REGULATING A DIVERSIFIED SECTOR

CONTENTS

This Good Practice Note is one in a series produced by the Housing Corporation. Each is linked to one or more of the fundamental obligations set out in our Regulatory Code and helps clarify our expectations of how associations will achieve compliance.

HOUSING CORPORATION

1 INTRODUCTION

1.1 Most housing associations were originally formed to provide below-market-price general needs housing. A number of them have, over time, become involved in a wider range of activities.

1.2 The Housing Corporation recognised this extension in the range of activities undertaken by housing associations and in May 2000 published *Regulating a diverse sector: the Housing Corporation's policy.* It set out our approach to regulating organisations delivering a range of different activities and services. The policy distinguished between activities which are regarded as social housing activities, and those which are regarded as non-social housing activities.

1.3 With the introduction of that policy, we sought to strike a balance between the proper protection of publicly funded assets and tenancies and enabling associations to innovate and respond to the dynamics of their local market, whilst recognising the importance of the sector maintaining its credit quality and lender confidence. Our policy sought, in the first instance, to measure the amount of diversification taking place. We now know, as published in our recent Sector Study 30b *Diversification: assessing the effects of the Housing Corporation's policy in Regulating a diverse sector,* that around 3% of the sector's stock is defined as non-social housing. We believe that the time is right to place less emphasis on definitions and greater emphasis on the importance and need for robust risk analysis and management. In revising our policy we have taken account of our experience since publication of the Regulatory Code, of changes in the operating environment of associations and past commitments made to the Public Accounts Committee in respect of the protection of public investment (Appendix 1).

1.4 Our fundamental expectation is that associations should ensure that they comply, and continue to comply, with the Regulatory Code as they take decisions on diversification. The aspects of the Regulatory Code which are particularly relevant to this policy are:

Housing associations must operate a framework that effectively identifies and manages risks: identifying all major risks that might prevent them achieving their objectives; with the necessary arrangements to manage risks and mitigate their effects. Regulatory Code paragraph 1.2

and

Housing associations must protect public investment: using their social housing assets only for social housing purposes; ensuring that their social housing assets are not placed at risk by non-social housing activities. Regulatory Code paragraph 2.4.

1.5 In considering whether to extend the range of business activities they undertake, associations must also take account of what activities are permitted by their governing instrument and more generally of the permissible purposes or objects as specified in s2 of the Housing Act 1996 and The Social Landlords (Additional Purposes or Objects) (No. 2) Order 1999.

1.6 The Corporation's expectations in relation to this Good Practice Note are set out in the accompanying Circular 04/04.

2 A RISK BASED APPROACH

2.1 As we emphasise in the Regulatory Code, effective and quantified risk management across all activities must be central to associations' governance and operations and be embedded in the culture of all associations. The framework for identifying and managing risk should be capable of differentiating between risk associated with current activities and those that arise from new and diversified activities. The balance of risks and rewards can then be assessed before deciding to undertake new activities, or to continue existing ones. Having the skills and experience to appropriately manage risk is as important as having the financial capacity to absorb risk.

2.2 Undertaking a rigorous risk assessment and implementing a robust risk management framework are key to ensuring that any risk to social housing assets and tenancies is minimised. As the majority of social housing has been funded, either directly or indirectly, by public funds, there is a legitimate public interest in those assets.

2.3 Our focus is on an association being able to demonstrate a clear business case for any investment and appropriate governance arrangements. Overall, an association should be able to assure itself and us that it has appropriate risk-management systems in place irrespective of the range of activities it undertakes. We expect the following mechanisms to be in place:

i the association's board has a clear role in determining the association's business approach. An association's board should set, and regularly review, its own 'prudential' limits on the different types and volumes of activity it will undertake. It is for each association to classify its different activities. These self-assessed limits for each activity, which will vary from one association to another depending on their business strategies, can be expressed as absolute figures or as a proportion of turnover or capital;

ii evidence of suitable skills and experience among board members and senior staff, together with the appropriate infrastructure, to undertake the association's range of activities;

iii a business plan and financial forecasts which reflect the types and level of activities and demonstrate a continuing ability to meet existing commitments, including those to existing lenders, as well as new commitments arising from diversification or other activities;

iv a risk-management framework, including risk appraisal and review mechanisms as well as scenario and sensitivity testing, that is capable of evaluating the different risks of each activity, their cumulative effect and the impact on the business as a whole;

v where applicable, an organisational or group structure with a clear purpose and well-defined framework, for the portfolio of activities.

2.4 Where we receive evidence that associations have proceeded with diversification without a clear and robust business case, we would regard this as a breach of the Regulatory Code and take appropriate regulatory action.

2.5 The Corporation has published a number guides on risk management including *A strategy for success: Effective risk amd business management and Ahead of the game: A good practice guide to business planning.* These and other publications are available on our website at **www.housingcorp.gov.uk**.

3 OUR DESCRIPTION OF SOCIAL HOUSING

3.1 We use as our description of social housing: *'homes for letting or low-cost home ownership and associated amenities and services, for people whose personal circumstances make it difficult for them to meet their housing needs in the open market'.*

3.2 We have taken the opportunity to clarify our description of social housing. However, there are inevitably grey areas in seeking to describe what we mean by social housing. We consider that our description includes the following types of activity and funding sources:

- housing (including supported housing) which:
  - has received public housing subsidy [1] or
  - has been transferred to a housing association from a public sector landlord (as defined in s63 of the Housing Act 1996) or
  - has been developed with charitable or other funds from private sources intended to provide social housing, for example stock built or purchased before government grant was available or
  - falls within the definitions of Temporary Social Housing or Temporary Market Rented Housing or
  - short-life leasing schemes for homeless families and similar activities which aim to tackle homelessness;
- Private Finance Initiative (PFI) schemes involving the ownership or management of social housing;
- management contracts of publicly owned

[1] Housing which has received public housing subsidy is defined as housing which has:
- been developed with grants or loans (or other public subsidy, as defined in Housing Corporation grant determinations for Social Housing Grant (SHG), and including free or discounted land) from the Housing Corporation, Local Authorities, Office of the Deputy Prime Minister or other governmental departments or agencies for the development or rehabilitation of housing stock; or
- been developed with donations from private companies in lieu of land as part of a planning agreement under s106 of the Town & Country Planning Act 1990; or
- had works done to it funded by Housing Association Grant or SHG.

housing for rent (including Local Authorities, Housing Action Trusts, government departments and other housing associations);
- shared ownership and low-cost home ownership schemes;
- housing for keyworkers in key public services (provided that the rent is below that prevailing in the market for similar accommodation, and the association has the power to control the letting, management and termination of the tenancies);
- care homes providing personal care (under Care Standards Act 2000);
- care homes providing adult placement where provided in general needs social housing;
- refurbishment, improvement or maintenance of social housing properties;
- property improvement, refurbishment or maintenance companies, provided the bulk of their work is concerned with social housing;
- regeneration work, defined as "improving areas that are recognised as being run down, neglected or otherwise deprived, where housing organisations have a role in improving the quality of life of present and future residents";
- Supporting People funded housing-related support activities including:
  i the provision of floating support;
  ii Home Improvement Agencies; and
  iii Care and Repair contracts;
- domiciliary and social care services (including the provision of services to non-housing association residents provided that at least some of the beneficiaries are housing association residents).

3.3 Our description of social housing excludes:

- market-rented housing;
- student accommodation;
- keyworker accommodation where the employer has control of lettings or the termination of tenancies;
- asylum seeker Home Office (NASS) contracted accommodation;
- care homes providing nursing care (under Care Standards Act 2000);
- build for sale on the open market.

3.4 If a unit has received any form of public subsidy in the past then it should be included as social housing regardless of the purpose of that unit. Unsubsidised housing may, however, also be categorised as social housing where it is let or sold in the same way and at the same rent levels or cost as subsidised social housing.

3.5 There are many instances where associations are working with tenants who require more than just the basic social housing, if those tenancies are to be sustainable. This means that developments which are predominantly social housing will often include buildings to facilitate the provision of essential services such as doctor's surgeries, advice centres, and training facilities. Where such elements are an integral part of the development and are addressed in the association's business case, the Corporation will not expect these to be separately identified and will regard the overall development as social housing.

3.6 The Corporation recognises that activities within our definition of social housing are not inherently less risky than activities which fall outside that definition. The key factor is whether or not an association has properly assessed and has the skills effectively to manage the risks arising from the activities it is involved in, whether they are social housing or not.

3.7 The inclusion of an activity within our description of social housing does not mean that grant funding is or will be available from the Corporation to support that activity.

4 MEASURING DIVERSIFICATION

4.1 In measuring diversification we look at the capital [2] and turnover [3] of activities that fall outside our description of social housing. Turnover is a more useful measure of service or contract-based activities. Capital is more likely to reflect bricks-and-mortar investment. Used alone, neither measure can fully capture the circumstances of all housing associations. We therefore use both measures in our assessment of associations' diverse activities.

4.2 If an association (or a group) derives at least 5% of its turnover or employs at least 5% of its capital in activities that fall outside our description of social housing then we require such associations (and the parent associations of diversified groups) to meet specific accounting disclosure requirements (currently set out in *The accounting requirements for registered social landlords: General determination 2000*).

4.3 We expect a majority of a housing association's business activities to be in social housing. We interpret 'majority' as meaning that 51% or more of an association's turnover or capital should be concerned with activities covered by our description of social housing. In assessing whether an association has breached or is likely to breach our interpretation, we will take account of the turnover of its diverse activities and the capital employed. In most circumstances we would not expect an association to breach 49% of turnover and capital.

4.4 If an association is operating close to this level, or above, we will also take the following factors into account:

- the origins, governing instruments, history and culture of the association and how these factors have influenced its existing portfolio of activities, its level of 'free' reserves and its strategic objectives;
- the nature of any further non-social housing activities and how far they complement the association's existing provision;
- the client group serviced by these activities; and
- the effect of previous Social Housing Grant (SHG) and Housing Association Grant (HAG) arrangements.

4.5 We will take account of an association's investment in a special purpose vehicle (SPV) or a joint venture company (JVC) when assessing the extent of an association's diversification.

4.6 Paragraphs 4.3 and 4.4 apply to:

i the group as a whole (that is, including registered and unregistered entities); and
ii each registered social landlord within the group.

We expect the group overall to meet our policy requirements, but we do not apply limits or controls on the activities of the non-registered entities in the group.

[2] We define capital as any fixed asset properties, including investment properties, but excluding office premises, which are:
- directly employed in the business of the organisation; and
- held at the balance sheet date at the value shown in the balance sheet (after depreciation but before deducting SHG and other public grants) or;
- held at valuation where a valuation has been used.

The fixed assets employed will depend on the size of the RSL and its accounting conventions (for example the basis of valuation and depreciation practices).

[3] Our definition of turnover is consistent with the format of the income and expenditure account set out in Appendix 1 to the Statement of Recommended Practice (SORP): Accounting by registered social landlords, Update 2002.

5 FUNDING OF NON-SOCIAL HOUSING ACTIVITIES

5.1 We expect an association which is seeking any new borrowings to do so in a way that minimises the risk to social housing assets and tenancies. This is the case whether the new borrowings are being used to fund social or non-social housing activities.

5.2 If surpluses are to be used to support funding of non-social housing activities the following principles should apply:

- accumulated surpluses derived from social housing may be used to fund non-social housing activities provided that social housing is not put at risk by use of such surpluses;
- associations must be able to demonstrate that any accumulated surpluses used in this way are not required to meet future costs and liabilities relating to their social housing;
- where an association initially uses its surpluses to invest in social housing, it may subsequently raise finance, to the extent of the original investment, on the security of those assets in order to release its surpluses for use elsewhere;
- where accumulated surpluses are invested in non-social housing activities, these can be undertaken by the association itself or an unregistered subsidiary, subject to the association having the appropriate constitutional powers in each case.

5.3 If an association is using its surpluses to support funding of non-social housing activities we expect it to take a prudent approach which would include taking a view about the level of surpluses required to be retained as a contingency.

5.4 Guidance for associations on assessing the availability of surpluses for the funding of non-social housing activities is attached at Appendix 2. This takes into account levels of different types of surpluses, the extent to which those surpluses can be and have been invested in housing properties and the additional loan funding which associations might be able to raise on the back of their social housing assets.

5.5 Guidance on how associations may fund diverse activities whilst minimising the risk to social housing assets and tenancies is attached at Appendix 3.

5.6 Associations will usually need to secure borrowings to fund diverse activities. We expect associations to apply the following hierarchy when deciding how to fund diverse activities. First recourse should be to secure the borrowing on non-social housing assets, second to utilise any available surpluses and finally associations may secure borrowing to fund diverse activities on social housing assets, but only if they are able to demonstrate:

- that any proposal to borrow against social housing assets is designed to support their social housing objectives (see 5.7 below);
- that there are satisfactory investment appraisal processes in operation;
- that they have a robust business case for non-social housing activities;
- that they have the capacity and skills to manage non-social housing activities;
- that they have received consent from appropriate funders, where applicable;
- that they have minimised the risk to their social housing assets and tenancies as a result of being involved in non-social housing activities; and
- that their overall performance (including their operational efficiency and service delivery performance) achieve a high standard and are not likely to be prejudiced.

5.7 The board, or its delegated committee, should consider, and approve, any proposal to secure borrowings on social housing assets to fund diverse activities, taking into account all of the requirements set out in paragraph 5.6. For example, we would not consider that a proposal to develop a standalone non-social housing development, even if projected to generate a profit to be used to cross-subsidise social housing activities, would be sufficient to satisfy the first bullet point in paragraph 5.6 above.

5.8 Paragraph 5.6 sets out our requirements where social housing properties are to be used to secure funding for diverse activities. We regard the criteria set out in paragraph 5.6 as good practice for associations which are considering new or additional involvement in any activity, regardless of whether or not it falls within our definition of social housing, and the nature of the security involved.

6 REGULATORY APPROACH TO DIVERSIFICATION

6.1 The introduction of the Regulatory Code in April 2002, and the new approach to regulation represented a move towards greater self-assessment. This note puts the onus on associations to take responsibility for the decisions they take and to ensure that they are properly able to manage the risks which follow on from those decisions. The association's board should review how it has complied with this policy when it considers its overall compliance with the Regulatory Code in its annual compliance statement.

6.2 The Corporation will monitor the involvement of associations in diverse activities through the review of financial statements and also through the collection of data in the RSR.

6.3 We will not conduct reviews of an association's diversification simply because a percentage of its activities are diverse. We will however select associations and assess compliance with this policy where we wish to be assured that the association is complying with our expectations on risk management, financial viability, protection of public investment and service delivery to tenants.

7 ENQUIRIES

7.1 If you wish to discuss any part of this good practice note further, please contact either:

- A member of the Regulation team at your local field office or
- FAEnquiries@housingcorp.gsx.gov.uk

APPENDIX 1

Commitments made to the Public Accounts Committee

1 ‘Regulating housing associations’ management of financial risk’ January 2002

The Committee recommended that the Corporation should ensure that RSLs’ commercial ventures do not jeopardise the provision of social housing, or the tax payers funds invested in that housing.

The Corporation agreed that the regulatory framework for housing associations should continue to guard against this risk.

2 ‘Improving housing through transfer’ March 2003

The Committee recommended that the Corporation should influence the use of surpluses from large scale voluntary transfer by RSLs into furthering social and related housing objectives.

The Corporation agreed, noting that as regulator of the sector it is already mindful of the importance of ensuring registered social landlords are contributing to ensuring the stock they own and the communities in which they work are sustainable.

APPENDIX 2

Guidance for associations on assessing the availability of surpluses for the funding of non-social housing activities

1 The general rule is that associations are free to invest their accumulated surpluses in either social or non-social housing activities, regardless of whether those surpluses have been generated from social or non-social housing activities.

2 As the board of an association may ‘undesignate’ designated surpluses, there may be circumstances where it is appropriate for designated surpluses to be regarded as available for funding non-social housing activities, for example where the association’s business plan does not anticipate net reductions in the level of designated surpluses in the future.

3 In assessing the availability of surpluses for the funding of non-social housing activities, the board may also wish to consider the additional loan funding it could raise on existing social housing properties, where the balance sheet shows a funding gap between net book value and loans on social housing properties. The additional funding used in the calculation here should not exceed the funding gap.

4 The assessment of the surpluses available for investment in non-social housing activities should not be seen as a one-off exercise at the time of making the investment decision, it is relevant on an ongoing basis. Consideration should therefore be given to the impact which anticipated future deficits would have on the assessment. We expect an association to take a prudent approach, which would include taking a view about the level of surpluses required to be retained as a contingency.

5 **Example 1**

An association has the following summarised (and re-ordered) balance sheet:

	£000
Net book value of social housing properties net of loan funding	500
Net book value of non-social housing properties net of loan funding	100
Net current assets	200
	800
Revenue reserves	450
Designated reserves	200
Restricted reserves	150
	800

Notes
1. The association is making surpluses on a consistent basis, and anticipates that this will continue in its business plan. As a result both revenue and designated reserves are predicted to increase in the future.
2. The association estimates that it could secure additional loan funding of £325,000 on its social housing properties.

The association calculates the surpluses available for additional investment in non-social housing activities at the balance sheet date as:

	£000
Revenue reserves	450
Designated reserves	200
Net book value of social housing properties net of loan funding	(500)
Net book value of non-social housing properties net of loan funding	(100)
Additional loan funding which could be secured on social housing properties	325
	375

Example 2

An association shows its social housing properties at a valuation and has the following summarised (and re-ordered) balance sheet:

	£000
Net book value of social housing properties net of loan funding	700
Net book value of non-social housing properties net of loan funding	100
Net current assets	200
	1000
Revenue reserves	450
Revaluation reserves	200
Designated reserves	200
Restricted reserves	150
	1000

This association calculates the surpluses available for additional investment in non-social housing activities at the balance sheet date as:

	£000
Revenue reserves	450
Designated reserves	200
Net book value of social housing properties net of loan funding	(700)
Revaluation reserve on social housing properties	200
Net book value of non-social housing properties net of loan funding	(100)
Additional loan funding which could be secured on social housing properties	325
	375

APPENDIX 3

Guidance on how associations may fund diverse activities and minimise the risk to social housing assets and tenancies.

In circumstances where associations are unable to satisfy the requirements set out in paragraph 5.6 and it is necessary to arrange separate funding for diverse activities, there are a number of ways in which associations can minimise the risk to social housing assets and tenancies.

1 The security given for most loans is a first fixed charge and generally prepared on an "all monies" basis. This secures all amounts due to the lender regardless of the number of loan agreements entered into. As the security given is not limited to a particular loan, social housing assets may be put at risk. In a default situation the lender would be able to enforce security over all security held, which could include social and non-social housing assets. To minimise the risk to social housing assets by use of an all monies charge, a provision may be incorporated in loan agreements that are specifically for diversification which prevents the lender from treating as security for diversification, any social housing assets given as security for other loans.

2 Where associations borrow under one loan facility for both social housing and diverse activities, similar provisions may be included in the loan agreement which will prevent social housing security becoming security for loans used for non-social housing purposes. Associations could utilise separate loan tranches within the overall facility to make this process transparent.

3 Secured lenders who have financed an association's diverse activities will have unsecured creditor rights if their security is insufficient to repay outstanding loan debt in a default situation. Associations should consider if risk to their social housing assets can be minimised through the negotiation of non-recourse loans if loans are available on this basis in the loan market.

4 Associations do not generally create floating charges as security for their borrowings, other than where lenders require a "lightweight" insolvency related floating charge for an association which is a company. Apart from where a lightweight floating charge is being taken, associations should not create floating charges over their social housing assets as security for borrowings for diverse activities. Where a lightweight floating charge is necessary,

associations should limit the circumstances in which this may crystallise to any steps being taken to appoint an administrator under the Insolvency Act or the crystallisation of another permitted floating charge.

APPENDIX 4

Questions and answers

Q1 My association is undertaking a mixed tenure development that includes SHG funded housing for rent and low cost home ownership, as well as market rent and build for sale units. Does the whole development count as social housing?

For accounting purposes the market rent and build for sale units should be identified as non-social housing but paragraph 5.6 of this note may be relevant in these circumstances when considering the funding of the development.

Q2 We are proposing to develop units for market rent, which are not part of a larger scheme, but are projected to produce a surplus which we will use to support our social housing objectives. Can we undertake this development on-balance sheet or must this be carried out through an unregistered subsidiary and can we use our social housing assets to support this activity?

Whether this is undertaken on-balance sheet or through an unregistered subsidiary is a business decision for your association, it will also be dependent on your legal vires. Although the scheme is projected to generate a profit, this is not sufficient to satisfy all the criteria in paragraph 5.6 and social housing assets should not be used to support this activity.

Q3 As a Large Scale Voluntary Transfer (LSVT) association we currently have an accumulated deficit and therefore no available surpluses. Does this mean that we are unable to undertake any diverse activities?

Not necessarily. Developments which include essential services may be regarded as social housing or you may have unencumbered non-social housing assets e.g. office premises, that may be used to support non-social housing activities. Alternatively, you may become involved in the regeneration of an area that involves mixed tenure development where you can meet the criteria set out in paragraph 5.6 of this note.

Q4 How should we treat mixed care and nursing homes?

You should apportion this on the basis of each type of bedspace.

Q5 Are surpluses generated from shared ownership sales included in available surpluses?

Yes.

Q6 Where a local authority has contracted with a private sector company for the provision of a key public service, would accommodation for those workers fall within your description of social housing?

Yes, as long as all of the conditions set out in our description are complied with.

Q7 The level of our diverse activities falls below the 5% capital and turnover threshold, are they subject to the terms of this policy?

Yes, however they are not subject to the accounting disclosure requirements.

Q8 If the last published Housing Corporation Assessment (HCA) has an amber or red light, can my association go ahead and diversify?

The latest HCA reflects the risks assessed as facing your association therefore on the face of it we would not expect to see you diversifying until performance deficiencies have improved.