

# Commercial Subsidiaries

## Potential & Perils

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November 2021

# What we'll cover

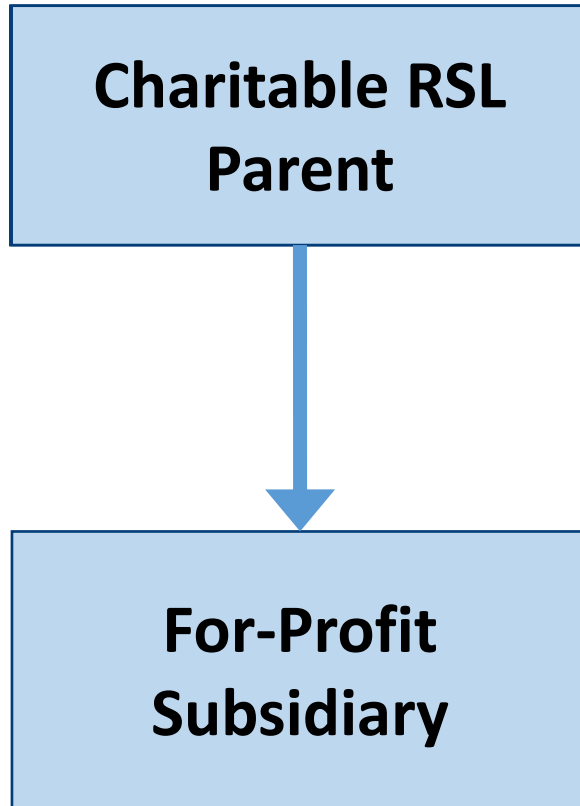
- Potential & perils
- Regulatory context
- Contagion & disguised risks
- Governance
- Top tips



# Potential and perils



# Potential



- Non-registered, for-profit subsidiary of RSL
- Delivering profit-making activity
- Meets charitable vires requirements
- Aim is to ring-fence social housing assets from risk of commercial venture failure
- Gift-aiding profits back to parent



# Perils

- Can't just roll the dice and risk losses, funds could have been used for charitable purposes
- Potential to learn from English experience – including headline-grabbing failures in Cosmopolitan, Broadacres, Gentoo
- Sector went through dalliance with large numbers of legal entities and complexity
- Exciting stuff – element of hubris behind some failures
- Realistic expectations important to avoid taking disproportionate risks
- Care needed to understand and secure necessary skills

# Perils (continued)

- Building profitable businesses that sell to others largely proved elusive, couldn't compete, couldn't take the risks
- Attaining necessary scale often requires large amounts of working capital, at odds with producing a return for the charitable parent
- Control matters – it is the group's responsibility to protect the social assets



# Learning From Problem Cases volume 5

- Regulator of Social Housing, England – forthcoming (working title: “It Couldn’t Happen Here”)
- 11 of 19 cases demonstrated issues relating in some way to group structure
- Themes include:
  - losses made in unregistered subsidiaries established to deliver commercial development, potentially putting social housing at risk
  - group structure arrangements lacking transparency, insufficient scrutiny by parent Board
- Featured strongly in previous versions too (incl. Cosmopolitan)

# Regulatory context





# Welsh regulatory context

- Welsh Government circular 05/08 (Group Structures)
- “Parent RSLs must be able to demonstrate that they are in control of their subsidiaries, whether they are registered or not”.
- Gov. consent: business case, must demonstrate benefits
- “All financial and contractual arrangements between an RSL and an unregistered subsidiary must be at arms-length and any loans or investments must be on a commercial, secured basis”.
- Must be able to show that “there is no leakage of the RSL’s reserves or assets into a non-registered subsidiary”

# CHC Code of Governance (2021)

**2.4.5** Where the board has agreed to establish formally constituted subsidiary organisation/s, it is clear about the **rationale, benefits and risks** of these arrangements.

The formal relationship between the parent and each of its subsidiaries is clearly recorded and the parent reviews, at appropriate intervals, whether these arrangements continue to best serve the organisation's purposes.

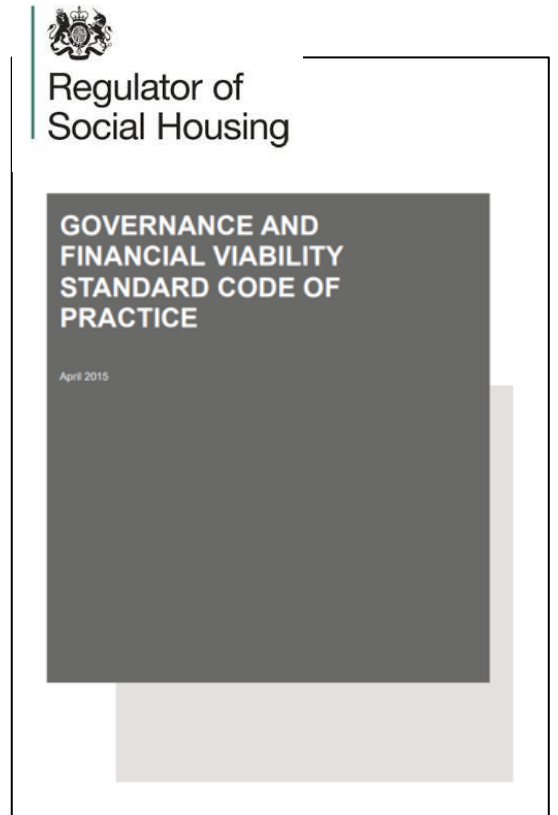
# Over the border

More recently updated, risk-based regulatory expectations

*“Boards should ensure they have a full understanding of:*

- Where liabilities exist between all entities (both registered and unregistered).*
- How a failure in one part of the group may affect other members of the group.”*

(Governance and Viability Code of Practice 2015)



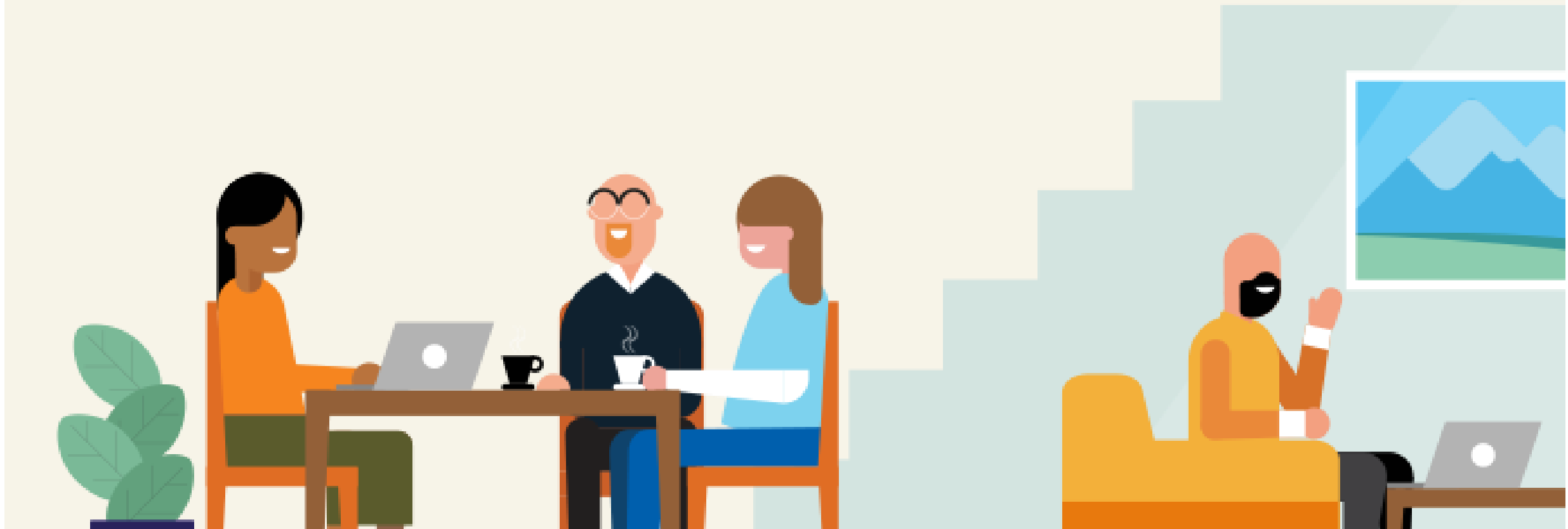
# English Sector Risk Profile 2021

“Boards must understand the potential risks associated with the finance and funding structures of non-social housing activities.

Boards must have appropriate governance structures and ring-fencing arrangements in place to ensure that social housing assets are not put at risk by, for example, guarantees or impairment relating to non-social assets.

...We will seek assurance from providers that non-social housing activity creates rewards commensurate with its associated risks, that this activity makes a clear contribution to the provider’s core purpose, and that social housing is not put at undue risk”.

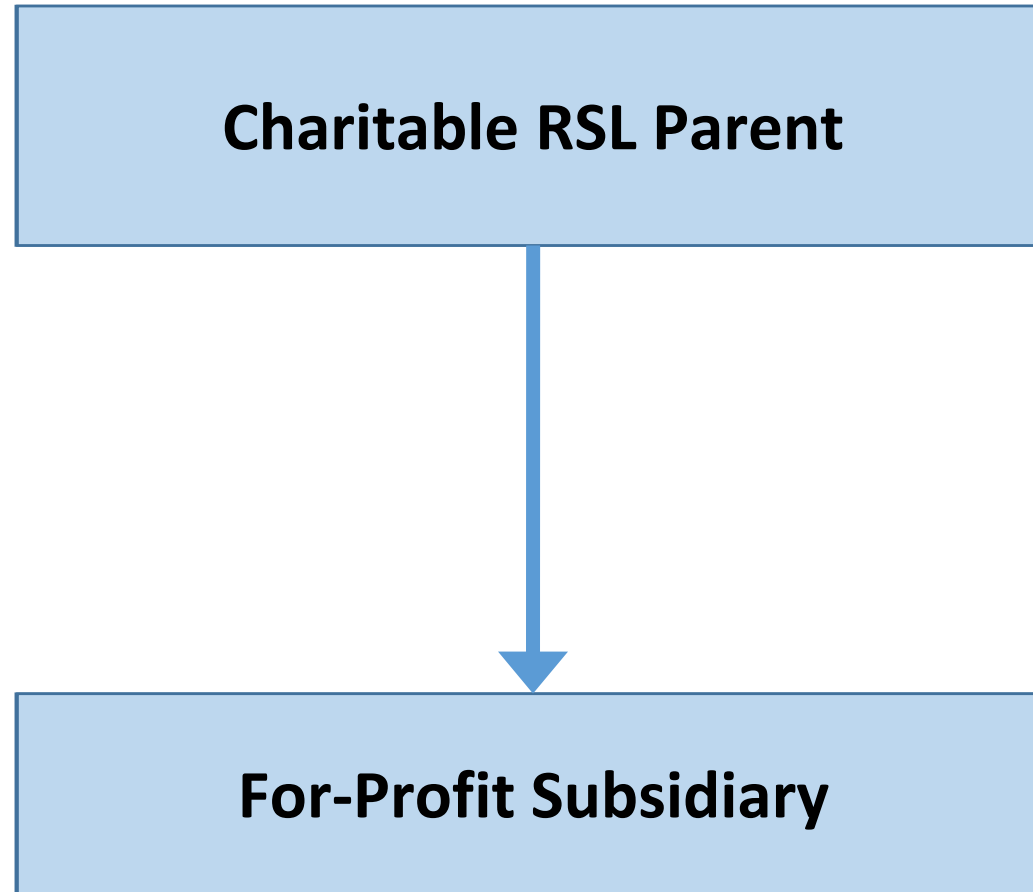
# Contagion & disguised risks



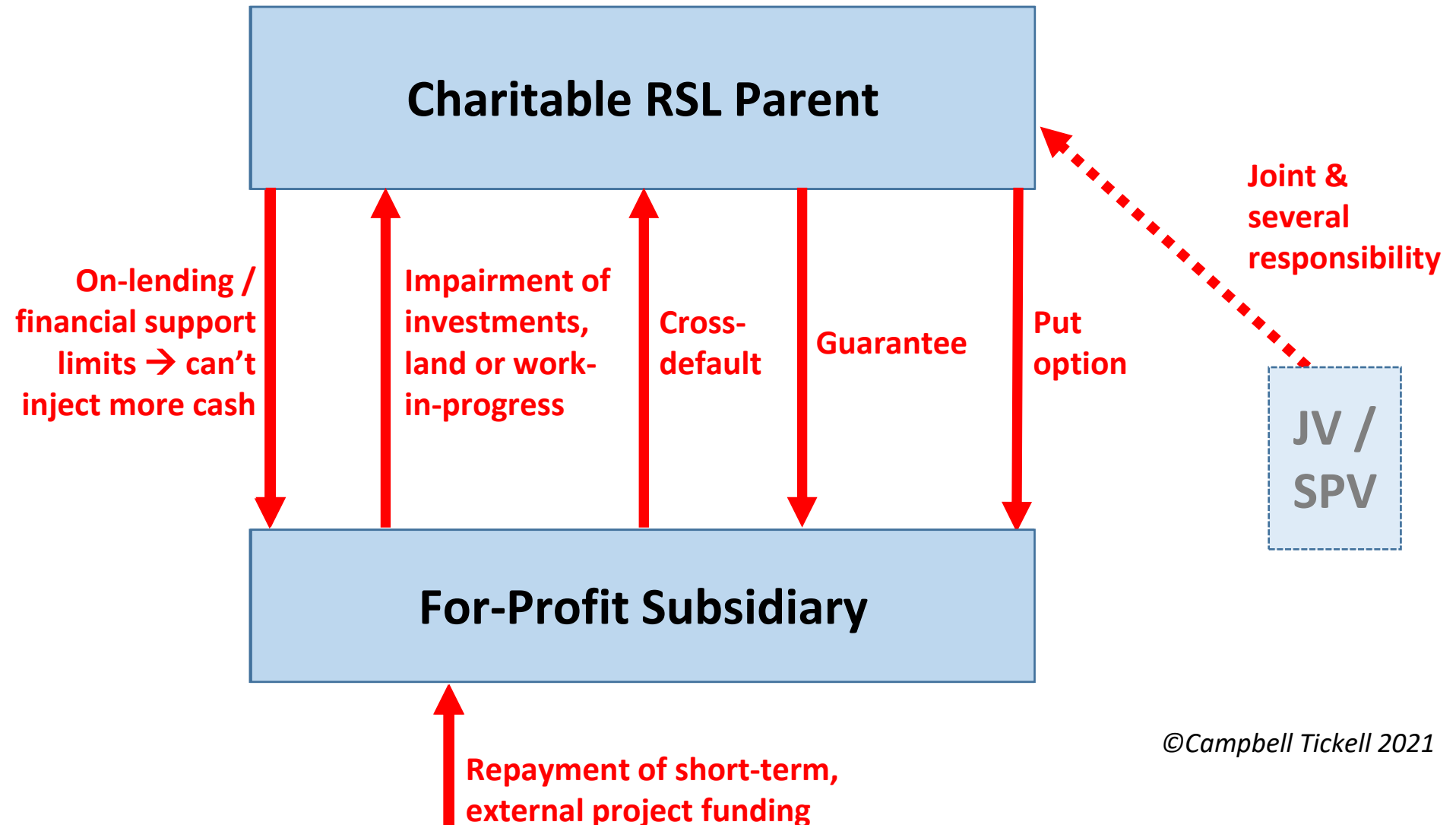
# Risks

- **Intention:** to ringfence commercial risks & potential liabilities away from the social housing assets in order to protect the former.
- **Unintended consequences:** can exaggerate & disguise risks
- Boards need to understand and mitigate the risks
- **Contagion** risks: risks the structures create
- **Disguised** risks: risks the structures hide
- Boards need to seek assurance on the controls of those risks

# Contagion risks: risks the structures create



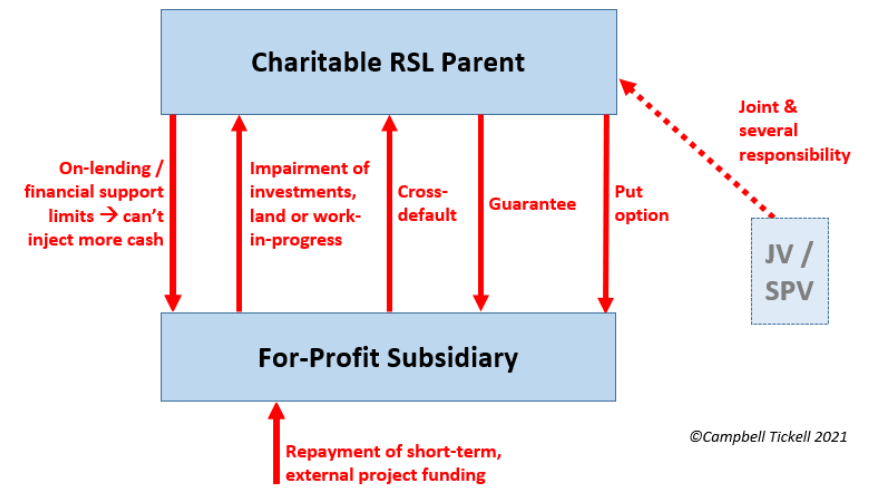
# Contagion risks



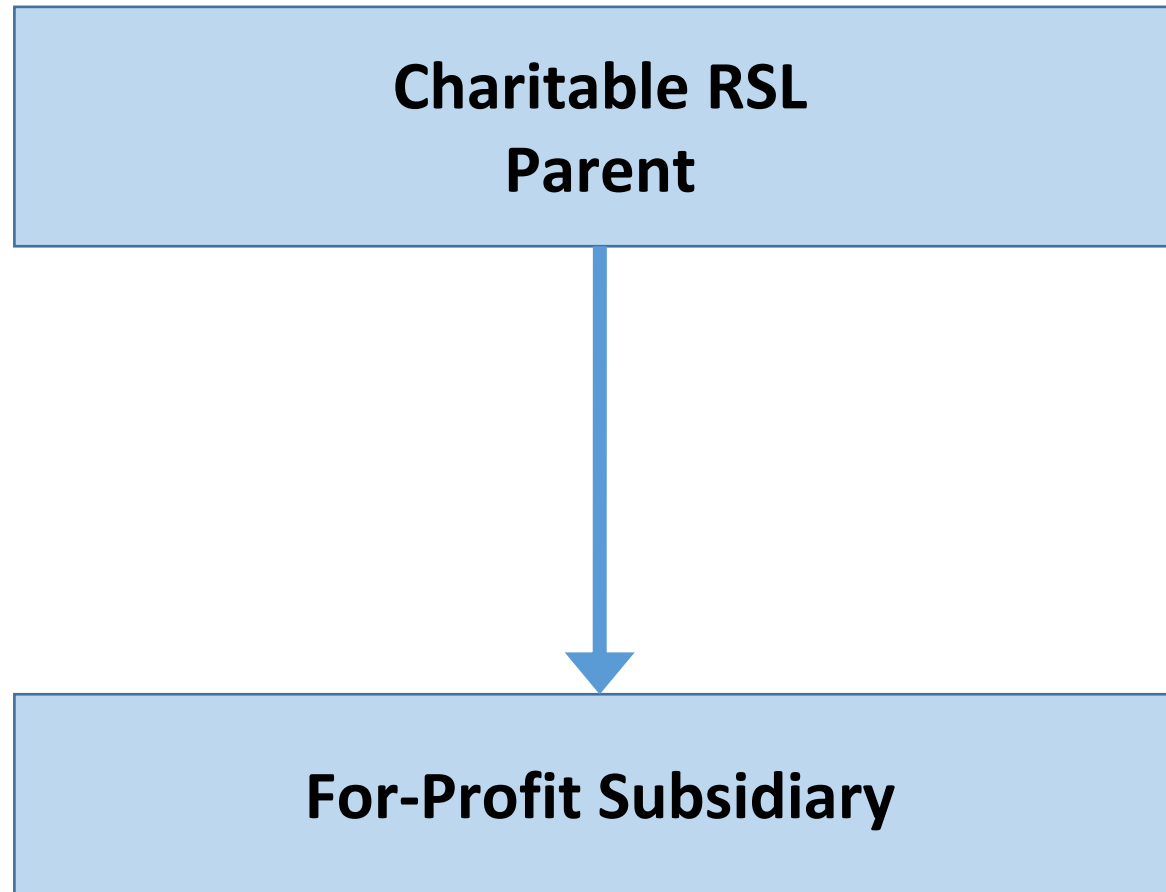


# Contagion risks - controls

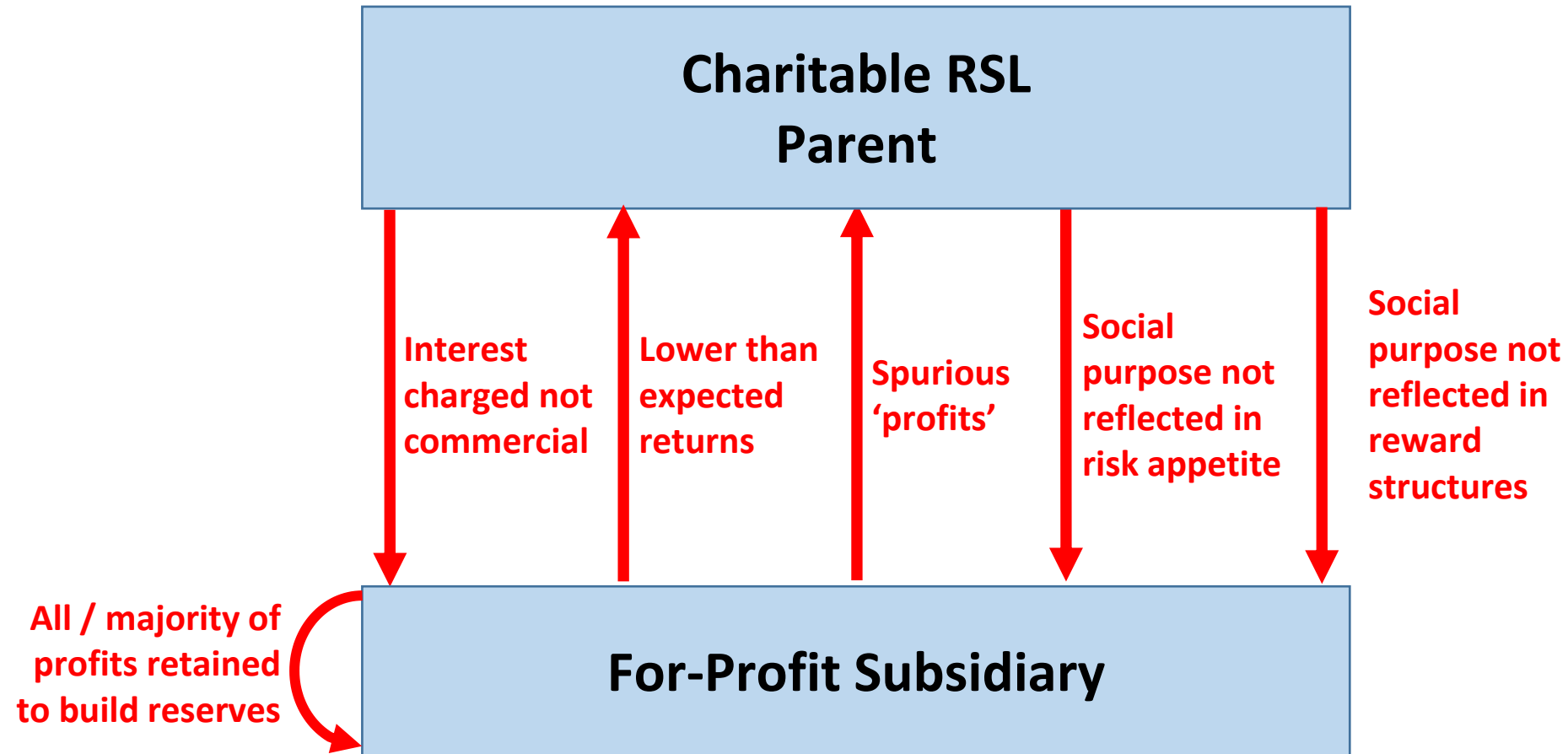
- Avoid joint & several, guarantees, put options & 3<sup>rd</sup> external party funding
- Negotiate parent loan covenant immunity to impairment
- Set well-calibrated golden rules on on-lending & impairment absorption limits
- Hard-wire golden rules into decision making
- Hold cash reserves in subsidiary
- Stress test impact of market shut-down on subsid / JV & subsequent risk flows to parent (NOT just consolidated group)



# Disguised risks: risks the structures hide

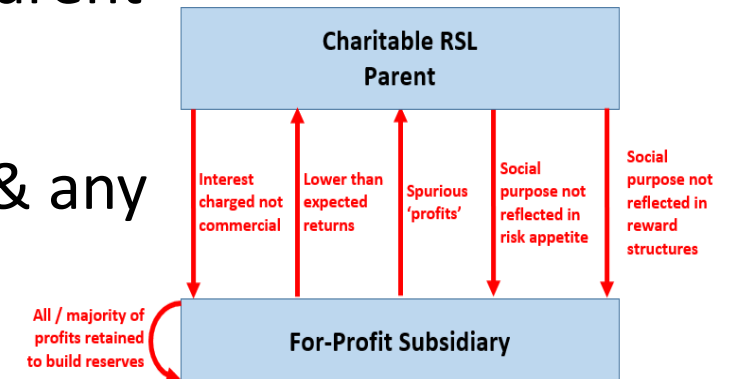


# Disguised risks



# Disguised risks - controls

- Board to seek independent legal & treasury advice on its investment policy
- Benchmark on-lending terms & margins
- Set clear appropriate expectations of commercial returns & report against them
- Take key investment and development decisions in Parent
- Parent Board sets / defines risk appetite for subsid
- Parent Board agrees appropriate overhead charges & any incentivised reward structures
- Ensure DevCo Board is not just commercial skills
- Strengthen NED & Executive induction to emphasise social objectives & Parent's risk appetite



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# Assurance to Parent Board

- Independent legal assurance on protection of social housing assets (joint & several responsibilities, guarantees, put options, cross-default)
- Occasional independent legal assurance on loan covenant register: accurate, complete, up-to-date, easily accessible, immunity from impairment, reflected in golden rules
- That processes for hard-wiring golden rules are understood & followed
- That results of stress-testing of subsidiary are reflected in identified risks & impact scores in risk register
- That are achieving expected rates of return on completed projects

# Co-regulation – good questions to ask

1. How are your social housing assets protected within your group structure?
2. How does the Board ensure visibility and control of all its entities?
3. How does the Board ensure that its investment decisions fit with the charitable status of the organisation?
4. How was the Board involved in the most recent decision to create a new JV or subsidiary?
5. How are risks and rewards shared between yourself and your JV partners?
6. What's the worst-case scenario & how would we respond?

# Governance

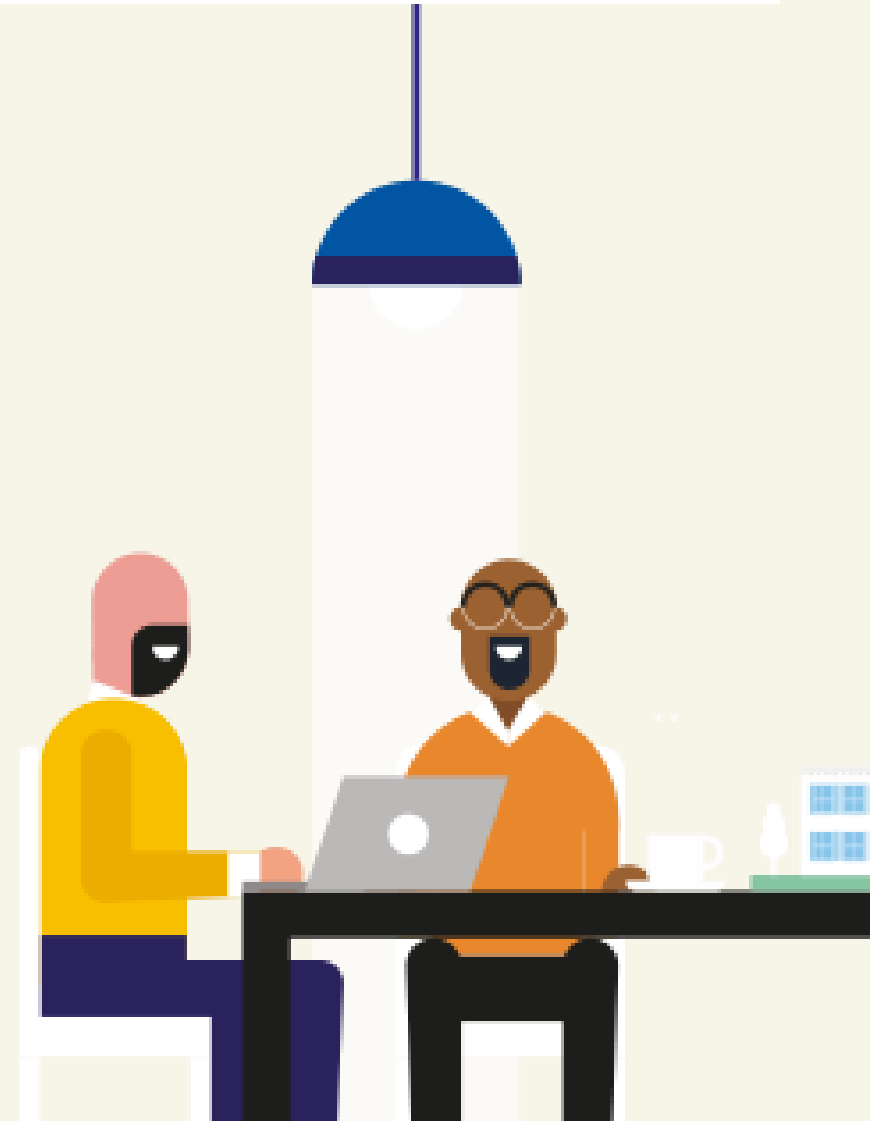


# Contemporary thinking about governance arrangements

- Separate need for legal entity from substance and ‘personality’
- Strategy set by parent Board (needs relevant expertise)
- Unified risk management and reporting
- Functional, executive-run subsidiary Boards (but Welsh Gov circular?)
- N.B. Exec also need to understand risks and benefits



## Top tips



# Top tips

- Make sure there's a clear, shared view about why
- Keep it simple
- Don't get carried away – balance enthusiasm with realism
- Understand what could go wrong
- Stay in control
- Don't expect 100% success
- Secure people who know what they are doing
- Stress-test impacts of worst-case scenarios on subsidiary & parent

# And yet (it isn't all about downside risk)

*“A ship in harbor is safe, but  
that is not what ships are  
built for.”*

William G.T. Shedd





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# Thank You

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