



DTP

Risk, stress testing, resilience – the role of the board



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Introduction

Providing advice to housing providers throughout the UK.

Established in 2006, DTP is an independent consultancy providing high quality advice and support to affordable housing providers, charities and commercial organisations.

Our mission is to help businesses improve and deliver better services to their customers.



A different perspective



Strategy and Governance

Strategy development

Group structures and mergers

Board recruitment, development and appraisal

Regulatory compliance, risk and IDA preparation

Care and support

Governance reviews



Finance and Funding

Business planning (Brix Certified Partner)

Raising finance and treasury management

Due diligence

Asset management and development



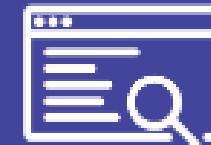
Resources

Human resources

Information management and technology

Interim management

Project management



Business Transformation and Change

Organisational reviews

VFM and efficiency reviews

Stock transfer and rationalisation

Performance improvement

Policy development and research

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Introduction



Andy Roskell
Managing Director

Overview

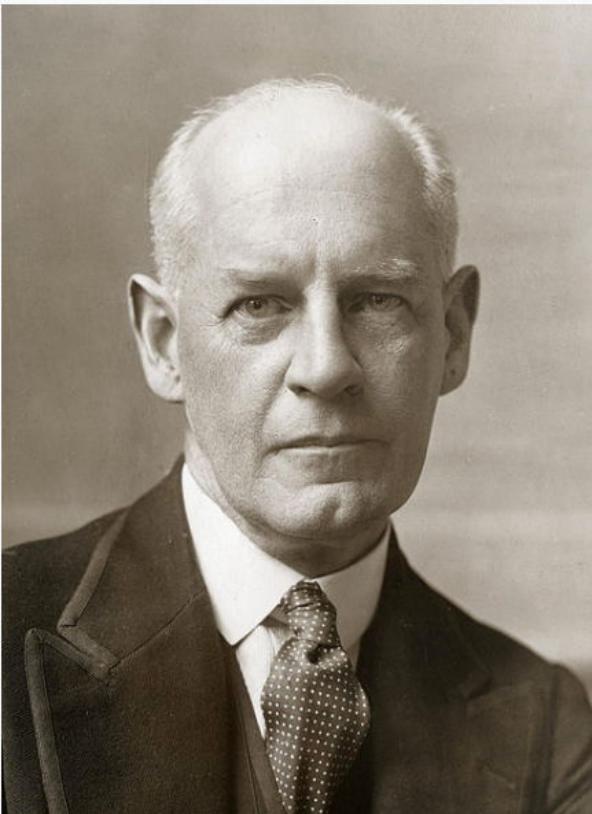


- We know **risk management** is important but what does ‘good’ look like for smaller associations?
- Ensuring **resilience** should be about establishing a **golden thread** that links your objectives to appropriate **stress testing**, the establishment of **rules** and **triggers** and on to **mitigation**.
- Lets explore the latest sector practice.

Overview



John Galsworthy



- John Galsworthy
- English novelist and playwright (1867 – 1933)
- Author of '*The Forsyte Saga*'
- Nobel Prize for Literature – 1932

“If you don’t think about the future, you cannot have one”

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Overview



and we can all remember what he said.....

Overview



- Thinking about the future is one thing, but trying to predict it is quite another...
- If the last few years have taught us anything, it's that it is very hard to try to predict anything!.....however....

Overview



- Giving serious thought to what things could happen.....
- and planning for how you might respond is of course a different matter
- In fact, it is entirely sensible..

Overview



- ...a 'No-Deal Brexit', for example, may never happen, but it would be sensible to prepare for this; to **stress test** the impact it might have and to prepare appropriate **mitigating strategies**

Overview



- Stress testing and thinking about the future have become the norm for registered providers of social housing in recent years
- This can be traced back to the financial crisis of 2007/08 when banks were required to improve their resilience

Overview



- The sector adopted a similar approach and it became the regulatory (though bespoke) requirement to do this in 2015
- The regulator (wisely) resisted calls to be prescriptive about the sort of tests it wanted to see performed

Overview



- Regulator took the view that what was appropriate for a provider in the South East wasn't necessarily right for a stock transfer association in the Midlands, or in the North
- Moreover, it was stressed that doing this just to 'please the regulator' was the wrong place to start from

Overview



- Recently the regulator has provided more specific guidance, but this still requires a tailored approach and it encourages greater consistency and is more to do with process, for example a greater emphasis on the **involvement of the board**

What to focus on



- We work with many clients on stress testing and board engagement
- It is important to consider the potential impacts on **your** business, taking account of **your** specific circumstances and **your** business activities

What to focus on



- Even where factors may affect the whole sector and wider economy – Brexit for example – it's about looking at how this might impact on your particular organisation
- There are however a few universal principles which can be applied

Key principles



- To begin with, stress testing needs to deploy a deep knowledge of your business and its potential challenges, in the face of adversity
- This analysis must be informed by the Corporate Plan (your corporate objectives)

Key principles



- The analysis must also be informed by the Business/Financial Plan, the Risk Register (which must fully reflect your business risks) and the assets and liabilities register.
- These must all be joined up, relevant and up to date

Testing – ‘on-set’



- Develop a series of tests which reflect known internal and external risks. Brexit will be on the list and the impact considered.....house prices/sales, inflation, debt cost, labour costs, materials, falls in sterling, ‘counterparty risk’ (contractor failure) etc.

Testing – ‘on-set’



- Use tests that are relevant to your business
- Make sure that you challenge (break) the business plan, at least in some tests

Testing – Examples



- Property market crash 20% (North) as base assumption. Increased incrementally until a point of business failure is reached
- From point of crash – no sales for 3 years (assuming crash of 11 years). End of Year 3, sales return, but at 80% of pre-crash value. 2.5% market value improvement is modelled each year until values return to 100% by end of Year 11. (Note: more prudent than last crash)
- Tenure switches from outright sale to affordable products, including SO are modelled. SO reduces exposure to outright sale, but ties up more capital/reduces forecast sale proceeds

Testing – Examples



- Bad debts, arrears and voids doubled
- From 2020 rent increases at CPI rather than CPI plus 1%
- Planned efficiency savings deliver only one third of expected benefits
- Regulatory downgrade leads to re-pricing of current low cost loans. These increase to either 5% (fixed) or 3% above LIBOR
- LIBOR increases versus base plan of 1% (2020/21), 2% (2021/22) and 3% thereafter
- 25% reduction in new models of care (supported) income

Testing – Examples



HA 2

- Bank of England's stress testing formula, with an overlaid assumption on the future rent policy for general needs homes:
- Inflation rising to 5%
- UK residential property prices falling by 33%
- UK commercial properties falling by 40%, causing fair value loss on investment property
- Unemployment rate at 9.5% - causing a rise in bad debts and voids
- Bank rate – average over one to three years at 3.25%

Testing – Examples



HA 2

- Bank rate peak level at 4%

When considering the impact on the financial plan we focus on assessing the following variables:

- Net Present Value (NPV)
- Maximum gearing
- Maximum interest cover
- Maximum EBITDA-MRI cash cover
- Peak debt
- Impairment capacity
- Liquidity

Testing – Examples



Variable	Break point (size of stress)
Voids	10%
Bad debt	10%
Sales income/house price reduction	30% sales income
Cost of sales	+5% development costs
Staff costs	5%
Compliance costs	£30m for three years
Interest	+5% variable rate
Rent decrease	-1% years two to six
Rent increase at Consumer Price Index (CPI) only	CPI+0% rent
Rent freeze	Rent at 0%
Short-term housing to local authorities, 20% reduction in income	20% reduction in care and support income

Testing – Examples



Variable	Break point (size of stress)
Remove additional development for sale	Remove additional development for sale
Help to Buy reduced	Reduce open market sales (150 in Prospect Homes, 100 in additional development for sale)
Help to Buy removed	20% reduction in sales
Increase development by 100 units per annum	100 additional affordable housing units per annum
Increase development by 150 units per annum	100 additional affordable housing units per annum
Transformation programme does not deliver	Remove transformation savings
Large, one-off fine/cost	£100m fine in year one
Consumer Price Index	-1%

Testing – Examples



HA Group 3

Variable	Break point (size of stress)
Development reduction	150 units per annum
Scottish development plan	386 units over four years
IT investment increase/continues	Double IT CapEx
Sales delay	24-month delay from year two
New subsidiary requires extra investment	£100m investment

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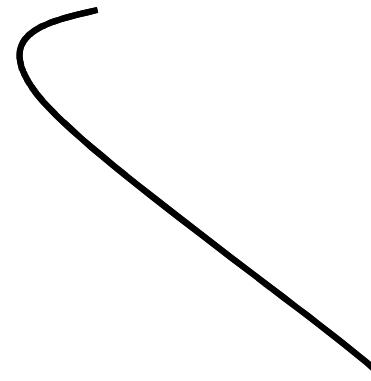
Testing – Outputs



Testing – Outputs

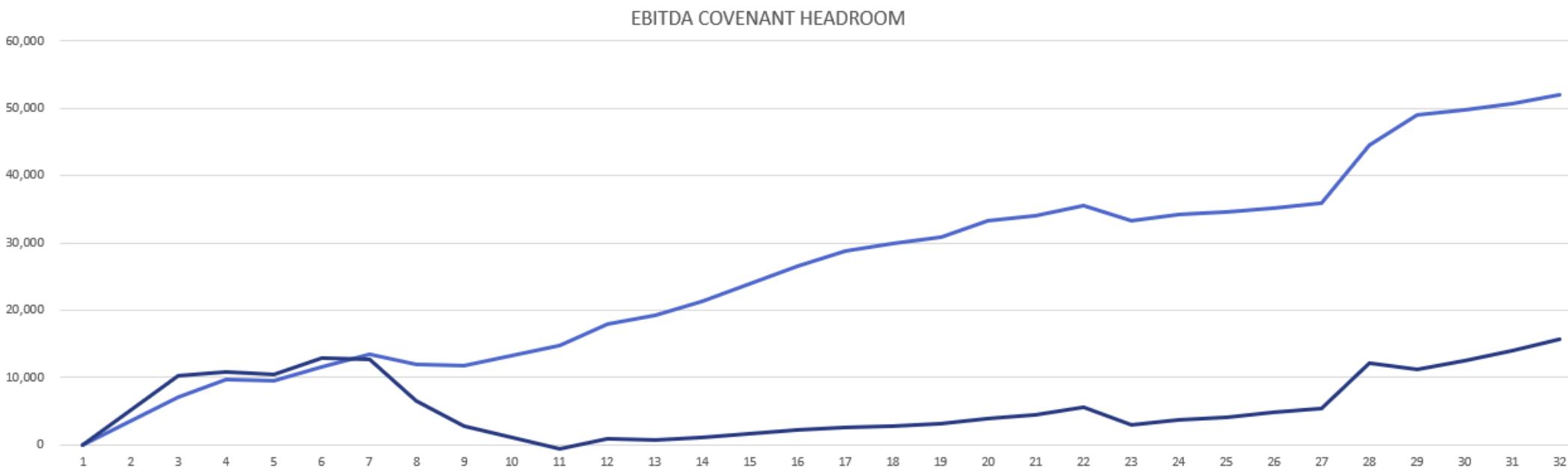
'Base' Plan

Scenario	Peak Debt £m	Peak Debt Year	Nett Debt Repayment Year	Minimum Interest Cover Headroom	Minimum Interest Cover Year	Minimum Debt Per Unit Headroom	Maximum Gearing Year	Cash in Yr 30 £m
Base Plan	382,913	5	19	7,148	1	206,679	5	474,540,723



The results of the '**Base**' plan can
be compared against the results
of **stress tests** to show impact

Stress Tests



Scenario		Peak Debt £m	Peak Debt Year	Nett Debt Repayment Year	Minimum Interest Cover Headroom	Minimum Interest Cover Year	Minimum Debt Per Unit Headroom	Maximum Gearing Year	Cash in Yr 30 £m
General tests					£'000		£'000		
	Base Plan	382,913	5	19	7,148	1	206,679	5	474,540,723
6	Govt Policy Change	378,336	5	> 30	(603)	9	206,713	5	7,500,000

Mitigation – ‘recovery’



- Develop credible plans to address risks and impacts
- Mitigations must be relevant to your business, practical (deployable) and up to date (not obsolete)
- Be clear how long actions can take to mobilise – this helps you to prioritise possible solutions

Mitigation – ‘recovery’



- Typically, RPs will look to a limited number of ‘big ticket’ items, such as:
Management costs (overheads, staff costs, office costs, services), **Development programme** (removal of uncommitted development), **Stock condition projections** (non-deferrable spend), **Treasury** (cheaper longer term funding) and **Stock disposals / rationalisation**

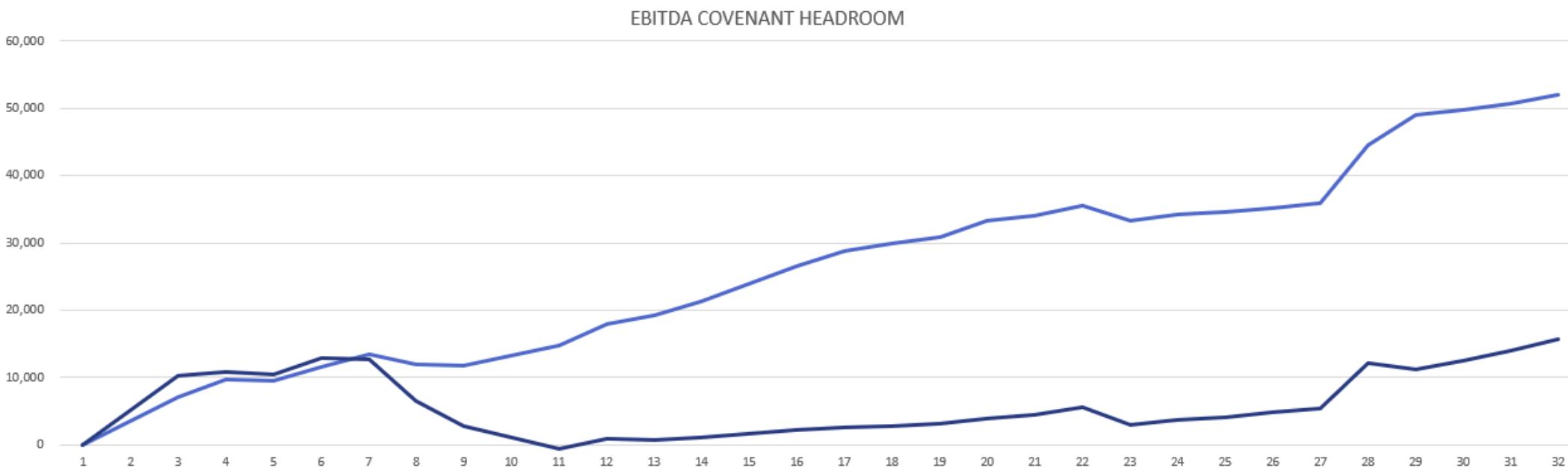
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Mitigations – Outputs



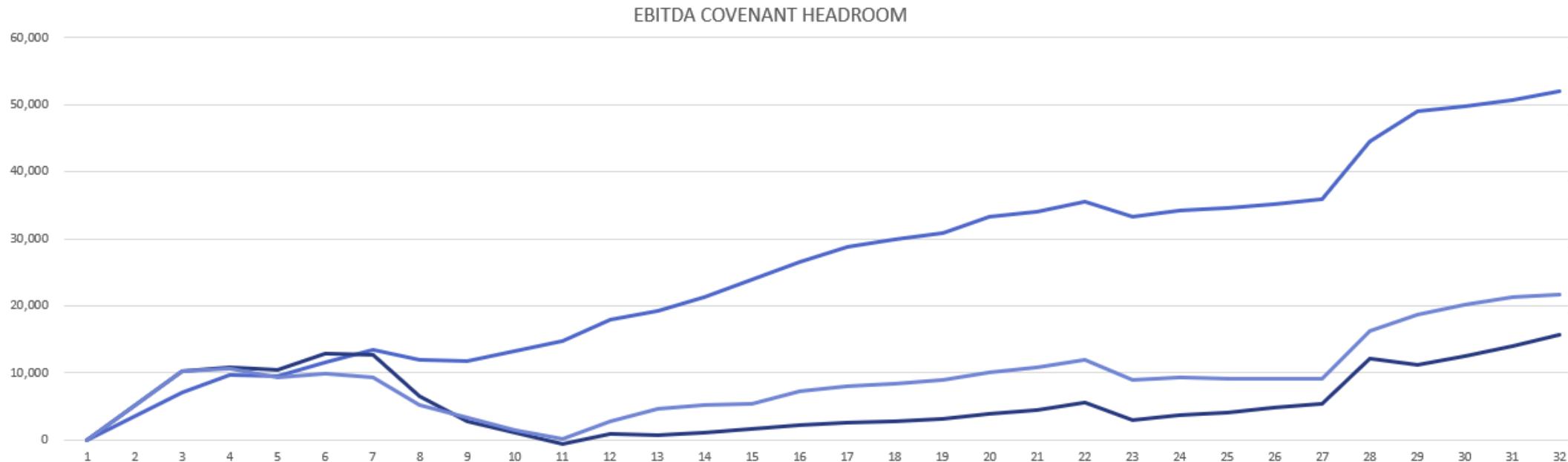
Mitigations – Outputs

Stress Tests



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Current mitigations



Scenario		Peak Debt £m	Peak Debt Year	Nett Debt Repayment Year	Minimum Interest Cover Headroom	Minimum Interest Cover Year	Minimum Debt Per Unit Headroom	Maximum Gearing Year	Cash in Yr 30 £m
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Assurance / Resilience



- Many RPs are looking to gain assurance on their resilience through 'Resilience Statements'
- Once developed, these are regularly updated and reported to Boards
- The Statements include 'Golden Rules', 'Triggers' and how these will be monitored and reported

Assurance / Resilience



- The Statements often set out an agreed approach to manage the process of acting when an ‘event’ occurs, or is projected to occur
- This helps to provide structure and confidence to officers in the event of an adverse ‘event’

Assurance / Resilience



- Regular review and updating of the Statement should ensure that risks and mitigations remain current and up to date.
- Some mitigations, will for example become obsolete (development programmes – get developed)

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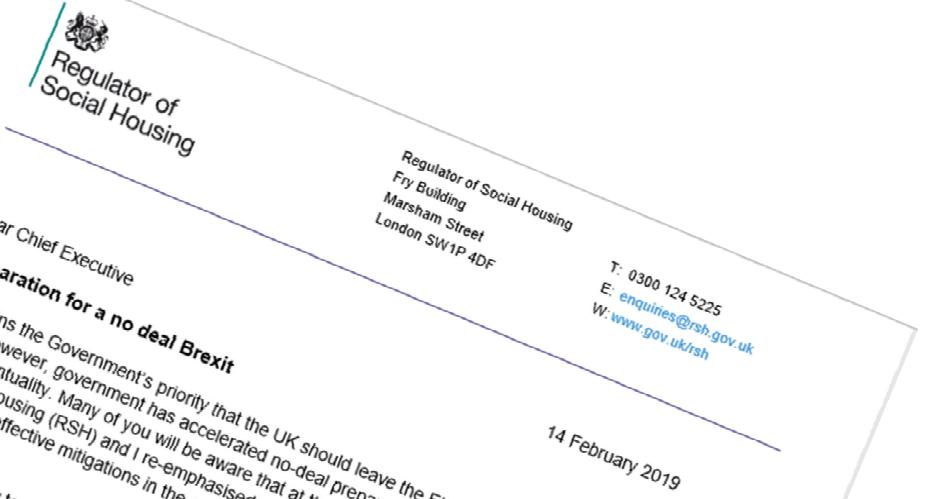
Regulator views



- Brexit – February 2019 letter – RSH advised ‘prepare for no-deal’ (Scottish Regulator also did this)



Fiona MacGregor, chief executive of the Regulator of Social Housing, and the letter



I am writing now to ensure that all providers are clear about the Regulator's expectations of them during this period of uncertainty, and to share examples of what providers should consider when stress testing their businesses. The Regulator is not requesting systematic information from providers at this time, however, where individual providers have identified specific exposures or risks which threaten their compliance with the [Regulatory standards](#), our expectation is that they will inform us of these in line with expectations.

In the current context, the Regulator expects providers to have an appropriate, robust and prudent business planning process in place, which includes carrying out detailed and robust stress testing against likely scenarios across a range of scenarios, and put appropriate measures in place to manage their assets and liabilities. In the current context, the Regulator expects providers to have an appropriate, robust and prudent business planning process in place, which includes carrying out detailed and robust stress testing against likely scenarios across a range of scenarios, and put appropriate measures in place to manage their assets and liabilities. In the current context, the Regulator expects providers to have an appropriate, robust and prudent business planning process in place, which includes carrying out detailed and robust stress testing against likely scenarios across a range of scenarios, and put appropriate measures in place to manage their assets and liabilities.

Regulator views



- Brexit – February 2019 letter:
- Reminder of regulatory expectations
- Use of Bank of England's 'EU withdrawal scenarios' document
- Reminder to communicate with RSH on material issues relating to non-compliance (or potential non-compliance) or ability to meet objectives

Regulator views



- Brexit – February 2019 letter:
- Considerations:
 - I. Deteriorating housing market conditions
 - II. Interest, inflation and currency risk
 - III. Access to finance
 - IV. Availability of labour
 - V. Access to materials and components
 - VI. Access to data

Regulator views



- Brexit – February 2019 letter:
Governance and Viability Standard:
 - Have in place an appropriate, robust and prudent business planning, risk and control framework and
 - Carry out detailed and robust stress testing against identified risks and combinations of risks across a range of scenarios and put appropriate mitigation strategies in place as a result.

Regulator views



- Context Corporate plan/Objectives
- Joined-up process, using Business planning, Risk Register and Assets & Liabilities Register
- Tests based on business activity
- Multi-variate tests also
- Should seek to ‘break the plan’

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Regulator views



- Effective, practical mitigations
- ‘Directed by the Board’

Role of the Board



- Active engagement
- Steer/direct, but delegate also
- Understand risks and mitigations
- Direct the tests and make a judgement on mitigations
- Monitor and review projections
- Gain assurance - be in control

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Role of the Board



Officers → **Modelling** ← **Board** → **Resilience**

Risks assessed,
A&L considered,
Corporate Plan/
Business Plan
Reviewed, Draft
Tests and Mitigat
ions developed

Business Plan
modelled, Draft
tests and
mitigations
modelled –
Draft outputs
considered

Board
considers Risk,
A&L, Bus Plan.
Reviews draft
outputs and
makes further
refinements of
Tests and
Mitigations

Business Plan
Re-modelled
and final
Outputs agreed
and reported.
Resilience
Statement
(inc Golden
Rules etc)
updated

Board approves
and ongoing
monitors perfor
mance, looking
at Golden Rules
and Triggers

Role of the Board



- Yes, predicting the future is impossible – but taking risk management and stress testing seriously should improve the likelihood of having one!