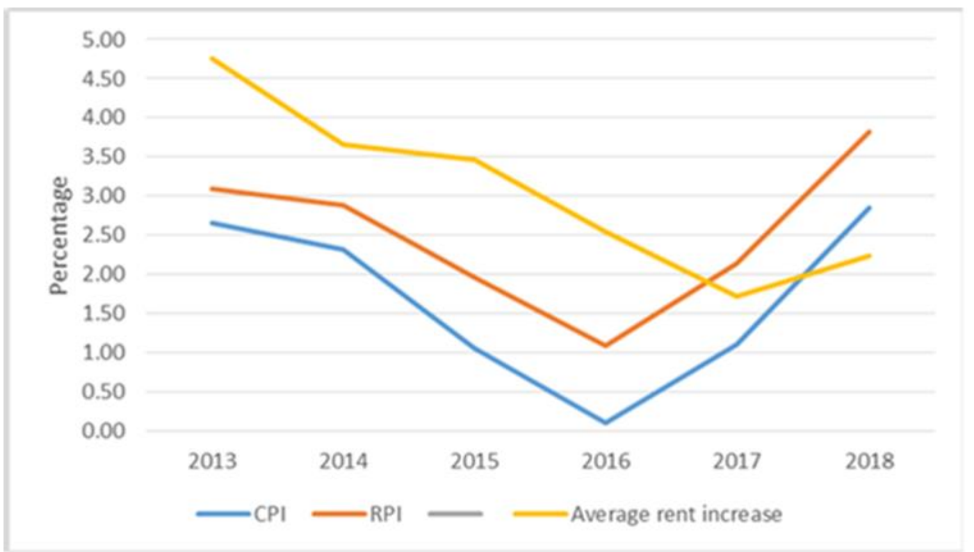
Regulatory Standard Number 3 requires each RSL to manage its resources to ensure its financial well-being and economic effectiveness.

Following our review of the 2016/17 financial statements and the completion of the 2017/18 financial risk assessment we conclude that, based on the information available to us, the majority of RSLs are compliant with the standard. In a small number of cases we are engaging with RSLs to determine if there is sufficient evidence to allow us to conclude that the RSL is compliant.

As a risk based and proportionate Regulator this conclusion comes with a caveat: we do not necessarily have all of the information that is available to each RSL, its auditors and its professional advisers. Consequently, if new information comes to light then our opinion on the financial health of individual RSLs may be revised.

1 Rents & inflation

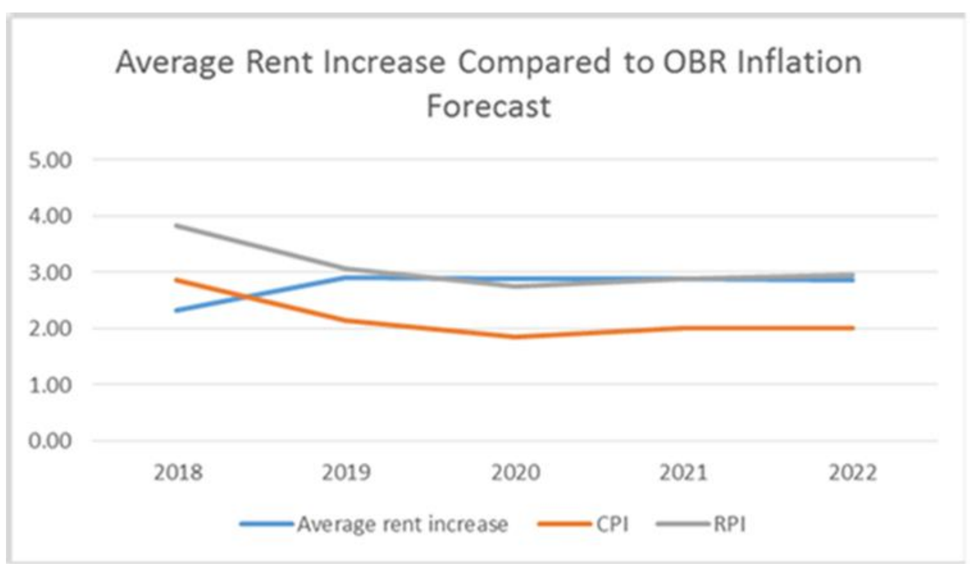
In June 2016 the inflationary outlook changed markedly as a consequence of the devaluation of Sterling, which followed the result of the referendum on the United Kingdom's membership of the European Union.



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

The substantial increase in inflation from June 2016 means that, during the year ended 31 March 2018, the average increase in rents being charged by RSLs is 2.2%, which is noticeably less than inflation whether measured by RPI or CPI

In their business plans most RSLs use a formula based on past inflation when setting their rents for the year ahead. There is therefore a risk that the increased inflation experienced since June 2016 will result in higher rents for RSLs in future years. This is consistent with our analysis of financial forecasts provided by RSLs.



For the period 2018-2022 we compared RSLs anticipated increase in rent (as set out in financial forecasts provided by RSLs) with the forecasts published by the Office for Budget Responsibility ("OBR") for the Retail Price Index ("RPI") and the Consumer Price Index ("CPI").

This indicated that, during the period from 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. 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.

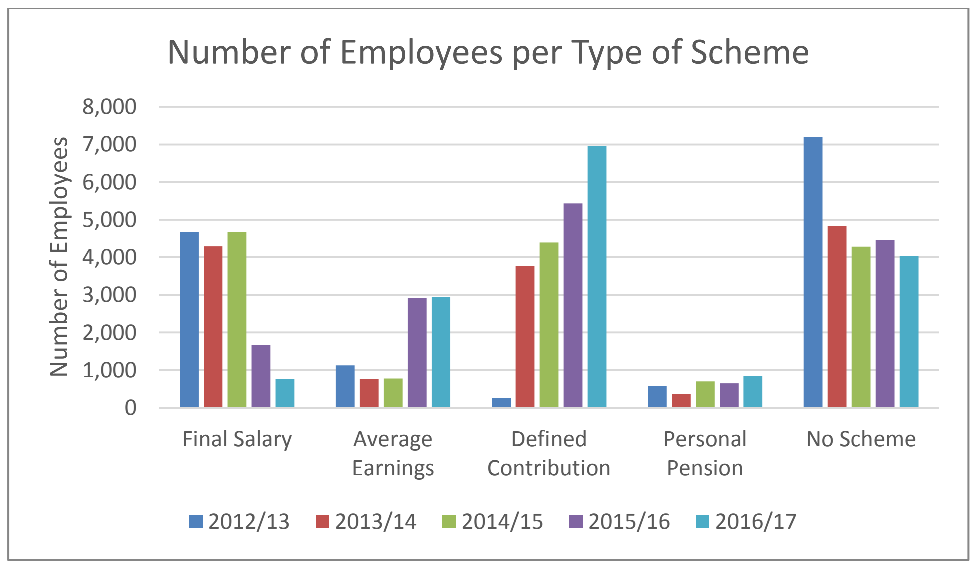
RSLs should consider tenants' ability to keep paying their rent over the longer term when deciding levels of rent increases.	**RSLs should:** • be clear on what is affordable for tenants and consider future affordability when determining annual rent increases; • demonstrate transparency on costs and a vigorous pursuit of VFM; • wherever possible give tenants genuine options and choices during rent consultations; • engage in dialogue with tenants about costs versus service levels; and • be clear on how tenants' views are taken into account.

Given RSLs' planning assumptions around rent increases and the fact that costs per unit continue to rise we expect all RSLs to look constructively and creatively at ways in which they can reduce costs without detriment to the interests of tenants.

We expect all RSLs to give this the highest priority in order to minimise the risk to tenants that their rent becomes unaffordable.

2 Pensions

There has been a substantial change in the way in which RSLs provide pensions for employees over the past five years. The pattern of provision is set out in the graph below.



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

Final Salary and Average Earnings schemes are examples of Defined Benefit pension provision. In these schemes the benefit on retirement is determined by a set formula related to the employee's average or final salary. This means that the risk attaching to any shortfall on return on investment is that of the employer – or in the case of multi-employer schemes the employers collectively – rather than the employee. This is the opposite of Defined Contribution schemes where the pension paid to the employee depends upon investment performance.

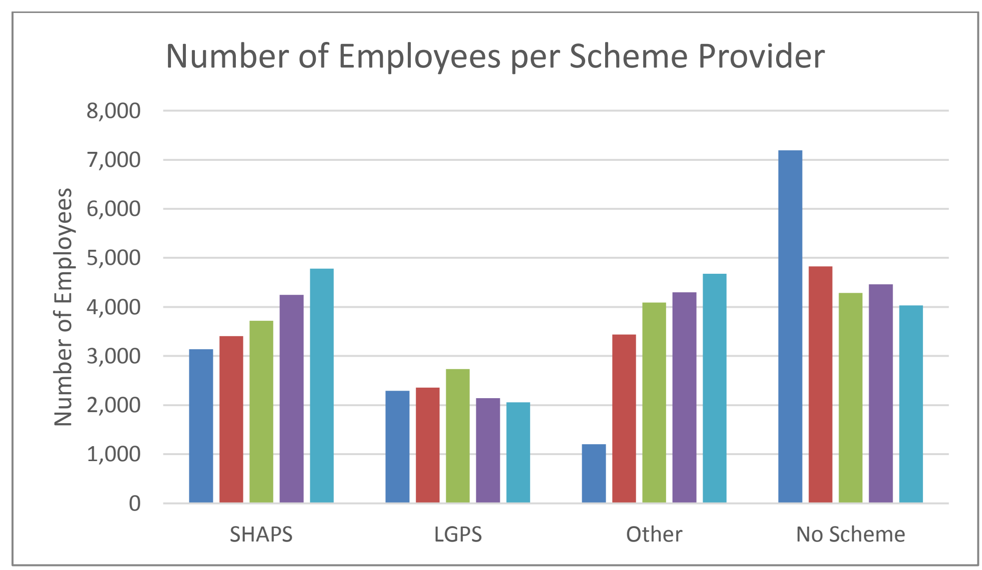
Three separate movements are evident from the returns provided to us by RSLs.

- an increase in the number and proportion of staff for whom a pension is provided, due to the statutory auto-enrolment provisions;

- a move from defined benefit provision to defined contribution as RSLs try to manage with greater certainty their future liabilities; and
- within defined benefit provision, a move from final salary to average earnings as RSLs try to reduce the overall cost of pensions.

The movement away from Final Salary and Defined Benefit to Defined Contribution is clear.

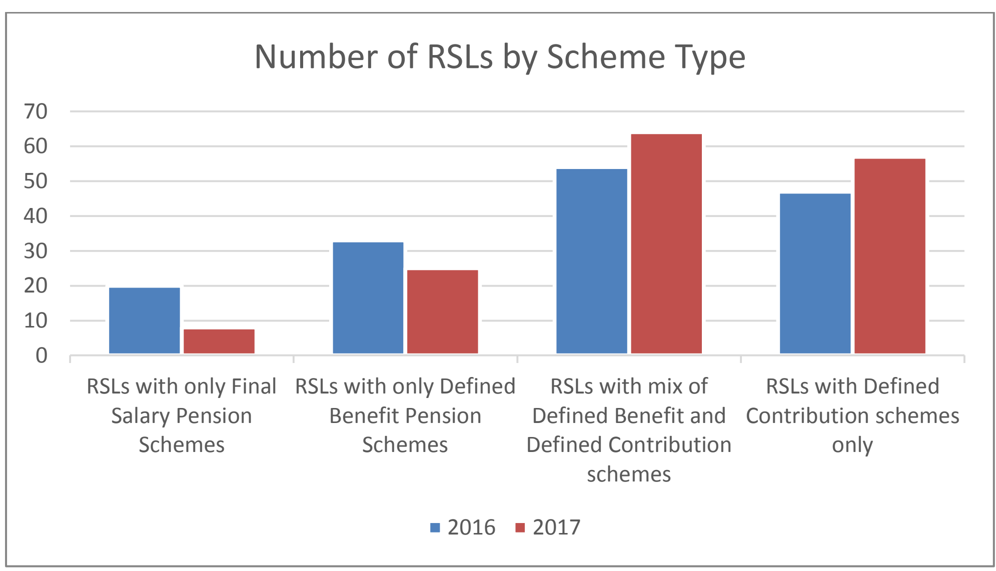
The Scottish Housing Associations Pensions Scheme ("SHAPS") remains the largest single provider with 31% of all employees. The Local Government Pension Scheme ("LGPS") is the second largest provider with 13% of all employees. Around 30% of employees belong to various other schemes while 26% of employees have no pension provision. We expect this number to fall as auto-enrolment continues.



- 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, 8 providing only Final Salary Schemes with 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 the RSL is carrying the risk of any shortfall on return on investment and so the eventual liability borne by the RSL is uncertain and cannot be controlled by each RSL.

We expect RSLs to take account of pension affordability in their business planning and financial forecasts. In particular RSLs should consider the impact of continuing to offer defined benefit schemes on future rent levels and on value for money for tenants.

3 Cash generated from operations

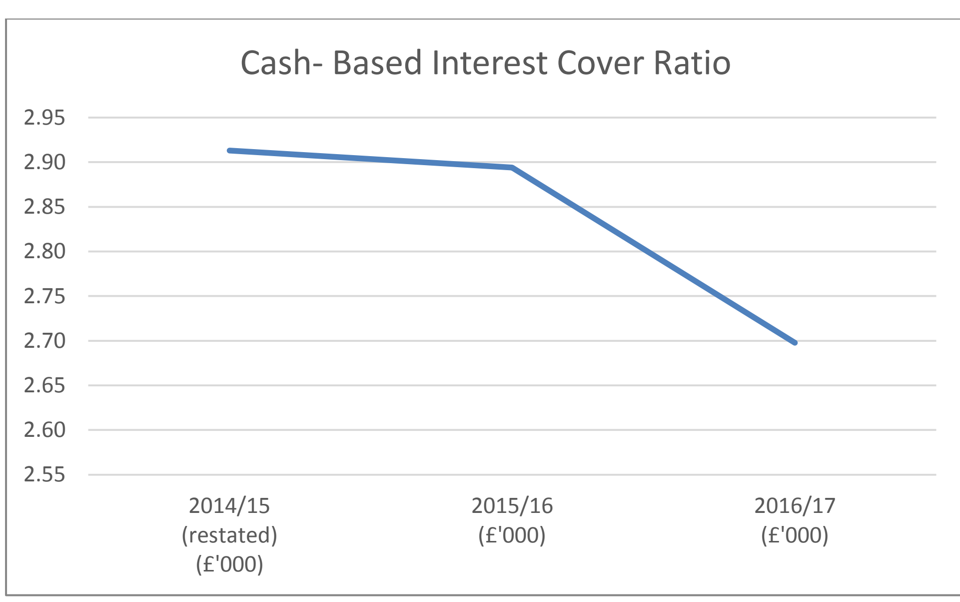
For many years we have used cash generated from operations to interest paid as a measure of the financial health of the sector and individual RSLs.

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.

This means that RSLs, in aggregate, have generated around £3 in cash from operations for each £1 that they have paid in interest.

The aggregate financial statements for the year ended 31 March 2017 showed a sharp fall in this ratio from 2.89 in the preceding year to 2.70.



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.

The reduction has 2 components: 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 financial projections provided by RSLs indicates that this ratio will continue to fall.

By 2020/21 it will fall to 2.58 and thereafter we expect it to decline towards 2.50. There are three reasons for this:

- The need to keep rents affordable is likely to act as a constraint on the ability of RSLs to increase rents;
- Increased borrowing to fund increased development; and
- An anticipated increase in the cost of borrowing.

With regard to the cost of borrowing, over the period 2018-2022, RSLs are forecasting that they will pay a total of £1.137bn in interest on debt.

The amount paid in 2017 was £163m, by 2022 this is anticipated to rise to around £260m, an increase of 60%.

- 39 RSLs will see interest paid more than double over the period.

- 33 RSLs will see interest paid fall, these are mainly non-developers who are paying off their debt.

The majority of interest is paid by systemically important RSLs. These are RSLs which because of their stock size, turnover, level of debt or significance within their geographic area of operation, we seek additional assurance through our regulatory engagement and regulation plans. As such, we seek to maintain a comprehensive and up-to-date understanding of their business plans and the associated risks.

In 2017 systemically important RSLs paid total interest of £101.3m, some 62.2% of the total paid. By 2022, the amount of interest that will be paid by RSLs which are currently designated as systemically important will increase to £168.0m, or 64.3% of the total paid.

This reflects a sector that is using its assets more intensively in order to invest in its housing stock for both existing and future tenants. it should not be seen as a weakening in the financial strength of the sector.

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.

4 Turnover & asset values

Turnover, or the income due to the RSL, has two main components – Social Lettings and Other Activities.

The table below illustrates modest growth in Social Lettings of 1.0% but a reduction of 16.5% in Other Activities.

Turnover	2014/15 £000	2015/16 £000	2016/17 £000
Social Lettings	1,321,901	1,349,505	1,362,522
Other Activities	214,879	236,394	197,473
Total Turnover	**1,536,780**	**1,585,899**	**1,559,994**

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

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 8.3% of the turnover compared to 9.1% in the previous year, 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.

	2014/15 (£'000)	2015/16 (£'000)	2016/17 (£'000)
Wider role activities	10,106	11,920	9,055
Care & support activities	108,112	116,824	107,552
Investment property activities	4,692	7,098	10,886
Factoring	9,374	11,491	9,798
Contracted out activities	10,113	11,153	6,962
Development activities	8,841	20,140	12,398
Other activities	63,641	57,768	40,822
Total turnover from other activities	**214,879**	**236,394**	**197,473**

The ratio of grant funding to the asset value shown on the Balance Sheet (now called the Statement of Financial Position) is shown in the table below:

	2014/15	2015/16	2016/17
Net Housing Assets	£10,503m	£10,826m	£11,322m
Grant Funding	£4,776m	£4,920m	£4,868m
Grant Funded (%)	45.4%	45.4%	43.0%

This change has resulted in a much reduced figure for grant funding in the restated 2014/15 financial statements. The proportion of Net Housing Assets funded by grants stayed broadly similar in the 2015/16 financial statements but has fallen by around two and a half per cent in 2016/17.

5 Investment in new & existing housing

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

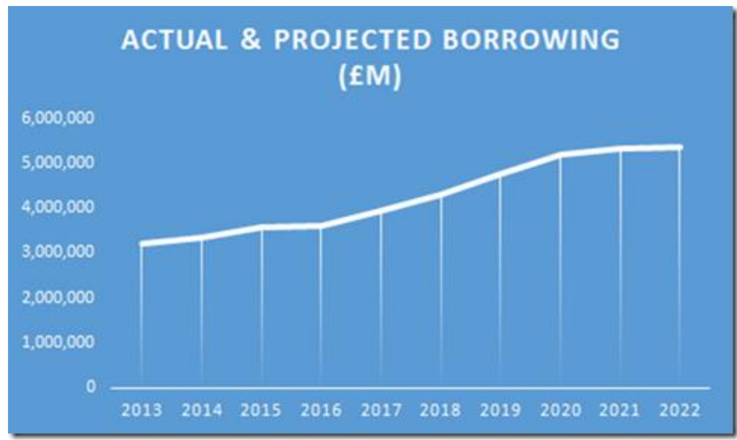
In 2016/17 RSLs invested £807m, an increase of almost one quarter on the previous year. Capital grants received increased by around a third to £330m while loan advances received (excluding re-financing of existing loans) increased by 47% to more than £307m.

	2014/15 £m	2015/16 £m	2016/17 £m	% Change in 2016/17	% Financed in 2016/17
Investment in new & existing housing	694.8	648.2	807.0	24.5	
Capital grants received	294.6	248.4	329.8	32.8	40.9
Loan advances received (excluding re-financing)	170.9	217.8	307.7	46.9	38.1
Sales of properties	45.8	40.7	50.2	23.1	6.2
Financed from Own Reserves	183.5	141.3	119.3	-15.6	14.8

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

It is noteworthy that the proportion of housing investment that was financed by loan advances, at 38%, is almost as significant as the proportion financed by capital grants received (41%). 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 Scottish Government's target of 50,000 houses in the present parliament.

The proportion of development financed by RSLs own reserves fell to just under 15%. There was an increase of 23% in cash receipts from property sales. This was anticipated due to the end of the statutory Right to Buy in August 2016.



The aggregate sector Statement of Financial Position (formerly known as Balance Sheet) shows that RSLs currently have outstanding borrowing of £3.950bn.

Our analysis of the Financial Forecasts shows that RSLs are planning to increase that to £5.365bn by March 2022, a rise of more than £1.4bn in the next 5 years. To put this in context, the increase in net borrowing over the previous 5 years was approximately £950m.

And, in addition to new net borrowings, the information from loan portfolio returns indicate that RSLs will be looking to re-finance up to £285m of their existing debt over this period. This represents a step change for the sector and for many RSLs.

RSLs will therefore be seeking private finance at an unprecedented rate over the next 5 years. And this will come at a time when lenders and investors will be taking a view as to the impact of the removal of the need for regulatory consent for disposals and constitutional changes. Some lenders have expressed reservations as to whether the required capacity will be available to RSLs, particularly in the medium to long term where lending markets may be less benign, with more competition for funds. In addition the regulation of lending itself and rules around capital adequacy may result in less funding being available.

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.

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.

6 Voids, bad debts and arrears

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, sector-wide, management of arrears and voids continues to be effective.

All of the performance measures which we consider have either remained around levels seen in previous years or shown a slight improvement in absolute terms.

	2013/14 £m	2014/15 £m	2015/16 £m	2016/17 £m	Change 2016/17 %
Total Arrears	51.6	52.1	49.7	48.9	(1.6)
Current Tenant Arrears	33.9	32.8	31.8	31.2	(1.9)
Former Tenant Arrears	17.7	19.3	17.8	17.7	(0.6)
Voids	15.1	15.1	14.9	14.9	-
Bad Debts	9.5	8.4	7.6	7.9	3.8

Lower levels of voids, bad debts & arrears despite changes from Welfare Reform

And, in analysing voids, bad debts and arrears in relation to Turnover, in all three cases performance has improved in the last year.

This is perhaps a more reliable indicator of performance in these areas.

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

We will continue to monitor these indicators across the sector as a whole and in relation to individual RSLs.

Scottish Housing
Regulator