Scottish Housing Regulator

Analysis of the Finances of Registered Social Landlords

May 2021

About us

We are the independent regulator of RSLs and local authority housing services in Scotland. We regulate to safeguard and promote the interests of current and future tenants of social landlords, people who are or may become homeless, and people who use housing services provided by registered social landlords (RSLs) and local authorities. You can find out more about us and what we do on our website www.housingregulator.gov.scot.

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.

Most of the analysis within this report is based on aggregate financial statements for the year ended 31 March 2020. However, following the start of the first national lockdown on 23 March 2020, we began to collect monthly returns from all landlords. Where appropriate, we have used the financial information within those returns to inform the judgments that we have made in this report. We have also used information provided by landlords since the start of the pandemic, mainly loan portfolio returns and financial forecasts to inform our judgment.

In this report we not only analyse the financial performance of RSLs prior to the pandemic but we also use all of the information available to us to identify the main risks and issues to the future financial health of RSLs and set out our regulatory position in relation to these risks and issues in the context of the pandemic and its likely aftermath.

We also carry out a detailed risk assessment on the financial health of each RSL. Regulatory Standard Number 3 requires each RSL to manage its resources to ensure its financial well-being, while maintaining rents at a level that tenants can afford to pay.

Whether and how we engage with an individual RSL depends upon our assessment of the financial risk in each case. Following the 2021 risk assessment we published 138 engagement plans for RSLs and are engaging with 25 RSLs on finance. Those wishing to understand our regulatory view of an individual RSL should reference the landlord's Engagement Plan.

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Highlights

Registered Social Landlords (RSLs) reported generally strong financial performance for the 2019/20 financial year. Liquidity was robust and RSLs continued to raise significant levels of new private finance from banks and the capital markets. During 2020/21 the limited financial data collected from monthly returns also indicated that RSLs' financial position remains strong.

Turnover RSLs increased turnover at the aggregate level by more than 5% to £1.8bn in 2019/20. Affordable lettings income went up by 6.1% to £1.6bn, contributing 88% of turnover.

Surplus RSLs reported an aggregate surplus of £251.1m for the year to 31 March 2020 showing a continuation of the upward trend of recent years. The net margin increased from 12.8% in 2018/19 to 14% in 2019/20.

Available cash RSLs increased cash balances by £102.2m during 2019/20, reaching £835.6m at 31 March 2020. Monthly COVID-19 returns submitted during 2020/21 showed cash balances continuing to increase, reaching £1.03bn at 31 March 2021.

Cash Generated RSLs maintained a strong financial position at the end of 2019/20, with increased cash generation (up £21.0m to £524.2m) whilst interest paid on debt rose £17.0m to £191.2m.

Interest Cover Increases in operating margins caused a 29 percentage point increase in EBITDA MRI (Earnings Before Interest & Taxation Depreciation & Amortisation, Major Repairs Included) interest cover, up to 262% in 2019/20.

Housing Investment RSLs invested more in new and existing homes, with net housing assets up £960.1m, or 7.6%, to £13,654.5m during 2019/20.

Borrowing RSLs increased debt facilities to £6.2bn at 31 March 2020, £5.2bn of which they had drawn down, with a balance outstanding of £4.5bn. RSLs had undrawn facilities of £1bn available, and had agreed new finance of £0.8bn in the year. Borrowing is set to further increase as RSLs forecast a requirement for an additional £1.2bn over the next 5 years to fund investment in new and existing homes.

Rents & Inflation In aggregate, rent increases were above inflation in 2019/20. RSLs' aggregate rents are forecast to increase by more than inflation for the next 5 years; however we are aware that many RSLs are looking to moderate their planned rent increases for 2021/22 in response to changed circumstances resulting from the pandemic.

Arrears, Voids & Bad Debts Following increases in 2020/21, the sector is forecasting reductions over the remaining years of the projections.

Pensions Movement to defined contribution schemes by RSLs who previously offered only defined benefit schemes has continued, but at a slower rate than in previous years. 69 RSLs now only provide a defined contribution scheme for employees, up from 64 in 2018/19.

Executive Summary

Overall Conclusion

At March 2020 most RSLs were managing their resources to ensure their financial well-being, while maintaining rents at affordable levels.

At that time, key indicators such as cash generation and interest cover remained strong and the aggregate net surplus had increased to £251m, a continuation of the upward trend in recent years.

So, RSLs entered the pandemic in a strong financial position and based on the 2020/21 monthly returns, as a whole, have coped well over the last 12 months with the short term financial impact of the pandemic and have maintained a strong aggregate financial position.

That said, RSLs are likely to face considerable challenges in the future in managing their resources to ensure their financial well-being, while maintaining rents at a level that tenants can afford to pay.

The medium term outlook for social landlords, society in general, and the wider economic environment, remains uncertain and as we look towards the transition out of lockdown RSLs will have to manage increased challenges in relation to service delivery and investment in new and current homes at a time when tenants' and service users may be facing increasing financial hardship.

Compliance with the Energy Efficiency Standard for Social Housing post 2020 (EESSH2) will require considerable investment in existing homes beyond that which is already provided in current financial forecasts and business plans of some RSLs.

While the post-Brexit EU-UK trade deal is implemented there also remains the possibility of further financial shock and uncertainty.

Ensuring financial well-being while maintaining rents at a level that tenants can afford to pay is a requirement for RSLs. Where we are engaging with an RSL about its business plan, we will discuss how it has satisfied itself that its rents are affordable. RSLs will need to look constructively and creatively at ways in which they can reduce costs without detriment to the interests of tenants and keep tenants' rent affordable.

Our decision on regulatory status and regulatory engagement depends upon our assessment of the risks for each landlord. In November 2020 we published details of the risks that we would focus upon in our 2020/21 risk assessment for RSLs. This can be read in more detail here.

Regulatory Standard 3 requires that each RSL manages its resources to ensure its financial well-being, while maintaining rents at a level that their tenants can afford to pay. Following our review of the 2019/20 financial statements and the completion of the 2020/21 financial risk assessment we concluded that the vast majority of RSLs comply with the standard. We have published engagement plans and regulatory statuses for all RSLs and are engaging with 25 RSLs on finance.

Turnover

The core business for RSLs is the provision of social housing. This generates an annual income of approximately £1.39bn (over 77% of turnover), predominantly from rent and service charges.

The aggregate turnover for RSLs is up more than 5% to £1.8bn, with affordable lettings showing growth in 2019/20 of 6.1% and other activities a 1% reduction for the same period. Affordable lettings turnover comprises an RSL's income generating activities (rents & service charges) but also the receipt of grant income. Most RSLs release grant income over the lifespan of the related assets.

RSLs are forecasting turnover to increase annually by on average 3.7% over the next 5 years, with operating costs forecast to increase by 2.5% pa over the same period. Overall, turnover is set to increase by 19.8% to £2.1bn, operating costs by 13.0% to £1.6bn.

Cash Generated from Operations

RSLs' governing bodies are responsible for ensuring RSLs have access to sufficient liquidity at all times and that funding is available for immediate cash flow requirements and that plans are in place to mitigate against possible adverse scenarios. RSLs' forecasts indicate that cash from operations is set to increase significantly from £479m in 2020/21 to £790m by 2024/25.

Cash Generated per £1 of Interest Paid

Cash generated by RSLs from operating activities for each £1 of interest paid dropped in 2019/20 to 2.74 (2018/19 2.89). This is mainly a result of an increase in interest paid. We do not view this reduction in interest cover as a long term weakening of financial strength. Rather, it reflects a sector using its assets more intensively in order to invest in its housing stock.

RSLs' Five Year Financial Projections (FYFPs) show this ratio continuing to fall, dropping to 2.58 in 2020/21 before increasing rapidly after this to 3.13 in 2024/25. The main driver of this is the increase in net cash from operations.

Investment in New & Existing Properties

RSLs have substantially increased expenditure on the acquisition and construction of properties and investment in existing properties. In 2019/20 RSLs invested £1,090.9m, an increase of £31.0m on the previous year. Net capital grant receipts decreased marginally to £466.9m (2018/19 £469.8m). Cash receipts from property sales fell by 67% to £22.6m, an anticipated consequence of the end of the statutory Right To Buy in Scotland in 2016.

As well as investing in new properties RSLs must ensure they maintain the quality of their existing housing stock to an acceptable standard. They must ensure they continue to invest adequately to provide homes that are safe and comply with the Scottish Housing Quality Standard (SHQS).

Together with ongoing planned and reactive maintenance to improve safety and quality, RSLs may also have significant additional investment requirements in relation to EESSH (Energy Efficiency Standard for Social Housing) and to the wider decarbonisation agenda. It is fundamental that governing bodies are aware of this and where appropriate are in possession of robust and up-to-date stock condition data. This can then be used as the basis for building a more in-depth understanding and in turn allow them to identify any current investment needs but also plan to meet new requirements.

Borrowing

RSLs' aggregate debt facilities secured reached £6.2bn by 31 March 2020. Of that total, £5.2bn had been drawn down, with a balance outstanding of £4.5bn. Available undrawn facilities are at just more than £1bn. RSLs agreed new finance of £0.8bn million in the 12 months to 31 March 2020. Borrowing is set to increase, with RSLs forecasting an additional £1.2bn in the next 5 years to fund investment in new and existing homes.

Lending and investor demand for RSL debt remains high despite the additional challenges caused by COVID-19. Maintaining lender and investor appetite is essential if the RSLs wants to maintain or increase levels of capital investment and new development. RSLs will inevitably see a negative financial impact should interest rates increase and need to understand the potential financial implications of this.

Many RSLs have projected significant increases in spend on existing stock in order to make up for the reduction in repair expenditure caused by COVID-19. This is expected to supress EBITDA MRI interest cover levels in the next five years. The latest forecasts indicate that the EBITDA MRI interest cover levels for RSLs over the next 3 years will decrease markedly before returning to their current level by Year 4.

Those with an EBITDA MRI interest cover covenant may find themselves unable to do this without breaching that covenant. A tighter interest cover position further increases the importance of effective monitoring of existing loan covenants to help mitigate the risk of breaches. If interest costs are greater than forecast or if income falls below forecast levels then it is essential to have clear mitigation plans in place to avert potential breaches.

Recent demand for Environmental, Social & Governance (ESG) investments and increasing use of ESG reporting standards has the potential to further increase the range of lenders and investors in social housing and lower costs. This type of lending tends to bring new stakeholders and accountabilities to organisations and RSLs should be aware of this.

The London Inter-bank Offered Rate (LIBOR) that underpins many financial and some non-financial contracts is expected to be phased-out by 31 December 2021. With around 40% of all RSL loans referenced to LIBOR, RSLs should be examining all financial contracts and discussing transition with lenders.

Rent Affordability

Landlords' Annual Return on the Charter (ARC) for 2019/20 showed the average weekly rent for RSLs was £87.94 in 2019/20, up 3.2% from £85.18 in the previous year. In our seventh National Panel report we considered affordability issues and found that around half of respondents had experienced difficulties affording their rent, including around 1 in 8 who are currently experiencing difficulties. This represents a 14% increase from the 2019 survey.

RSLs' projections indicate that during the period 2021-2025, average rents are assumed to increase by around 2.5% each year. We are aware that a number of RSLs are looking to moderate their planned rent increases for 2021/22 and some RSLs are freezing rents.

The Consumer Price Index (CPI) over the same period starts at just over 0.5% and rises to around 2% in Year 5. 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. RSLs will need to consider this when determining the continuing affordability of rents for tenants in receipt of benefits and for those in work who may not receive pay rises.

Arrears & Voids

Throughout the past few years, RSLs have worked hard to manage and mitigate the effects of changes in the welfare system on 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. At 31 March 2020, RSLs' management of arrears, voids and bad debts continued to be effective. RSLs are forecasting lower levels over the next 5 years despite changes in Welfare Reform and the COVID-19 impact.

Mean arrears and rent lost to void properties deteriorated across the first six months of the COVID-19 pandemic, however in the latter part of 2020/21 we saw performance remaining more stable even improving slightly in the last quarter to 31 March 2021.

Pensions

In previous years, there has been a steady movement by RSLs away from Defined Benefit (DB) pension schemes to Defined Contribution (DC), although this has showed signs of slowing recently and more than half of RSLs still have some exposure to DB and the risks attached. They are accruing future liabilities that they cannot control, with the eventual liability to be borne by the RSL and its tenants remaining uncertain. A fall in equity value, weak gilt yields, and interest rate reductions have all contributed to many schemes being under-funded.

Many RSLs belong to pension schemes where liabilities are revalued on a triennial basis, creating a risk of increasing costs if the scheme is found to be in deficit. In the past this has meant additional contributions being required from exposed RSLs to close any deficit. This can impact on the RSLs financial position, have implications for their business plans, and must be reflected in their financial statements.

Although many RSLs have taken a proactive approach to managing this risk, governing bodies may want to seek independent advice, where appropriate, to understand their risk exposure and the impact on cash flow arrangements. This advice could be in conjunction with a consideration of the potential impact on rent levels, cost efficiencies and value for money.

Financial Review 2019/20

Statement of Comprehensive Income

The surplus for the year of £251.1m reported at 31 March 2020 shows a continuation of the upward trend of recent years. The net margin increased from 12.8% in 2018/19 to 14% in 2019/20. The reported £155.1m increase gives total comprehensive income for the period of £406.3m. This increase is almost entirely due to an actuarial gain in respect of pension schemes of £156.0m. Key movements at a glance were:

- turnover up £88.9m (5.2%)
- operating costs up £57.8m (4.2%)
- operating surplus up £94.4m (31.6%)
- interest payable up £19.1m (10.9%)
- surplus for the year up £33.1m (15.2%)
- actuarial pension gain up £246.2m (272.9%)
- total comprehensive income up £278.6m (218.3%)

	2017/18 (£'000)	2018/19 (£'000)	2019/20 (£'000)
Turnover	1,615,967	1,704,433	1,793,283
Operating costs	(1,295,664)	(1,371,728)	(1,429,495)
Gain/(loss) on disposal of property, plant & equipment	10,245	(1,174)	1,710
Exceptional items	(477)	(33,433)	26,970
Operating surplus	330,071	298,098	392,468
Share of operating surplus/(deficit) in joint ventures and associates	(1,765)	7,618	526
Interest receivable	7,331	6,450	10,090
Interest payable	(169,139)	(175,350)	(194,494)
Other financing (costs)/income	9	(2,059)	(3,410)
Release of negative goodwill	384	646	638
Movement in fair value of financial instruments	6,769	(4,283)	(1,633)
Decrease in valuation of housing properties	(6,079)	(8,174)	(15,799)
Reversal of previous decrease in valuation of housing properties	16,109	95,083	62,729
Surplus before tax	183,690	218,028	251,116
Tax payable	(125)	(40)	(36)
Surplus for the year	183,565	217,987	251,080
Unrealised surplus on revaluation of housing properties	72,707	0	0
Actuarial gain/(loss) in respect of pension schemes	53,413	(90,215)	156,021
Gain/(loss) in fair value of hedged financial instruments	2,677	(140)	(836)
Total comprehensive income for the year	312,362	127,633	406,265

Table 1: Aggregate Statement of Comprehensive Income

Analysis of turnover

Turnover for 2019/20 was £1,793.3m (2018/19 £1,704.4m), an increase of £88.9m (5.2%) and a continuation of the pattern of annual increases illustrated below. Readers will not be surprised to see affordable lettings as the main contributor to the annual increases alongside a largely static profile in income from other activities (see Figure 1).

Affordable lettings income is up £90.9m to £1,586.8m (2018/19 £1,495.9m). At 6.1% this is the largest annual increase in recent years, with the majority coming from gross rent & service charges, up £63.1m, and grants released from deferred income, up £23.9m. RSLs continue to manage their void properties effectively, with rental income lost remaining stable with a 3.8% increase (2018/19 3.7%) to £16.9m (2018/19 £16.3m), or 1.22% (2018/19 1.24%) of gross rent and service charges.

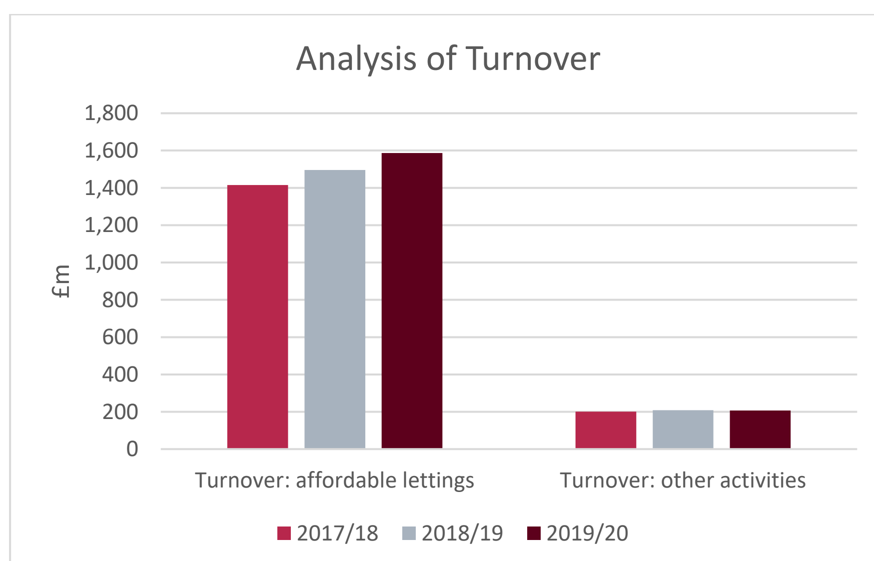

Figure 1: Analysis of turnover, split between affordable lettings and other activities

Analysis of operating costs

Operating costs for 2019/20 were £1,429.5m (2018/19 £1,371.7m), up £57.8m (4.2%). Figure 2 below illustrates the upward trend in affordable lettings costs, and a marked stability in the cost of other activities.

A 5.2% (2018/19 6.5%) increase in affordable lettings costs of £60.0m (2018/19 £70.5m) represents a slower rise with turnover growth now moving ahead. However we have seen a relatively large 12.1% increase in planned & cyclical maintenance revenue spend, up to £151.8m (18/19 £135.4m), a significant increase against what has recently been a period of more stable spending.

Also of interest is the split in expenditure between new build housing development and investment in existing properties. In 2019/20 the Sector spent £1.1bn across both capital and revenue expenditure, with around £840m (76%) on the acquisition and construction of housing properties and the smaller figure of £260m (24%) on the improvement of existing properties.

Bad debts always form a relatively small part of letting costs but can still be a useful measure of how efficiently RSLs are managing their letting and rent collection. The trend of annual increases continued in 2019/20 with a 6.9% increase (2018/19 16.9%) to £13.5m (2018/19 £12.6m), or 0.99% (2018/19 0.97%) of net rent and service charges. Although a small aggregate sector figure we are watching to see how it might move as along with voids and arrears it is one that we anticipate could be adversely affected by COVID-19.

A more material impact of COVID-19 is likely to be a drop in planned maintenance spend in 2020/21, with further delays and re-profiling expected to be reflected in annual accounts over the next few years. Individual RSLs will have to assess the impact of the pandemic on their existing business model and consider what the next 18 months and beyond are likely to bring. From this assessment RSLs should consider developing and implementing a revised business plan. SHR has published supplementary advice to assist RSLs with their approach to business planning in the pandemic and post-pandemic environment.

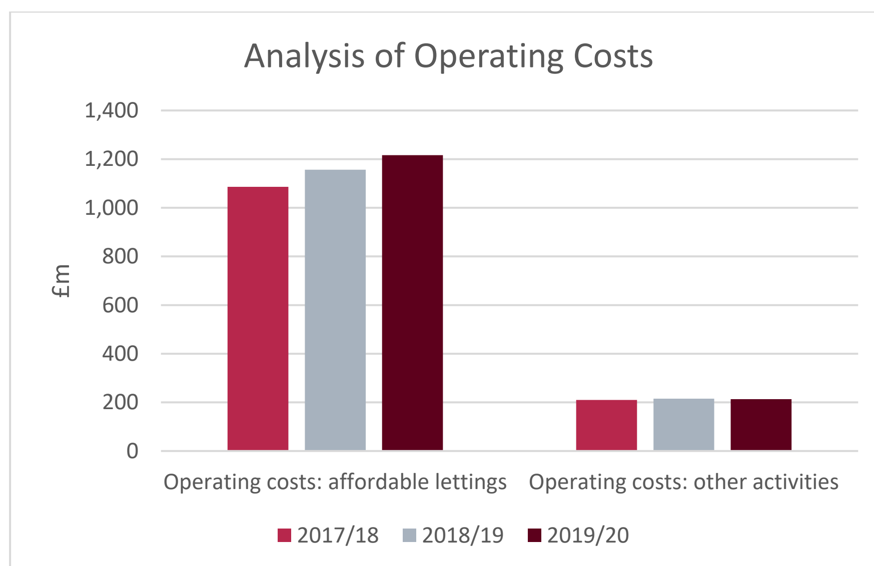

Figure 2: Analysis of operating costs, split between affordable lettings and other activities

Surplus and total comprehensive income

The 2019/20 aggregated operating surplus of £392.5m (2018/19 £298.1m) was a rise of £94.4m (31.6%). The fluctuations of recent years continued, up on the previous year after a drop but also up on 2017/18. We now see income growing marginally faster than costs, with turnover up 11.0% since 2017/18 against a 10.3% jump in operating costs over the same period. Key to the 2019/20 increase were:

- affordable lettings surplus up £30.9m to £370.4m (2018/19 £339.5m)
- a £60.4m favourable swing on exceptional items, a gain of £27.0m from a 2018/19 loss

The number of RSLs with operating deficits in 2019/20 dropped to five, and only two with 2018/19 deficits repeated those in 2019/20. RSLs in deficit peaked at 10 in 2018/19 so although the number has always been low it has still halved. The recent history is summarised in Table 2 below, and we watch to see whether 2019/20 starts a trend towards no deficits at all.

Operating surplus/(deficit) (£'000)	2017/18	2018/19	2019/20
Below 0	8	10	5
0 - 2,500	118	114	114
2,500 - 5,000	21	20	16
5,000 - 7,500	5	5	11
7,500 - 10,000	1	5	3
Above 10,000	5	4	7
	158	158	156

Table 2: Operating surplus/(deficit) by RSL

Across three years, operating deficits can be attributed to only 15 RSLs. Six appear more than once in that period, none appear every year and one has transferred to another RSL.

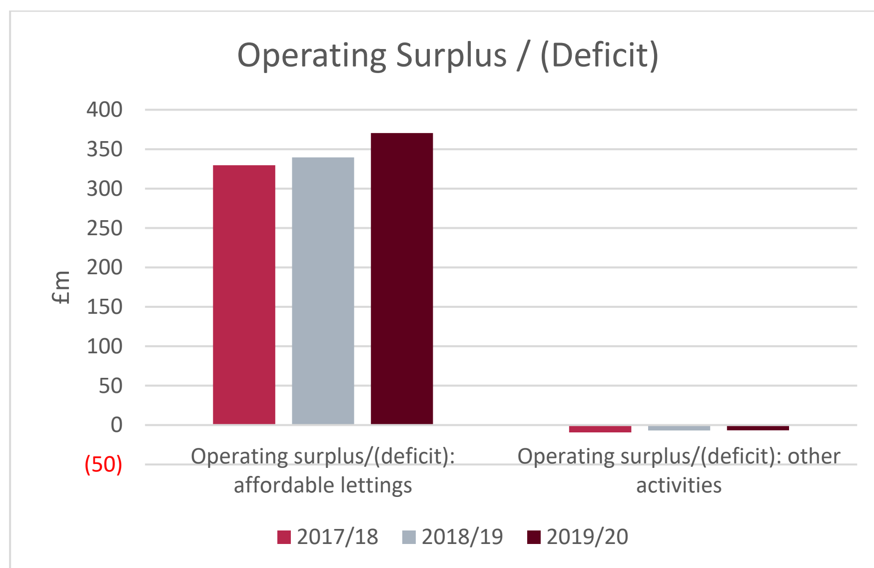

Figure 3: Operating surplus/(deficit), split between affordable lettings & other activities

Figure 3 shows a steady increase in surplus from affordable lettings and also a reduction in the level of loss from other activities.

Aggregated net surplus after tax for 2019/20 rose £33.1m (15.2%) to £251.1m (2018/19 £218.0m).

- interest payable up £19.1m to £194.5m (2018/19 £175.4m)
- interest receivable up by £3.7m to £10.1m (2018/19 £6.4m), reflecting steadily rising cash balances.

Interest rates are significantly below the long-term average and RSL borrowing continues to increase. It is essential that RSLs effectively manage interest rate risk and plan for any interest rate increases in the future. Governing bodies should ensure they undertake robust stress testing to understand the sensitivity of business plans to increases in interest rates.

As a percentage of turnover, 10.3% in 2019/20 it is a small increase on recent years which had seen some levelling out between 2017/18 (10.0%) and 2018/19 (9.9%).

Other key contributors in arriving at net surplus included:

- a £62.7m gain on the reversal of previous decreases in the valuation of housing properties, although this was down £32.4m from 2018/19 (£95.1m)
- movements in the valuation of housing properties can fluctuate quite significantly and 2019/20 saw a further £7.6m drop to an increased loss of £(15.8)m (2018/19 £(8.2)m)

In Table 3 we see 2019/20 had the biggest jump in RSLs recording net deficits, up four to 17. There are 12 RSLs (2018/19 7) now generating a net surplus in excess of £5m. However it is also noted that the 2019/20 median of £599k is £100k down on the 2018/19 mark, and the lowest recorded in recent years.

Net surplus/(deficit) (£'000)	2017/18	2018/19	2019/20
Below 0	11	13	17
0 - 2,500	130	125	121
2,500 - 5,000	11	13	6
5,000 - 7,500	4	3	5
7,500 - 10,000	0	2	2
Above 10,000	2	2	5
	158	158	156

Table 3: Net surplus/(deficit) by RSL

The reported surplus of £251.1m increases by £155.1m to give total comprehensive income for the period of £406.3m. This is mainly due to an actuarial gain in respect of pension schemes of £156.0m.

Actuarial gains and losses on pension schemes such as the Scottish Housing Association Pension Scheme (SHAPS) can fluctuate widely on an annual basis. In 2019/20, RSLs saw an overall actuarial gain of £156.0m, following a loss of £90.2m in 2018/19. The actuarial gain is reflected by the movement in total pension provision for liabilities, which has reduced by £160.9m to £51.8m.

In 2019/20 the majority of RSLs (139) reported an actuarial gain, ranging from £23k to £8.2m. A total of 13 RSLs reported no gain/loss and only four recorded a loss, the largest of those being £2.9m. Unlike defined benefit schemes, defined contribution scheme providers contribute a fixed amount but have no obligation to cover shortfalls in the pension scheme.

The movement in provision and associated gain/loss reported under other comprehensive income is a result of movements in underlying pension scheme actuarial assumptions. These include the likes of forecast changes in the rate of any increase in the level of pensions paid, future increases in salaries, inflation, a discount rate linked to gilts, and assumptions on how long a pension is expected to be paid. In 2019/20, changes to the assumptions led to a decrease in liabilities, meaning an actuarial gain for the year.

Statement of Financial Position

The consolidated net assets position at 31 March 2020 of £3,909.4m is an increase of 18.8% on the 31 March 2019 figure. The key movements in the year were:

- net housing assets up £960.1m (7.6%)
- net rent receivables down £10.1m (23.2%)
- cash and cash equivalents up £102.2m (13.9%)
- provisions down £24.5m (50.7%)
- pension liability down £160.9m (75.6%)

	2017/18 (£'000)	2018/19 (£'000)	2019/20 (£'000)
Net housing assets	11,945,135.6	12,694,411.4	13,654,512.8
Other non-current assets	385,630.8	349,491.1	396,661.5
Receivables due after more than 1 year	97,596.4	82,250.1	66,547.5
Net rental receivables	34,749.0	43,464.8	33,385.5
Other current assets	203,001.3	208,710.2	218,481.1
Cash and cash equivalents	660,164.8	733,450.2	835,631.4
Loans falling due within 1 year	(187,398.0)	(213,905.6)	(186,244.7)
Other payables due within 1 year	(408,887.0)	(392,439.9)	(462,177.6)
Deferred income due within 1 year	(151,931.0)	(191,170.4)	(181,669.2)
Net current assets	149,699.1	188,109.3	257,406.5
Loans due after more than 1 year	(2,701,320.6)	(2,905,161.2)	(3,223,982.5)
Other payables due after more than 1 year	(1,424,603.2)	(1,491,206.4)	(1,422,179.1)
Provisions	(155,220.0)	(48,276.9)	(23,849.2)
Pension asset/(liability)	(17,110.3)	(212,716.7)	(51,806.0)
Deferred income due after more than 1 year	(5,114,035.7)	(5,366,123.7)	(5,743,918.8)
Net assets	3,165,772.1	3,290,777.0	3,909,392.7

Table 4: Aggregate Statement of Financial Position

RSLs are continuing to invest in their housing properties with net housing assets up £960.1m, or 7.6%, to £13,654.5m.

Cash also increased significantly in 2019/20, up £102.2m to £835.6m. There is always a link to new borrowing and funds drawn down in anticipation of spend. Our loan portfolio analysis highlighted an increase in amounts drawn down in 2019/20, and a corresponding drop in undrawn facilities. This follows the large increase in new facilities put in place during 2018/19.

Net rent receivable was down £10.1m (23.2%) to £33.4m (2018/19 - £43.5m). In cash and percentage terms this looks like an upturn in performance. We also look at the ratio to affordable lettings turnover. For 2019/20 it was the equivalent of 7.7 days (2018/19 10.6 days) and at that lower level it is not only a strengthening of the position from the previous year but also the lowest recorded figure in recent years. However, we will not lose sight of the pressure on tenants ability to pay, especially now with the full rollout of Universal Credit complete and possibly the full impact of COVID-19 still to fully hit large numbers of tenants, and therefore we will always expect arrears and debt management to form one of the most critical functions for all RSLs.

Cash Generation

Cash is crucial to the ongoing financial viability of any organisation, and in particular cash generated from operations. RSLs are no different, looking to fund their ongoing investment in the construction of new housing and improvements to existing housing and also to service their private finance debt.

- net cash in from operating activities up £21.0m (4.2%)
- net cash out from investing activities up £87.9m (16.2%)
- net cash in from financing up £108.9m (107.5%)
- net change in cash up £42.3m (69.0%)

	2017/18 (£'000)	2018/19 (£'000)	2019/20 (£'000)
Cash and cash equivalents at the beginning of the year	643,109.6	672,107.6	732,080.4
Net cash flow from operating activities	508,493.3	503,150.3	524,227.0
Tax paid	(46.7)	(44.4)	(30.5)
Net cash flow from investing activities	(521,752.6)	(543,034.6)	(630,897.4)
Net cash flow from financing	30,361.2	101,271.3	210,251.9
Net change in cash and cash equivalents	17,055.2	61,342.6	103,551.0
Cash and cash equivalents at the end of the year	660,164.8	733,450.2	835,631.4

Table 5: Aggregate Statement of Cash Flows

Material adverse movements in cash from operating activities can impact directly, particularly on the ability to cover capital repayment costs and debt servicing, while still remaining committed to the ongoing development of both new and existing housing.

Interest paid increased by a further £17.0m to £191.2m (2018/19 £174.2m). We cover this in more detail in our section on borrowing and interest but the recent trends in cash from operating activities and debt servicing are also illustrated in Figure 4 below.

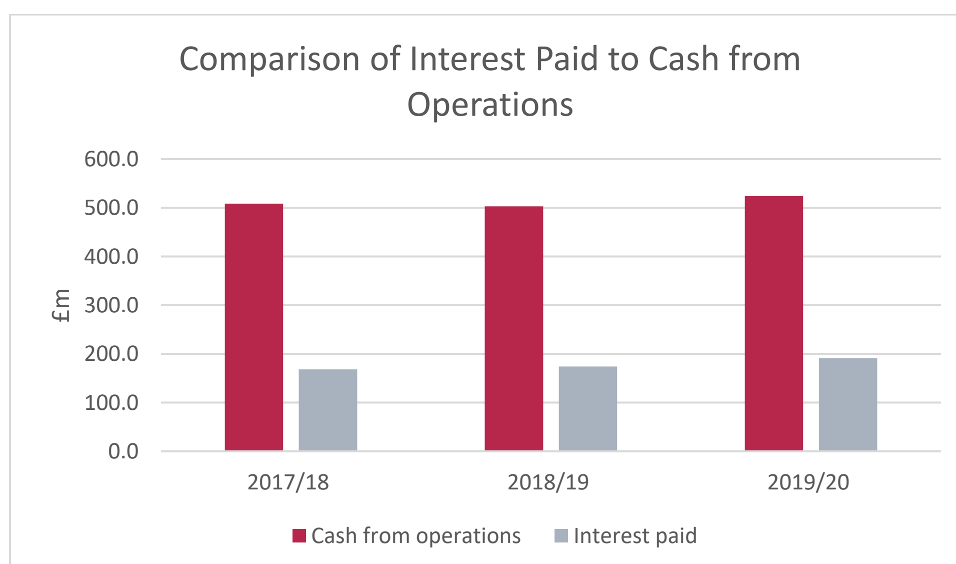

Figure 4: Interest paid compared to cash generated from operations

Systemically important RSLs, a group which are subject to additional information and assurance requirements accounted for £128.0m, or 66.9% of the £191.2m interest paid.

The overall impact is that cash generated from operating activities for each £1 of interest paid has dropped to 2.74 (2018/19 2.89), as shown in Table 6 below. Despite this we are confident that this remains a healthy sector wide interest cover margin and should therefore

continue to be a source of assurance for lenders and other key stakeholders alike. It also underlines the importance of RSLs continuing their efforts to seek and implement operational efficiencies across their organisations.

	2017/18	2018/19	2019/20
Net cash from operations (£m)	508.5	503.2	524.2
Interest paid (£m)	168.1	174.2	191.2
Ratio	3.02	2.89	2.74

Table 6: Cash generated per £1 of interest paid

Cash out on investing activities is primarily the investment in new housing and improvements to existing housing. In 2019/20 that increased by £87.9m taking net annual spend to £630.9m (2018/19 £543.0m).

	2017/18 (£m)	2018/19 (£m)	2019/20 (£m)
Acquisition and construction of properties	(905.8)	(1,059.9)	(1,090.9)
Purchase of other non-current assets	(50.2)	(29.9)	(41.9)
Net capital grants received	385.0	469.8	466.9
Sales of properties	41.1	67.9	22.6
Sales of other non-current assets	3.2	4.1	6.0
Interest received	4.9	5.0	6.4
Net cash outflow from investing activities	(521.8)	(543.0)	(630.9)
Loan advances received	333.0	557.8	839.6

Table 7: Aggregate cash flow from investing activities

There was further growth in the development and capital maintenance programmes, albeit the smallest increase in the last three years, up £31.0m (2.9%) to £1,090.9m (2018/19 £1,059.9m). And after last year's sharp rise, net capital grant receipts were down, a marginal £2.9m to £466.9m (2018/19 £469.8m). However, when combined with £839.6m of loan advances (2018/19 £557.8m), this more than offset the recorded £1.1bn of capital costs.

Analysis of Costs per Unit & Ratios

With operational cost inflation rates often rising faster than rental income inflation, there is always a considerable amount of pressure on RSLs to find ways to be as efficient and effective as possible. Cost per unit is one measure that has consistently been used to provide more cross sector information.

Analysis of unit management & maintenance costs

Unit management & maintenance costs increased 2.7% to £2,455/unit (2018/19 £2,391), marking a continuation of year on year increases, but with growth down on the 4.5% increase in 2018/19 this was more in line with the lower level of increases in prior years.

	2017/18	2018/19	2019/20	% Change 2018/19-2019/20
Management & maintenance administration	1,236	1,299	1,314	1.2%
Planned maintenance	463	457	502	9.8%
Reactive maintenance	590	634	639	0.8%
Total direct maintenance	1,053	1,091	1,141	4.6%
Total management & maintenance	**2,288**	**2,391**	**2,455**	**2.7%**

Table 8: Aggregate management and maintenance cost per unit

Ratio of Reactive to Planned Maintenance

The 2019/20 data displays a similar pattern to prior years. The most common category remains 25%-50%, with 58 RSLs , followed by 50%-75% with a further 42 RSLs. The key points are:

- 22 RSLs have a ratio greater than 100% (2018/19 24), five of those exceeding 200% (2018/19 5)
- 59 RSLs have a ratio between 50% & 100% (2018/19 61), 17 of those between 75% & 100% (2018/19 23)

In addition five RSLs (2018/19 9) have maintained a ratio of greater than 100% across the past three years, a key indication that reactive costs are consistently exceeding planned maintenance costs for those RSLs. Where appropriate we engage with RSLs with a high ratio to better understand their business reasons for this.

Aggregated Total Staff Costs

Governing bodies are responsible for ensuring that employee salaries, benefits and their pension offerings are at a level sufficient to ensure the appropriate quality of staff to run the organisation successfully, but which is affordable and not more than is necessary for this purpose.

Total staff costs increased by 3.2% to £471.9m in 2019/20. That level of increase is 1.0% down on the 2018/19 increase but still above both CPI and RPI for the year. Average weekly wages also increased by 3.2% in the 12 month period covered by these accounts.

Total FTE staff has seen a 1.6% increase to 12,913. At the same time the average cost per FTE has also risen by 1.6% to £36,541 for 2019/20.

	2017/18	2018/19	2019/20	% Change 2018/19-2019/20
Staff Costs	£438.8m	£457.2m	£471.9m	3.2%
Staff Number (FTE)	12,876	12,715	12,913	1.6%
Average Cost per FTE	£34,082	£35,954	£36,541	1.6%

Table 9: Aggregate staff cost information

Employee FTE numbers in the ARC and AFS returns use different definitions, so care is required when interpreting the results. We look closely at the staff costs of those RSLs that may be showing disproportionate increases in order to better understand any underlying reasons.

Staff costs per unit have increased year on year, rising almost 10% in the five years from 15/16. However the 1.0% increase in 19/20 is much closer to both CPI and RPI than we have seen in the past and in fact the smallest increase for a number of years. It is also below the 3.2% increase in total staff costs noted above.

The aggregate cost of employing the most senior officer in the RSL for 19/20 was £11.4m (18/19 - £11.3m), compared with £11.1m in 15/16. This represents a modest rise of only 2.7% across the five years.

Overall, there is no particular trend at sector level but there are some RSLs where the cost has risen well in excess of inflation in recent years. We are aware from our regulatory engagement that a number of RSLs have implemented structural or personnel changes which we would anticipate impacting the results, but this does not account for all of the RSLs identified.

Table 10 below shows the distribution of Chief Executive emoluments excluding pension contributions per unit and range results across the last three years:

	2017/18	2018/19	2019/20
Minimum	7	7	6
Maximum	622	679	718
Median	60	59	60

Table 10: Distribution of Chief Executive emoluments excluding pension contributions per unit

The distribution curve has a very similar path to prior years. The median value has not fluctuated hugely in recent years and although there was a 10% increase in 2016/17, the trend has been downward or at least stable since then.

There are also a number of RSLs where there are no CEO costs recorded and this will largely be due to their particular structure for example staff are employed by the Group parent and not the individual subsidiary RSL or the RSL may have transferred to another RSL. In 2015/16, a total of 16 RSLs had no CEO cost. This figure had risen slowly but steadily to reach 19 in 2018/19 but at least in part due to recent transfers of engagement it has dropped back to 16 in 2019/20.

Borrowing & Effective Interest Rates

Total borrowings continued to grow and at 31 March 2020 facilities secured had reached £6.2bn. Of that total, £5.2bn had been drawn down, with a balance outstanding of £4.5bn.

	Total Facilities £'m	Facility Drawn £'m	Facility Undrawn £'m	Balance Outstanding £'m
As at 31 March 2020	6,179.2	5,177.0	1,002.2	4,522.7
As at 31 March 2019	5,971.7	4,768.2	1,204.0	4,149.9
Increase/(decrease)	207.5	408.8	(201.8)	372.8
% Change	3.5%	8.6%	(16.8%)	9.0%

Table 11: Summary of total facilities available from the Loan Portfolio annual returns

The effective rate of interest fell marginally in 2017/18 to 4.59% and again in 2018/19 to 4.52%. Capitalised interest has increased steadily in the last two years which is reflective of the higher levels of development during that time. As noted earlier, interest payable continues to rise, up 10.9% to £194.5m or more than 15% if we look at it over a two year period, indicating that debt secured over that period was at more beneficial rates. A detailed

analysis of the borrowings can be found in our analysis of the Annual Loan Portfolio returns at 31 March 2020.

	2017/18	2018/19	2019/20
Interest payable (£m)	169.1	175.4	194.5
Capitalised interest (£m)	7.0	6.9	6.6
Loans outstanding at year end	3,915.0	4,149.9	4,522.7
Effective interest rate	4.59%	4.52%	4.64%

Table 12: Aggregate effective interest rate based on loans outstanding from Loan Portfolio annual return

The Bank of England reduced interest rates to 0.25% on 11 March 2020 and then to an historic low of 0.1% on 19 March 2020, where it remained at the time of writing. This should be reflected in a reduction in the effective interest rate for many loans.

We have also previously noted that the growth in interest payable was outstripping the turnover growth. A marked drop in growth in 2017/18 might have signified the start of the reversing of that trend but larger increases again in 2018/19 and now 2019/20 has taken it to the highest level seen, certainly in recent years. The table below shows the progression over the last three years.

	2017/18	2018/19	2019/20
Turnover (£m)	1,616.0	1,704.4	1,793.3
Interest payable (£m)	169.1	175.4	194.5
Percentage turnover required to service debt	10.47%	10.29%	10.85%

Table 13: Percentage turnover to service debt

Despite the increase in development activity the increase in the percentage of overall turnover required to service debt has only increased by 0.38% over the last two years. This shows the confidence that lenders have in the sector and the appetite of RSLs to continue developing and investing in their homes. More information on the interest rates can be found in our published analysis of the loan portfolio returns as at 31 March 2020.

It can also be beneficial to put the results into a the wider UK context by comparing them to those published by the Regulator of Social Housing, the social housing regulator in England. In recent years we have seen the Scottish figures compare very favourably with those in England, and this trend has continued in 2019/20 with close to 50% more turnover required by English providers in order to service their debt, a statistic that stems from the long standing difference in grant rates available between north and south of the border.

	2017/18	2018/19	2019/20
Turnover (£bn)	20.5	20.9	21.2
Interest payable (£bn)	3.2	3.2	3.3
Percentage turnover required to service debt	15.61%	15.31%	15.57%

Table 14: Percentage turnover to service debt[1]

Our own analysis indicates that strong interest cover will become even more important going forward, combined with robust cost control and value for money initiatives. We are aware through our engagement with RSLs that many are actively looking at ways to improve operational efficiencies and reduce their cost base.

[1] Source: RSH 2020 Global accounts of private registered providers

Governing bodies should have a clearly expressed strategy which reflects their risk appetite and wider operating environment and also possess the necessary skills and experience to allow them to understand and effectively challenge any advice given. An effective approach to Treasury Management is essential if RSLs are to comply with Regulatory Standard 3. The importance of relationships and communication with funders remains vital.

EBITDA MRI interest cover is a key measure of RSLs ability to cover ongoing finance. This measure has continued to improve over the last three years. The increases in operating margin have caused a 28.57 percentage point increase in EBITDA MRI interest cover to 261.83% in 2019/20 This is the second consecutive year in which levels of EBITDA MRI interest cover have risen (see Table 15).

These levels compare favourably with aggregate levels for Registered Providers in England as a significant number rely on housing developed for sale to bolster their surplus figures which isn't the case among RSLs. Grant levels in Scotland are also significantly higher than England meaning that RSLs need to borrow less to fund development and therefore have lower levels of interest payable.

	2017/18	2018/19	2019/20
EBITDA MRI (%)	231.55	233.26	261.83

Table 15: EBITDA MRI as percentage of interest payable

Rent Increases & Inflation

The trend of rents increasing above CPI has been in evidence over the last few years. Our requirements around rent affordability are set out in Regulatory Standard 3 which requires each RSL to manage its resources to ensure its financial well-being, while maintaining rents at a level that tenants can afford to pay.

Back in March 2020, prior to the full onset of the pandemic in the UK, the Office of Budget Responsibility ("OBR") published their Economic & Fiscal Outlook. This showed:

- the CPI increased by 1.76%, and the corresponding figure for RPI was 2.57%
- both peaked in 2018 at 2.72% CPI and 3.64% respectively

The graph below shows the average rent increase in the RSL sector compared with both CPI and RPI rates since 2018.

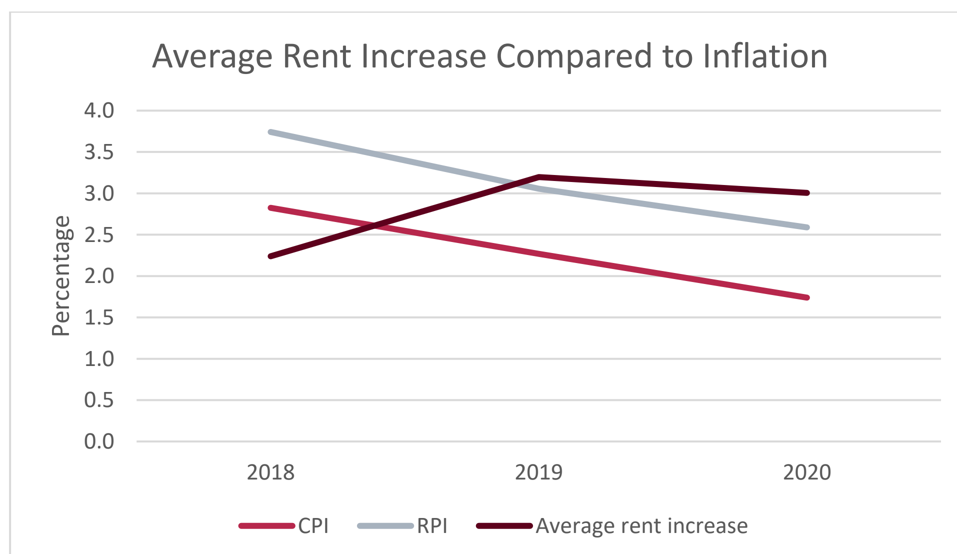

Figure 5: Comparison of RSL average rents from ARC returns to inflation[2]

The graph indicates a mid-term change against inflation. Initially rent increases while climbing were lagging behind inflation, or at least RPI inflation. This is particularly clear over the 2018/19 period with inflation rates falling as rent rises increased. That period took rent increases above both RPI and CPI. The movement since then has seen all rates falling, the gap between RPI and CPI narrowing, and a widening of the gap between annual rent increases and inflation rates. The sector average is based on the ARC for 2020.

Inflation rates and the projected future rent levels, from a regulatory perspective, remain important assumptions for forward financial projections.

Arrears & Voids

RSLs continue to work hard to manage and mitigate the effects of changes in the welfare system and COVID-19 upon tenants and the RSL itself. Lenders make it clear that they will monitor arrears and voids closely in view of the sensitivity of these measures to changes in the welfare system.

In considering voids, arrears and bad debts against turnover we see that these measures have either remained around previous levels or shown some improvement. This helps reinforce the impact that the work done by RSLs to mitigate these is having.

	2017/18	2018/19	2019/20
Voids (%)	1.25	1.24	1.22
Bad Debts (%)	0.87	0.97	0.99
Arrears (%)	2.79	3.34	2.45

Table 16: Voids, bad debts & arrears figures from AFS returns

Pensions

RSL payments towards pension provision generally form part of an employee's overall remuneration package, however governing bodies have a duty to ensure they are affordable. A fall in equity value, weak gilt yields, and interest rate reductions have all contributed to many schemes being under-funded.

Aggregated Pension Liability

In 2019/20 RSLs reported an aggregated net actuarial gain of £156.0m (2018/19 £(90.2)m loss). That level of gain was unusually high, especially following the high loss in the previous year. 2018/19 was the first year where RSLs offering the SHAPS DB scheme were able to fully disclose their individual pension liability. Prior to that, the majority, by FRS 102 exemption on multi-employer schemes, treated pensions for accounting purposes as DC schemes not DB as it was deemed not possible to calculate the individual liabilities from a multi-employer scheme.

The impact of this first time incorporation of full SHAPS liabilities was a material rise in the aggregate net pension liability to £212.7m. In 2019/20 there was a significant swing the other way, with the net liability dropping to £50.1m. We see the causes of this variance as broadly twofold; 2018/19 included significant one-off charges on the initial recognition of DB schemes and a favourable swing in 2019/20 from a net actuarial loss to a gain. A brief analysis of the £50.1m net liability shows the following:

[2] Source: Economic and fiscal outlook – November 2020 - Office for Budget Responsibility (obr.uk)

- two RSLs recorded a pension scheme asset (2018/19 2)
- 42 RSLs had no pension asset or liability (2018/19 21)
- 108 RSLS had a pension liability (2018/19 135)
- the maximum liability for an individual RSL was £13.6m (2018/19 £15.8m)

RSLs who continue to contribute to a DB scheme run the risk that the liability for servicing the past service element of the provision will increase. And this does not take into account the increasing and unquantifiable liability of existing active members.

The next triennial SHAPS valuation is due in September 2021 and whilst the funding position has improved considerably, there is no guarantee that this will continue. The COVID-19 impact on global markets is also expected to be felt for some considerable time yet, and there is no guarantee going forward that the drop in liabilities seen in 2019/20 will be sustained and consequently, RSLs cannot quantify their future costs and liabilities.

Pension Scheme Types

In previous years, there had been a steady movement away from DB schemes to DC schemes, although this has showed signs of slowing recently.

The main DB schemes are Final Salary (FS) and Career Average Revalued Earnings (CARE). Pensions are calculated as a percentage of employee’s final or average salary, meaning there will always remain an unknown future liability for the employer.

DC schemes, on the other hand, are dependent on the investment performance of the scheme and the level of contributions received on behalf of each employee. The total contributions at retirement purchase an annuity which then pays the pension.

Key points to note are:

- 44 RSLs continue to have employees in a FS pension scheme
- RSLs with active DC schemes continue to rise, up three to 131
- Three RSLs have no employees and therefore no pension scheme

An analysis based on the number of employees shows a similar trend of reducing DB members and increasing DC members.

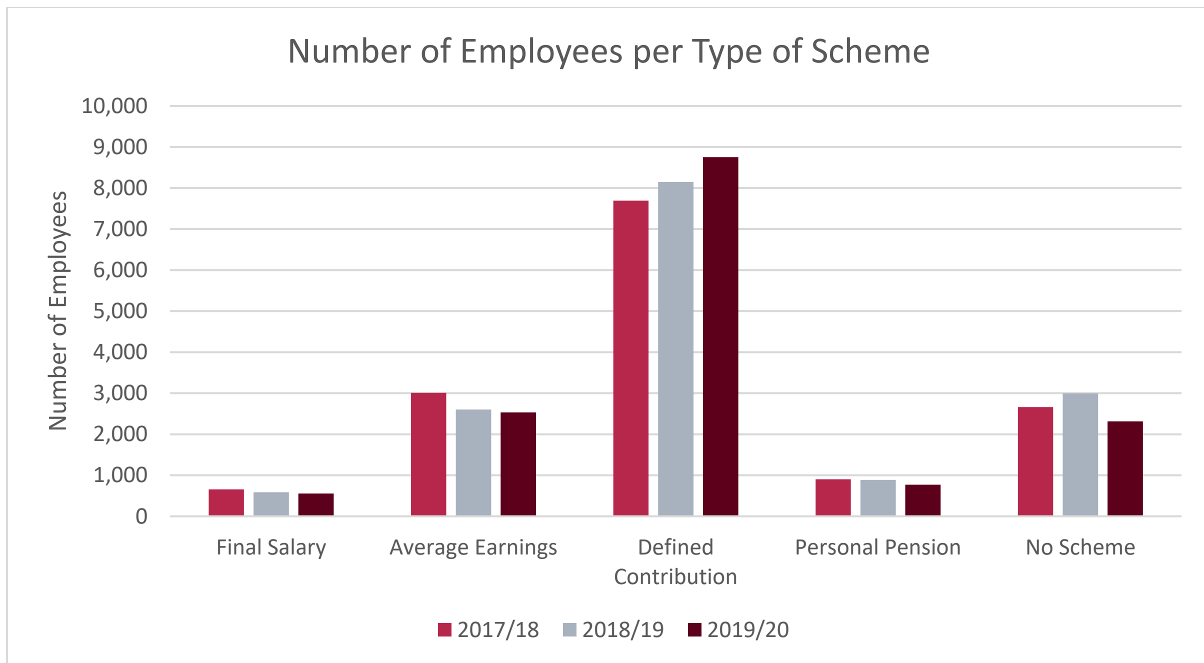

Figure 6: Number of employees contributing to different types of pension scheme

In 2019/20, there were 14,926 employees (2018/19 15,218) of which 12,613 (2018/19 12,223) were in a pension scheme. The key points are:

- DC remains the scheme type with the largest membership, up from last year at 58.6% of total members (2018/19 53.6%)
- DC membership increased again in 2019/20 to 8,753 (2018/19 8,149)
- the reduction in FS membership continues to slow, falling to 557 (2018/19 585 members)
- another drop in CARE schemes to 2,532 members (2018/19 2,604)
- employees in no pension scheme has taken a considerable drop, down 23% to 2,313 (2018/19 2,995)
- Personal pension employees have fallen again, to 771 (2018/19 885)

Scheme Providers

The main scheme providers are SHAPS and the Local Government Pension Schemes (LGPS). As in prior years:

- SHAPS remains the largest single provider with 34.7% of current employees
- LGPS remains the second largest with 12.4%

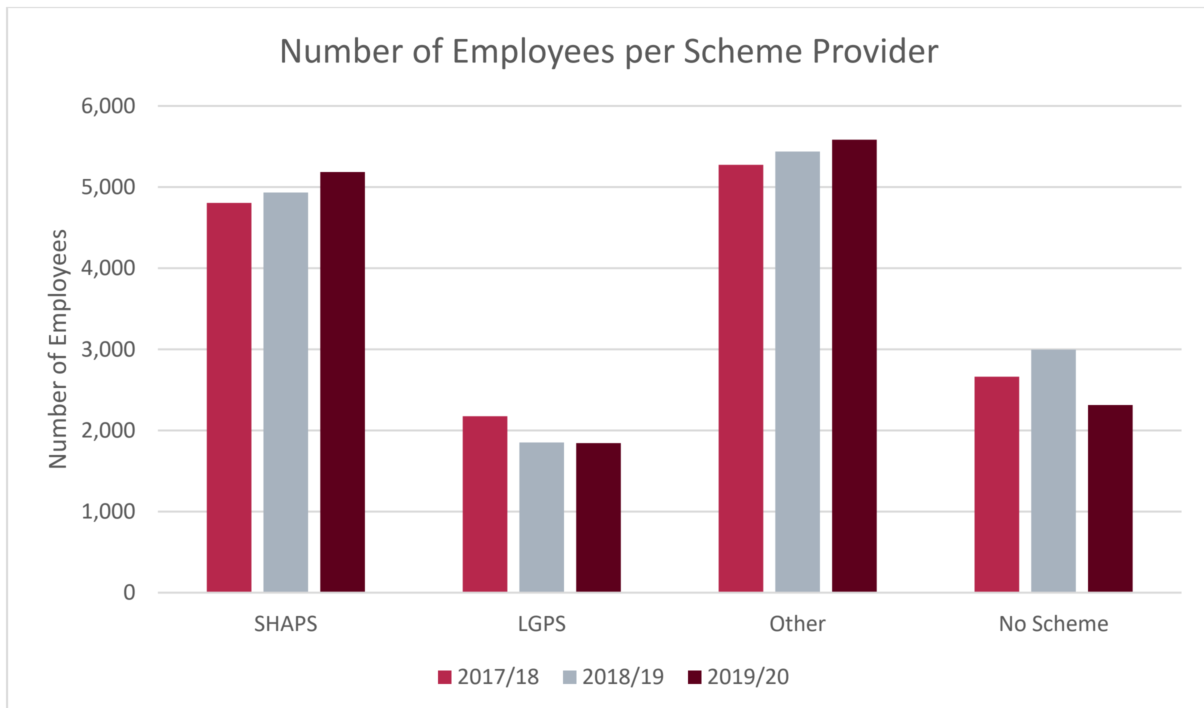

Figure 7: Number of employees contributing to different pension scheme providers

One key difference between SHAPS and LGPS is that SHAPS allows employers to move from DB to DC without incurring a cessation penalty. Such penalties arise when withdrawing from a scheme causing the full pension liability to crystallise and with LGPS offering limited switch options a subsequent cessation penalty can arise. For most RSLs, a cessation penalty would be far beyond their ability to pay so RSLs in LGPS face a far greater financial risk by being unable to exercise a move from DB and unable therefore to exert some degree of control over their future pension costs and liabilities.

LGPS moved from FS to CARE on 1 April 2015. During 2019/20, 32 RSLs (2018/19 32) were members of the LGPS with 1,843 employees (2018/19 1,851) making contributions.

Profile by Scheme Type

This analysis looks at the various types of pension scheme that RSLs offer. The profile has noticeably changed over the last couple of years, coinciding with what for many RSLs was the introduction of the full SHAPS defined benefit liability to the balance sheet.

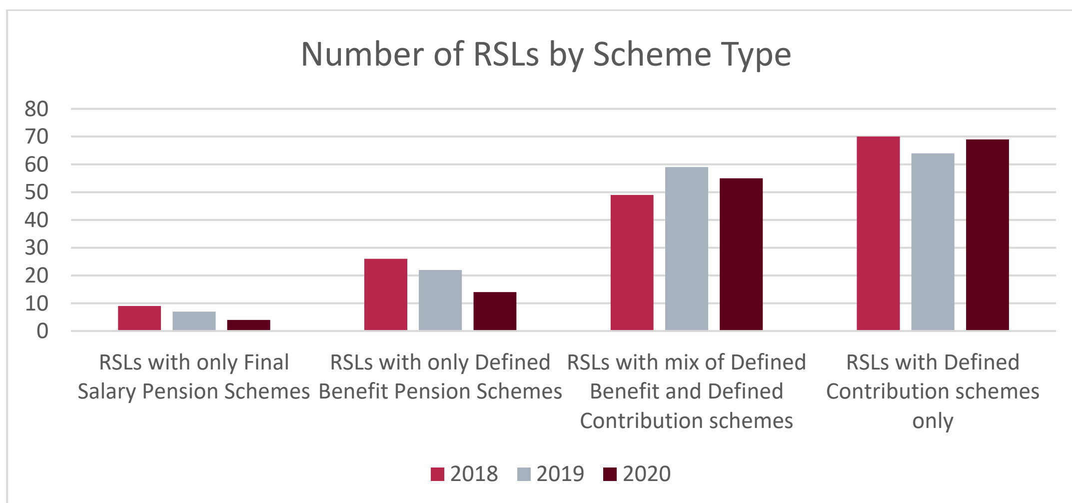

Figure 8: Number of RSLs with different types of pension scheme

In 2019/20:

- 69 RSLs only provide a DC scheme for employees (2018/19 64)
- Now only four RSLs offer only a FS scheme (2018/19 7) and a further 14 have a CARE scheme
- 55 RSLs offer both DB and DC, with 32 of those having at least 50% of their employees in a DB scheme

As noted in prior years, we discussed this with these landlords and concluded that they came to the decision that the DB scheme was no longer justifiable. This was due to the risk to their longer term solvency and being in the best interests of tenants.

There are still more than half of all RSLs with some exposure to DB schemes. We expect RSLs to take pension affordability into account in both their financial projections and their business planning and if they continue to offer DB schemes, we also expect this to be in conjunction with a consideration of the potential impact on rent levels, cost efficiencies and value for money.

The Impact of the Pandemic

On 11 March 2020, the World Health Organisation declared that the COVID-19 virus was a global pandemic. The UK Government announced on 23 March 2020 that the whole country would be going into lockdown and since then a variety of restrictions have remained in place to prevent widespread transmission of the virus.

In recognition of this, we made a decision to pause our normal regulatory engagement with RSLs to allow them to focus on dealing with the effects of the pandemic. Following a request from the Social Housing Resilience Group, we implemented a monthly data collection return collecting key information on the impact of the pandemic. The limited financial data that we have collected would indicate that the sector's financial performance remains robust.

The aggregate cash balance for the sector has increased from £848m at 1 April 2020 to £1.03bn at 31 March 2021, an increase of over 21%. The forecast closing cash balance at 31 March 2021 was £737m based on the FYFPs meaning that the actual cash position has improved by almost 40% compared to the forecast. The main reason for this is likely to be the lower levels of planned maintenance and development spend experienced as a result of the restrictions that have been in place. As RSLs start to catch up on this work, they will need to be aware of any impact on their interest cover covenant calculations. Where issues are identified, it is important that RSLs speak to lenders and SHR at the earliest opportunity.

Overall, at sector level, cash balances have increased and remain positive. Where our analysis has indicated that any individual RSL was potentially experiencing cash flow issues we have engaged with them on an individual basis to gain further understanding.

Aggregate gross arrears for the sector have remained relatively flat across 2020/21 with the minimum of 4.37% occurring in March 2021 and the maximum of 4.73% occurring in August 2020. However, this includes a number of RSLs who have experienced high levels of gross arrears and we have engaged with them on an individual basis to gain an understanding of how they are managing this.

Voids increased over the initial period of lockdown with the total number of empty homes peaking at 4,667 in June 2020. Since then, the total number of voids has been decreasing steadily and the levels are now currently lower than they were at the beginning of the year.

The Next Five Years

Aggregate projections to 2024/25

We now get annual FYFPs from all RSLs, whereas previously they were not a requirement for those with less than 250 units who were not actively developing. This means that we are able to report more fully on the trends coming out of these projections and on what direction the sector sees itself travelling in the short to medium term. For this report, the projections cover the period from 2020/21 to 2024/25.

The analysis is at a higher level than the review of the 2019/20 financial statements. This is, in part, to respect the uncertainty brought about by the worldwide COVID-19 pandemic. We absolutely appreciate that there has been, and will continue to be, significant financial implications for all RSLs individually and for the sector as a whole, now and going forward, but at the same time, we also wish to acknowledge the work that goes into producing these projections each year.

Turnover, costs, surpluses and inflation

The headlines from the aggregate 2020 FYFPs are that turnover is forecast to increase annually by an average of 3.7% over the next five years whereas operating costs are forecast to increase by 2.5% per annum. Overall, turnover is set to increase by 19.8% to £2.1bn and operating costs by 13.0% to £1.6bn.

The trend towards turnover increasing at a faster rate than operating costs has been evident over recent FYFPs. In the 2020 models, both 2020/21 and 2024/25 have operating costs increasing at a faster rate than turnover (3.4% compared to 0.9% and 1.4% compared to 2.7%) with the other three years seeing turnover increase by at least two percentage points more than operating costs. Indeed for 2022/23, the difference is 5.2 percentage points.
To put this into context, aggregate five year inflation forecasts are between 1.88% and 2.18% with the annual average being 2.08%. Rent increases are forecast to have margins on top of that of between 0.39% and 0.47%, an annual average of 0.43%, whereas operating costs are forecast to have margins of between 0.16% and 0.25%, an average of 0.21%.

Affordable lettings remain the main source of income for RSLs, but a number of other regular sources of income continue to make up the total turnover as can be seen in Table 17.

	2020/21	2021/22	2022/23	2023/24	2024/25
Net rents and service charges	79.64%	79.26%	78.71%	78.77%	80.43%
Developments for sale	0.54%	1.17%	0.27%	0.15%	0.14%
Grants released from deferred income	8.98%	8.85%	11.15%	11.67%	9.88%
Grants from Scottish Ministers	0.71%	0.96%	0.74%	0.47%	0.47%
Other grants	0.92%	0.90%	0.45%	0.42%	0.42%
Other income	9.20%	8.87%	8.68%	8.51%	8.65%

Table 17: Forecast turnover split, 2020 FYFP

Other income consists mainly of care or support activities and continues to be a major source of income for a number of RSLs. However, another key driver for turnover is now grants released from deferred income. This does not generate any additional cash for RSLs

and is dictated by accounting policy choice. The higher levels noted in Years 3 & 4 of the projections reflects RSLs with development who have adopted the performance method for accounting for grants.

The outcome of all of this is that operating surpluses are forecast to increase from £319 million in 2020/21 to £513m in 2024/25.

Interest payable is also forecast to increase from £197m in 2020/21 to £255m in 2024/25 both as a result of the increase in the level of outstanding debt and increases in the interest rates that are being forecast. Despite this, net surpluses rise by an average of 5.7% each year, eventually reaching £260m in 2024/25 (see Figure 9).

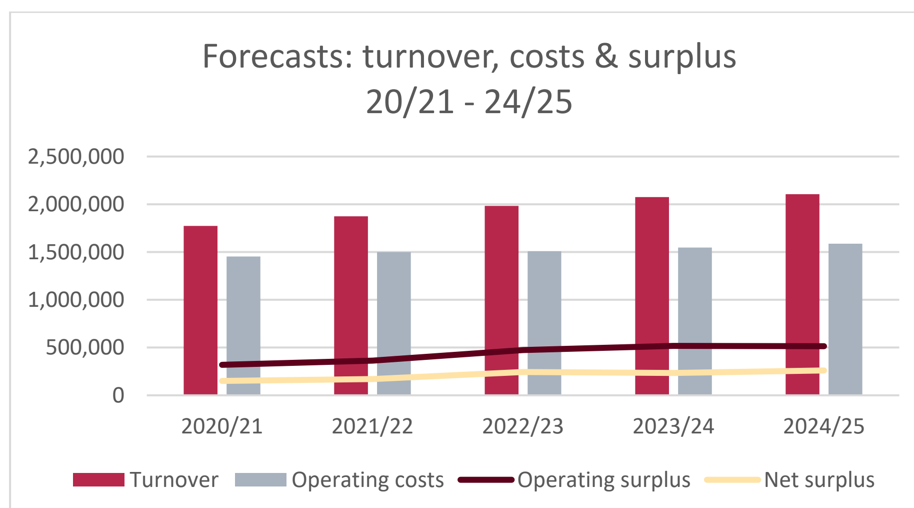

Figure 9: Turnover, operating costs and surplus, 2020 FYFP

Financial position and cash generation

The projected aggregate financial position headline is the continuation of steady growth in net assets. With an average annual increase of 4.7%, it is worth noting that this is not the result of projected period of significant fluctuations up and down, but instead reflects steady year on year increases in growth from 3.3% in 2020/21 to 5.6% in 2024/25. This will take aggregated net assets to £4.85bn by the end of the current FYFP period with net housing assets increasing to £16.9bn

Net rent arrears were forecast to increase sharply in 2020/21 both in monetary and percentage terms. They then show a moderate monetary increase in 2021/22 before dropping off slightly in the remaining three years. However, as a percentage of turnover, they fall from 3.9% in 2020/21 to 3.2% in 2024/25. It is likely that this is at least partly due to the projected impact of the pandemic, especially around the potential end date of furlough payments.

The sector retains a fairly high level of cash in the short to medium term. However, they are forecasting significant cash outflows over the first three years, dropping by 43% to £472.2m. It then recovers over the final two years to reach £530.1m by the end of 2024/25. A summary of the net current asset position is shown in Figure 10.

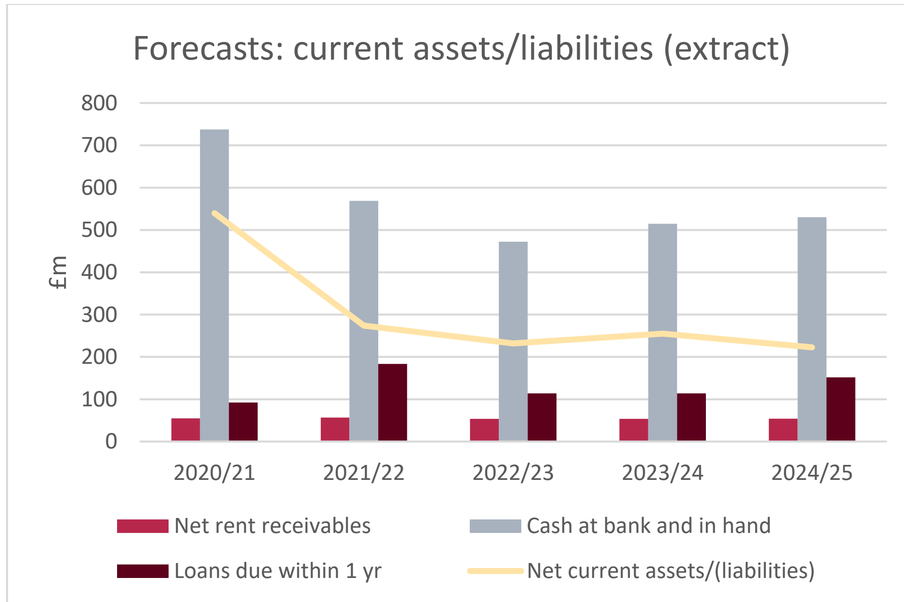

Figure 10: Extract of forecast net current assets, 2020 FYFP

Across the same period, we also see a projected increase in funding of 25.29% to £6.1bn. As with the asset values, the trend for the increases is at a reducing rate from 8.01% in 2020/21 to 0.90% in 2024/25. Again, this is largely consistent with the pattern of development activity. The level of debt by 2024/25 is as follows:

- loans outstanding due within 1 year increase to £153.5m
- loans outstanding due after more than 1 year increase to £5.9bn

As can be seen from Figure 10, net current assets are forecast to decrease over the five year period from a high point of £539.7m in 2020/21 to £222.6m in 2024/25. The high figure for 2020/21 is driven by the cash balance which has resulted from debt drawdowns in previous years that have yet to be utilised. This figure is likely to be even higher based on the monthly COVID-19 returns submitted during 2020/21 which showed cash balances continuing to increase, reaching £1.03bn at 31 March 2021. However, in all years, the figure remains positive and the current ratio is stable in most years at around 1.5.

As we have said elsewhere, cash is crucial and sufficient cash generation remains key to the ongoing financial viability and longer term sustainability of individual RSLs as well as the sector as a whole. We will always take a keen interest in where and when cash is projected to go, whether maintaining the smooth running of day to day operations or sustaining a significant longer term development programme.

The headline figures from the aggregated cash flow are set out in Table 18.

	2020/21 (£m)	2021/22 (£m)	2022/23 (£m)	2023/24 (£m)	2024/25 (£m)
Net cash from operating activities	479	613	681	742	790
Returns on investment and servicing of finance	(189)	(209)	(224)	(239)	(248)
Capital expenditure and financial investment	(772)	(976)	(779)	(620)	(575)
Net cash from financing	390	404	226	160	49
Increase/(decrease) in net cash	(92)	(169)	(97)	42	16

Table 18: Extract of cash flows, 2020 FYFP

As can be seen from this, cash from operations is set to increase significantly to £790m by 2024/25. This is consistent with our previous comments that turnover is, on average increasing at a faster rate than operating costs. There is actually a reduction of 8.0% in 2020/21, however, this is followed by a steep increase of 27.9% in 2021/22 tapering off to 6.6% in 2024/25.

Interest paid continues to increase across the five years with the reducing levels of increase reflecting the profile of the increases in outstanding debt discussed earlier. RSLs are not forecasting any significant additional income from interest received with the figure hovering around the £4m mark in all five years.

The ratio of cash generated from operations to interest paid is initially forecast to follow a similar trend to the recent actual data, falling to 2.48 at the end of 2020/21. However, the figure increases rapidly after this, eventually reaching 3.13 in 2024/25 (see Table 19). The main driver of this is the rapid increase of net cash from operations previously discussed.

	2020/21	2021/22	2022/23	2023/24	2024/25
Net cash from operations (£m)	479.2	612.8	680.7	741.5	790.2
Interest paid (£m)	193.5	213.3	227.5	242.6	252.5
Ratio	2.48	2.87	2.99	3.06	3.13

Table 19: Ratio of cash generated from operations to interest paid, 2020 FYFP

The most volatile figure in the cash flow is capital expenditure and financial investment. Increases of 19.9% and 26.5% are experienced in the first two years before drops of 20.2%, 20.4% and 7.3% are then experienced. This reflects the profile of development commented on elsewhere in the report. It is also likely to reflect the re-profiling of investment spend that has been necessary as a result of the COVID-19 pandemic.

Financial ratios

Interest cover is forecast to remain healthy over the five years, despite a drop of 9.1% in 2020/21 to 249.8%. In the subsequent four years, it increases steadily to eventually reach 314.6% in 2024/25, which equates to an average of 292.4% across the projection period. This compares to an average figure of 261.4% in the 2019 FYFPs.

Interest cover continues to be of interest to lenders and is a common ratio for loan covenants. Whilst we remain aware that certain aspects of the ratio's calculation can vary from RSL to RSL and from lender to lender, it means that it can be difficult to compare published aggregated figures and what RSLs report to their governing bodies and lenders. What we can say is that, whatever the nuances of the calculations, the aggregate figure is strengthening in the short to medium term.

A summary of the forecast interest cover and gearing figures is provided in Table 20.

	2020/21	2021/22	2022/23	2023/24	2024/25
Interest cover (%)	249.8	289.2	301.0	307.2	314.6
EBITDA MRI (%)	215.89	200.66	253.29	274.54	261.13
Gearing (%)	113.0	122.5	123.8	119.9	114.2

Table 20 Interest cover and gearing forecasts, 2020 FYFP

Lower levels of planned maintenance and development spend experienced as a result of the restrictions that have been in place means many RSLs have projected significant increases in spend on existing stock. This is expected to supress EBITDA MRI interest cover levels in the next five years. The latest forecasts indicate that the EBITDA MRI interest cover levels for RSLs over the next three years will decrease markedly before increasing to current levels in Year 4.

The increase in gearing in the early years reflects the rapid increase in debt finance in that period. Even though debt continues to increase over the full five year period, the rate of increase slows and the increase in net assets causes the gearing levels to fall. The levels of gearing experienced by RSLs reflects the nature of the sector and the reliance on both grant and private finance to fund developments.

Treasury management remains key and we will always expect RSLs to plan their treasury requirements well in advance. For any RSL, the relationship they have with their lender is important and will remain so going forward. We know the financial profiles of RSLs will experience some volatility over the next 12 months as they experienced a reduction in maintenance/investment spend in 2020/21.

Many RSLs may be looking to address a “catch up” requirement for the repairs and investment work not done in 2020/21, but those RSLs with an “EBITDA MRI” interest cover covenant may find themselves unable to do this without breaching covenants. Reporting on covenant compliance should, more than ever, be a key discipline for RSL finance staff, with close monitoring of loan agreements to ensure ongoing compliance with them and the covenants.

Alongside improving interest cover, the key profitability ratios also project an upward trend (see Table 21).

	2020/21	2021/22	2022/23	2023/24	2024/25
Gross surplus/(deficit) (%)	18.0	19.4	23.9	24.9	24.4
EBITDA to revenue (%)	21.3	20.2	26.5	29.5	28.8
Net surplus/(deficit) (%)	8.5	9.1	12.3	11.3	12.4

Table 21: Forecast profitability, 2020 FYFP

Of greater interest for some at this time is the forecast impact of the COVID-19 pandemic, in conjunction with the continued impact of Universal Credit, on voids, arrears and bad debts. Table 22 sets out the sector position from the FYFPs.

	2020/21	2021/22	2022/23	2023/24	2024/25
Voids (%)	1.7	1.5	1.4	1.3	1.3
Arrears (%)	3.9	3.8	3.4	3.3	3.2
Bad debts (%)	2.1	1.7	1.6	1.5	1.5

Table 22: Forecast voids, arrears and bad debts, 2020 FYFP

As can be seen from this, in terms of percentages, the sector is anticipating that following spikes in 2020/21, these will reduce over the remaining years of the projections. This is also reflected by reductions in the monetary amounts of each of these. The impact of all of this is that the average rates over five years are broadly similar to the projections from 2019 suggesting that RSLs feel that their planning assumptions are sufficiently prudent to absorb most of the potential impacts of the COVID-19 pandemic.

Future development and improvement

2021 marks the end of the Scottish Government commitment to deliver 50,000 affordable homes within the current Parliament. Future grant rates are uncertain at the time of writing and this is likely to have impacted the level of development that is being forecast in the medium term. A summary of the current development plans is shown in Table 23.

	2020/21	2021/22	2022/23	2023/24	2024/25
New social rent properties added	5,250	7,203	6,388	3,435	2,649
New MMR properties added	770	947	1,313	812	533
New Low Costs Home Ownership properties added	0	84	91	44	8
New properties - other tenures added	5	0	30	0	0
Total number of new affordable housing units added during year	6,025	8,234	7,822	4,291	3,190

Table 23: Forecast development numbers, 2020 FYFP

When considering the development programmes projected by RSLs, it is important to bear in mind that whilst some RSLs include their aspirational plans, many RSLs only include developments in their projections where there is a clear commitment or where a site has been identified. This will lead to a natural tailing off of projections in the later years.

The total number of units forecast to be developed of just under 30,000 is a slight reduction compared to the 2019 FYFP figure of just over 32,000. The new units will be funded mainly by social housing grant of £2.1bn (48.8% of the total cost) and private finance of £1.9bn (44.0% of the total cost). A full breakdown of the forecast development funding based on the year that the units are due to be completed is provided in Table 24.

	2020/21 (£'000)	2021/22 (£'000)	2022/23 (£'000)	2023/24 (£'000)	2024/25 (£'000)
HAG	445,735	603,327	562,260	315,765	216,386
Other Public Subsidy	4,526	6,116	2,988	909	150
Private Finance	405,028	542,647	459,366	303,446	221,087
Sales	1,192	28,264	15,652	10,445	5,656
Cash Reserves	50,448	59,623	50,963	37,140	36,872
Other Finance	534	0	6,163	0	0
Total Cost Of New Units	907,462	1,239,977	1,097,393	667,705	480,151

Table 24: Forecast funding of new development, 2020 FYFP

In addition to the more traditional methods of financing development, a small number of RSLs are looking to use the proceeds of sales. Whilst the numbers remain small at this time, the risk attached is greater as it relies on the ability to be able to sell the properties at a high enough price and volume to meet the required investment in new properties.

Whilst the level of development being forecast has fallen slightly, the overall numbers remain high. A small number of RSLs are responsible for the majority of the development, however, there remains a significant number of RSLs who are developing for the first time in a number of years or, in some cases, for the first time ever. RSLs should refer to our development thematic when making decisions about whether to undertake a development project. The thematic sets out 10 positive practice principles that will assist governing bodies as they go through the process.

COVID-19 has led to significant disruption to RSL developments. Delays or increased cost pressures caused by supply chain disruption and changes to working practices have seen development risk increase. The general slowdown in economic activity has increased risk of business failure, including in the construction sector. It is important that RSLs have appropriate plans in place to mitigate these risks.

The projected scale of growth in units, and as a consequence debt, will in turn have an impact on the level of interest payable. The percentage of turnover required to service the interest payable shows marginal increases across the five years from 11.11% in 2020/21 to 12.11% in 2024/25. This compares to the percentage of turnover spent on revenue planned

maintenance which falls from 9.75% in 2020/21 to 7.8% in 2024/25. The aggregate FYFP continues to show a tendency for the cost base to move towards RSLs spending a greater proportion of their income on indirect costs such as interest payable.

In addition to the new development programme, many RSLs are forecasting significant capital expenditure on their existing properties. In total, they are projecting spend of almost £1.5bn over five years which equates to £4,691 per property.

RSLs have significant additional investment requirements in relation to both EESSH and their pre-1919 stock. In total, they are forecasting capital and revenue spend of £165m on EESSH requirements and £241m on pre-1919 properties, the majority of which are likely to be tenements. Based on information provided to us on numbers of pre-1919 properties owned, this equates to a cost of almost £22,000 per unit.

It is important that RSLs fully understand the condition of the stock that they own and what investment is required to maintain it. This includes any additional requirements in relation to Health and Safety as a result of reviews by SG. A good asset management strategy, with clear links to financial projections and business plans, will help to increase confidence in the long term viability of the RSL.

Difficult choices may have to be made by RSLs between essential ongoing investment in the existing housing stock and contributing to new supply. The needs of current tenants will have to be balanced with future demands and forecasts from RSLs would indicate unprecedented levels of debt need to be raised and serviced.

Rent increases and inflation

Looking forward, our analysis of the inflationary assumptions in the FYFP returns compared to the forecast figures published by the OBR in November 2020[3] shows that RSL rents will increase by around 2.5% each year. This compares unfavourably to the forecast for both CPI and RPI in the short term as can be seen in Figure 11.

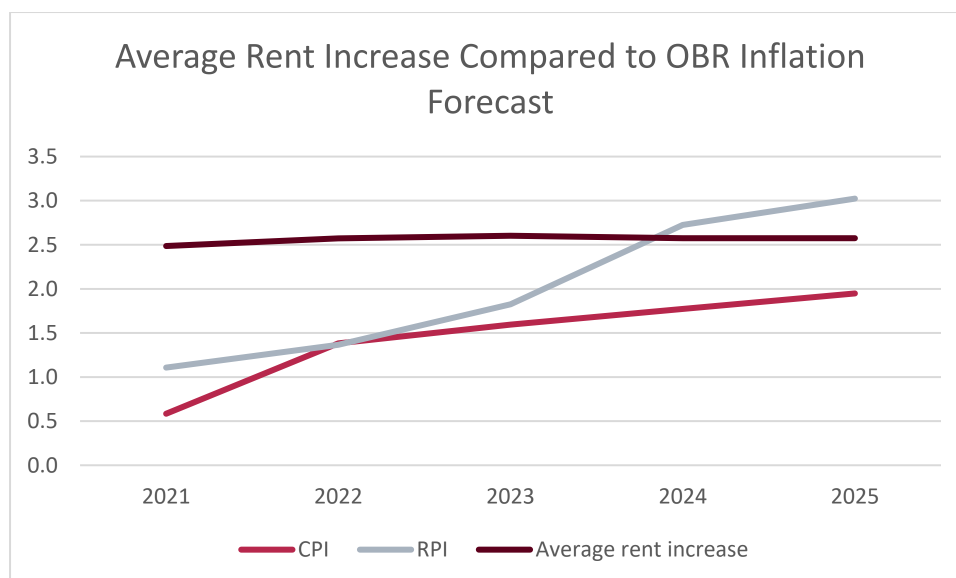

Figure 11: Average RSL rent increases per the FYFP compared to OBR inflation forecasts

The rates being forecast by the OBR have been severely affected by the COVID-19 pandemic with CPI now forecast to be below the Bank of England target rate of 2% until at

[3] Source: Economic and fiscal outlook – November 2020 - Office for Budget Responsibility (obr.uk)

least 2025/26. However, RPI is expected to increase more quickly and from 2023/24 moves above the average rent increase being forecast.

Considering this from an individual RSL level, the spread of rent increases compared to inflation is shown in Table 25.

	2021	2022	2023	2024	2025
Average rent increase (%)	2.49	2.57	2.60	2.57	2.57
CPI or less	2	3	6	6	6
CPI to RPI	3	0	0	76	132
RPI or more	148	150	147	71	15

Table 25: Spread of RSL rent increases compared to OBR forecasts of inflation

As can be seen from this, the majority of RSLs are forecasting that rents will increase more quickly than RPI for the first three years in the FYFP. For the final two years this moves towards rents increasing more quickly than CPI, but not RPI. Very few RSLs are forecasting increases of CPI or below whereas, in the latter period of last year's FYFP, just over 20% of RSLs were forecasting increases of CPI or below. The implication of this is that for three years rents are forecast to increase at a level that is well above the level that CPI is forecast to increase by. This is likely to increase the pressure on how affordable rents are to tenants, especially with the movement towards Universal Credit where the responsibility for paying rents lies with the individual.

The trend of rents being forecast to increase above CPI has been in evidence over the last few years. Our expectations around rent affordability are set out in Regulatory Standard 3 which requires each RSL to manage its resources to ensure its financial well-being, while maintaining rents at a level that tenants can afford to pay.

RSLs face the potentially conflicting and difficult challenges of keeping rents at levels that tenants can afford to pay but at the same time continuing to provide all of the tenant services and maintenance whilst building the necessary financial headroom for the risks they face.

The drivers of rent increases can be many and complex, with some of them beyond the control of RSLs. However, tenants are finding it more difficult to afford their rent. Our National Panel of Tenants and Service Users reported in October 2020 that:

- nearly a third are not managing well financially at present (31%), and the same proportion are not managing well with their housing costs (31%).
- over a quarter often have to delay or miss paying a bill (28%), and nearly half indicated that money worries have a bad effect on their relationships.
- around half have experienced difficulties affording their rent (51%), with nearly three quarters experiencing difficulties with non-housing bills (74%).
- 80% were concerned about the future affordability of their rent. These concerns were most commonly related to future rent increases.
- most respondents had experienced difficulty heating their home (62%).

Rent increases above inflation are likely to become less affordable for tenants who have other pressures on their income such as low wages, food and fuel poverty to contend with.

We require landlords to:

- demonstrate to their tenants that their rents will remain affordable and that they have effective dialogue with their tenants on rent levels and increases.
- vigorously pursue cost efficiency and value for money.

Cost efficiency and value for money will be crucial in keeping rents affordable in the coming years. Landlords do considerable work in this area, but we are asking whether more can be done. They need to critically question whether everything possible has been done to be efficient and drive costs from their business, before passing costs onto tenants.

Projected borrowings

Our analysis of the FYFPs shows that RSLs expect to increase debt to just over £6bn by 2024/25, an increase of around £1.2bn over the five years. In comparison to the £1.5bn increase forecast last year, this is a slight reduction. However, the higher starting point means that total debt after five years is higher than previously forecast (see Figure 12).

Whilst the level of increase in outstanding loan balances has decreased, the amount of additional loan finance being forecast remains significant. However, lenders continue to indicate that the sector remains an attractive option and we expect RSLs will be able to access new funding for their development and investment programmes.

At the time of writing, the Bank of England base rate of interest is at the historically low level of 0.1% due in part to the combined impact of the COVID-19 pandemic and Brexit. The OBR are forecasting that this will reduce further and will actually be below zero for a significant period of time. This is likely to impact on the interest rates being paid by RSLs for any new borrowing and we would expect this to be incorporated into assumptions for long term projections and any associated sensitivity analysis.

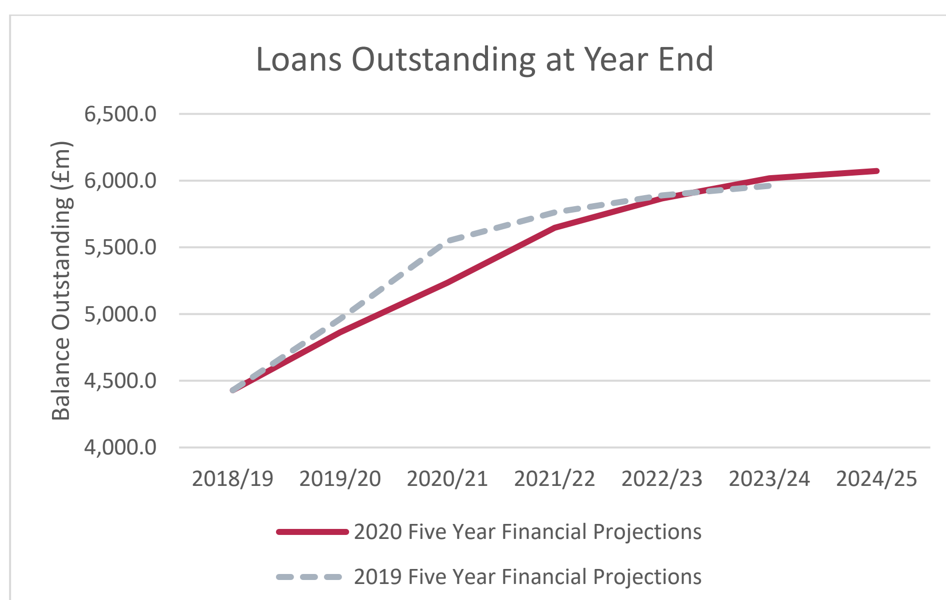

Figure 12: Loan balances outstanding from AFS and FYFP

As part of the risk analysis of their treasury proposals, we expect RSLs to consider all of the benefits and drawbacks of the different forms of finance that are available, taking professional advice as necessary. This will include being very clear on what type of relationship the lender has with its clients.

Glossary

Annual Return on the Charter (ARC)	The annual return that collates data on the indicators from the Scottish Social Housing Charter.
Audited Financial Statements (AFS) return	The annual return that collates data from the audited financial statements of RSLs.
Care organisation	Any organisation employing greater than 50% of their FTE staff in a care role.
Career average revalued earnings (CARE)	A defined benefit (DB) pension scheme based on the average salary across each year of scheme membership.
Consumer Prices Index (CPI)	The benchmark inflation rate calculated by the Office of National Statistics (ONS) and used by the Bank of England to determine monetary policy.
Defined benefit (DB)	A pension scheme that pays benefits based on a link to employee salary and where the risk lies with the employer.
Defined contribution (DC)	A pension scheme that pays benefits based on the level of contributions paid into a fund and where the risk lies with the employee.
EBITDA MRI (Earnings Before Interest, Tax, Depreciation, Amortisation, Major. Repairs Included)	[(Operating surplus + depreciation + impairment – capitalised maintenance costs) / interest payable]. A version of interest cover commonly used as a loan covenant.
Final salary (FS)	A DB pension scheme that pays benefits based on the highest salary in the last 3 years of scheme membership.
Five year financial projections (FYFP)	The annual return that collates 5 year financial projection submissions from RSLs.
Gearing	[(Total outstanding debt – cash & cash equivalents)/net assets]. Commonly used as a loan covenant, the calculation used by SHR cannot generally be compared to covenant calculations as it does not adjust for grants held as deferred income in the statement of financial position.
Housing Association Grant (HAG)	Grant funding provide by the Scottish Government to part finance the development or purchase of social housing by an RSL.
Interest cover	[(Net cash from operating activities + interest received) / interest paid]. Commonly used as a loan covenant, the calculation used by SHR cannot generally be compared to the covenant calculations as it is based on figures from the cash flow 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.
Loan Portfolio (LP) return	The annual return that collates data on the outstanding debt held by RSLs.
Local Government Pension Scheme (LGPS)	The common name applied to all pension schemes offered by Local Authorities, for example the Strathclyde Pension Fund.
Performance method	Accounting policy choice allowing capital grants to be released as deferred income when the performance criteria related to the grant are met. Can only be used where housing assets are valued using a revaluation method.
Registered Social Landlord (RSL)	As registered under the Housing (Scotland) Act 2010 to provide Scottish Secure Tenancies. This does not include Local Authorities.
Retail Prices Index (RPI)	RPI is another ONS inflation rate, this one including housing costs.
Stock / unit numbers	The unit numbers entered into the Annual Financial Statements, or AFS, 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, how they manage the risks they face, and the impact these may have. We seek some additional assurance through our engagement 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.

Scottish Housing
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