



SFHA Finance Conference - 12 November 2019

Ian Brennan, Director of Regulation

It's difficult to believe that 12 months have passed since I last spoke to the Finance Conference here at Crieff

A huge amount has happened in that time.

I will try to cover as much as possible in the time allowed, but please feel free to ask about anything during the Q and A session, even if it's something that I haven't covered.

As this is a finance audience it seems appropriate to start with a look at **Sector Finances**.

From our analysis it's clear that most RSLs remain in possession of sound finances.

Sector wide cash-based interest cover actually increased in 2018, after a period when it had fallen.

But clearly, this is a sector-wide picture, there are individual RSLs who face a more challenging position than might be assumed from looking at the overall sector position.

And even though the sector finances are in generally good shape, we are increasingly concerned about arrears and voids.

Arrears across the sector have risen by more than 4% and now sit at £52.5m.

And voids have risen by almost 5% to £10.2m.

I am sure most landlords are continuing to do their utmost to deal with arrears.

But this is a sizeable increase and one that will be challenging for landlords to manage.

Next month we will publish our latest report on the RSL Loan Portfolio.

There will be some interesting numbers.

As you would expect given the amount of new build going on, there has been a substantial increase in borrowing, total facilities rising by around 14% to just short of £6bn.

There has been an even larger increase in the amount outstanding, around 17% to 4.15bn.

Finance Directors are looking to take advantage of the present low interest rate environment.

So we are seeing a greater proportion of new borrowing, about a third of new loans, being used for re-financing rather than new build.

Our view is that sector finances remain strong.

But given this record amount of borrowing there is a need for RSLs to keep a very close eye on things.

And there are a couple of future challenges which I will come on to.

Moving on now to **Tenant and Resident Safety**.

During the past year, a number of RSLs have incurred - and are continuing to incur - significant expenditure on rectifying serious issues that impact upon tenant and resident safety.

In some cases, there is non-compliance with regulation and legislation.

And the non-compliance is historic and it is going to prove costly to fix.

In one instance the Health and Safety Executive has served an enforcement notice on an RSL for contravening the control of asbestos regulations.

During the past year, a number of landlords have notified us that, whereas they had thought they were compliant with safety regulations and legislation, they discovered through their assurance processes that they weren't.

In the case of these landlords it's obviously commendable that the non-compliance has been recognised and is now being addressed.

And it's clearly incumbent upon all landlords to make sure that they are in fact compliant.

Legal and regulatory compliance is the minimum that landlords should be asking of themselves.

So it's vital that all RSLs assure themselves that there is adequate provision in business plans to cover all of the expenditure that will be required to keep tenants and residents safe.

We would encourage all landlords to look closely at this as part of a wider approach to asset management.

And to this end we are planning to review our Recommended Practice on Asset Management over the coming months.

Rent Affordability is always a concern for us.

And, earlier this year, a report on our National Panel of Tenants and Service Users found that over a third of panel members have experienced difficulties in affording their rent.

And more than two thirds are concerned about the future affordability of their rent.

I think these are sombre numbers.

And I'm sure that landlords will be reflecting upon this and challenging themselves as to whether they are doing everything they possibly can to keep rents affordable.

When we look at the data that landlords have provided to us it is an equally sobering picture.

Total rent collected in the year ended March 2019 increased by 4.7 per cent.

Stock increased by 1.1 per cent.

So, that means that the average social rent charged by RSLs increased by more than three and a half per cent.

And the average RSL rent is now £4,510.

And every year we analyse landlords' data from their annual returns on the Social Housing Charter.

That analysis shows that last year the average rent increase for all social landlords in Scotland was 3.7%. That's up on the previous year's level of 2.4%. And it's the highest level since current monitoring began in 2013.

Our perspective is always that of the tenants whose interests we safeguard.

It's important that landlords demonstrate to their tenants that their rents will remain affordable and that they are having effective dialogue with their tenants on rent levels and increases.

So, landlords should be asking themselves whether they are doing everything possible to be efficient and drive costs from their business before passing costs on to tenants.

This will feature strongly in the risk assessment that we are currently carrying out and in our engagement with RSLs in the coming year.

Statutory Intervention

Last December we published a report which looked at lessons learned for both the sector and ourselves from our experience of using our intervention powers.

In each case the root of the problem that led to our intervention was weak governance.

In some landlords the organisational culture left the RSL vulnerable to poor behaviour.

Specifically we have seen management over-ride of internal control.

Whistle blowers have been disregarded.

There has been an absence of effective challenge from management teams and governing bodies.

And there has been a lack of internal audit which operates effectively.

As you all know internal audit is mandatory under the new framework.

For me an effective and adequately resourced internal audit function is one of the most important internal controls that an organisation can have.

In some of our interventions there was no internal audit.

In others internal audit had given assurance on systems that wasn't justified.

On the subject of internal audit quality, I still hear stories of RSLs tendering and weighting the internal audit contract 50/50 between quality and price.

I understand the importance of getting good value and not spending tenants' money without good reason.

But if you think the cost of having an effective internal audit is high then you should consider the cost of not having an effective internal audit.

It's not for us to tell RSLs how to carry out tendering exercises.

But from my own perspective, as an Audit Committee Chair, I would never want to tender for internal audit on the basis of less than 70/30, quality to price.

And I would probably be more inclined to go for 80/20.

When it comes to internal audit services I would certainly encourage the promotion of quality in bids.

Why?

Because false assurance is worse than no assurance at all.

We are keen to be a learning organisation ourselves, so we also used the intervention report to reflect on the main lessons for SHR.

Here is what we have learned from our experience of intervention to date.

Firstly, there aren't any quick fixes.

Recovery for an organisation that has failed to meet regulatory standards is a long process.

It won't be quick and it won't be cheap.

Secondly, the ability of the RSL to build its own capacity - leadership and governance - is crucial, especially if it wants to continue to be independent.

Thirdly, where an RSL is showing signs of non-compliance, it's vital that it gets good advice as early as possible on how to address the issues.

Fourthly, while we are keen to get an early decision on the way forward in order to minimise the cost to tenants, we recognise the difficulties in this.

In the immediate aftermath of an intervention the organisation can be in a state of denial.

And the governing body needs to take time to fully understand the position before they can take a decision on the way forward.

And finally there is a key role for lenders.

Where an organisation is facing potential issues there can sometimes be a reluctance to be entirely candid with lenders about the scale and the scope of the issues.

But we will always be entirely frank with lenders and investors.

And so I think it is in the RSLs interests to ensure that it demonstrates two things to its lenders and investors.

First of all that it understands the extent of regulatory concern.

And secondly that it is planning to address the issues and to work towards compliance.

And experience has shown that where an RSL is candid and demonstrates a willingness to address the issues then lenders are keen to be part of the solution.

So some key learning points for both the regulator and the regulated from our experience of intervention.

Just before leaving this subject, in the interest of balance I would add that we do see a huge amount of good practice in the sector.

I wouldn't want to give the impression that the issues set out in our intervention report are sector-wide.

I want to touch briefly now on the issue of **Cyber Security**

We see a key part of our role as being to raise awareness of risk across all landlords.

So last month we wrote to Chairs and Directors about a number of serious incidents that have affected a small number of RSLs.

This is clearly a very challenging and complex area.

So it's important that management and governing bodies are assuring themselves that they are doing everything that's necessary to protect their tenants interests and their personal information.

We hear a lot from RSLs about how they want to shift channels and deliver more services through digital.

This is commendable.

But only if the RSL is taking care of security and data compliance and there is a sound digital foundation for this channel shift.

I spoke earlier about internal audit.

This might be an area for internal audit to review.

SHR itself has recently been re-accredited under the Cyber Essentials Plus program.

This is a Government-backed, industry-supported scheme to help organisations protect themselves against common online threats.

From talking to colleagues in SHR who have taken this forward, I don't under-estimate the amount of work that is involved in this accreditation. But protecting your data and your tenants data is crucial.

So, if you haven't already done so, I would certainly consider Cyber Essential Plus.

I couldn't possibly leave here today without mentioning **Brexit**.

We wrote to RSL directors in February of this year, ahead of what we then assumed would be the UK's departure from the EU on 31 March.

And then we wrote again in October ahead of the second deadline.

And of course the situation has changed again since then.

But our position remains consistent.

Our message here is twofold.

First of all RSLs need to understand the risk to their business and their tenants and service users. Clearly in these circumstances there is the potential for greater volatility and unexpected scenarios.

This means considering more challenging sensitivities: your idea of a "worst case scenario" may have to be revisited.

And secondly, if you do see a material risk to your business or your tenants then come and talk to us.

Finally, let's talk about the new **Regulatory Framework**

A lot has changed in the new framework.

But the fundamentals haven't changed.

We continue to safeguard the interests of tenants, people who are or may become homeless, and the recipients of housing services provided by landlords.

And we continue to monitor the performance of housing activities of all landlords and also the financial health and governance of Registered Social landlords.

In the new framework we talk about the need for insight, self-awareness, openness and honesty and how landlords should seek to drive improvement.

If we were forced to reduce all of the guidance that we issue to the sector to a single sentence then that would probably be it.

If a landlord is genuinely self-aware and analytical and open and honest about its performance and if it is looking to identify and drive improvement then it will be well managed and it will be well governed.

And well managed and well governed landlords will have no issues in meeting our standards.

In order to achieve this you need to be constantly challenging yourself.

Where you think you are doing well you should ask,

"How could we do better?"

And where you are not doing quite so well you need to ask,

"How do we make sure that we comply with standards?"

Within the new Framework we have tried to build in some tools to help organisations to be self-aware and analytical.

The change that has prompted most discussion is the introduction of the Annual Assurance Statement.

Our deadline for the first submission was 31 October.

And we published the statements on 7 November.

And only yesterday we published the list of landlords which we will visit to help us understand the work and the processes involved in getting the assurance required.

There isn't some devilishly clever algorithm underlying the choice of these landlords.

We simply wanted to get a good spread in terms of size and geography and between local authorities and RSLs.

There are a small number of statements still outstanding and we are engaging urgently with the landlords concerned.

We appreciate the volume of work that has underpinned the production of the statements and clearly most landlords have carried out their work in this area with diligence and a keen awareness of the risks.

Some early reflections on the process and the statements:

The introduction of this requirement has been the catalyst for a lot of discussion amongst landlords, within landlords and also between landlords and ourselves.

This in itself is encouraging: it indicates that the new framework has highlighted the need for good governance, assurance and internal control within landlords.

We talk to Chief Executives and other senior staff who have very much welcomed the new process.

They tell us that they have been challenged to a greater extent than before.

And we speak also to Board members who tell us that their responsibilities are much clearer to them now.

And that they feel empowered to challenge, to get the assurance that they need to sign off the assurance statements.

Even people who were initially sceptical are telling us that they can see the value of the statements and the processes that are required to deliver the assurance.

As to the statements themselves, they are now on our website for everyone to see.

For me, some of the most interesting statements have been those that have said that they are compliant but, in the course of the process, they have identified some new issues that they hadn't been aware of before.

And they will address these issues to make sure they remain compliant.

So what happens next?

The statements will now be considered as part of the risk assessment process that we have just kicked off.

We'll be publishing our usual summary of the risk assessment process at the end of this month.

And at the end of March 2020 we will be publishing refreshed engagement plans for all landlords and a regulatory status for each RSL.

Conclusion

So a great deal has happened in the past 12 months.

How do we see the position?

Sector finances remain sound although we are engaging with a small number of landlords where we judge that there is a risk to their financial health.

But those strong finances have been built around rent increases that are, on average, above inflation. We see increasing challenges around **rent affordability** and we will be engaging to get assurance that RSLs are doing everything possible to keep rents affordable.

And we know that some landlords are facing big bills to rectify historic under-investment and non-compliance with legislation and regulations around tenant and resident safety.

Tenant and resident safety is a key priority for us. We will be looking to RSLs to assure themselves on this issue. And, where appropriate, we will be engaging to allow us to judge whether tenants and residents are appropriately protected.

We know that some organisations have recognised that they haven't done enough in the past around key areas like asbestos and legionella and are now taking the appropriate action.

We would ask all landlords to challenge and assure themselves on this point and to make sure that they have enough provision in their business plan to meet all future requirements.

On **Brexit**, consider contingency planning and come and talk to us if you see a material risk to your business or tenants.

Cybersecurity should be on the agenda, it's vital to protect your data and your tenants data.

The new framework has already had a positive effect and is helping RSLs to deal with the challenges that they face. We are in the first full year of operation and we are sure that RSLs will be looking to build on the positive progress so far.

Boards and senior officers should think carefully about the role that internal audit can play in providing assurance around compliance and should make adequate resources available to internal audit.

I look forward to answering your questions.