Stress testing
Are you for ready for future challenges?

9 July 2015

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This session

Learning from recent events

The role of your financial plan

The role of the Regulator

Using the results

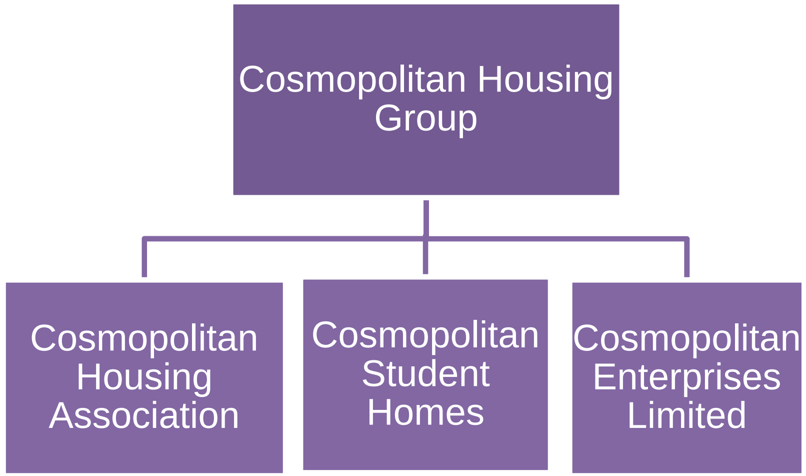
Key issues

Learning from recent events

Learning from Cosmopolitan

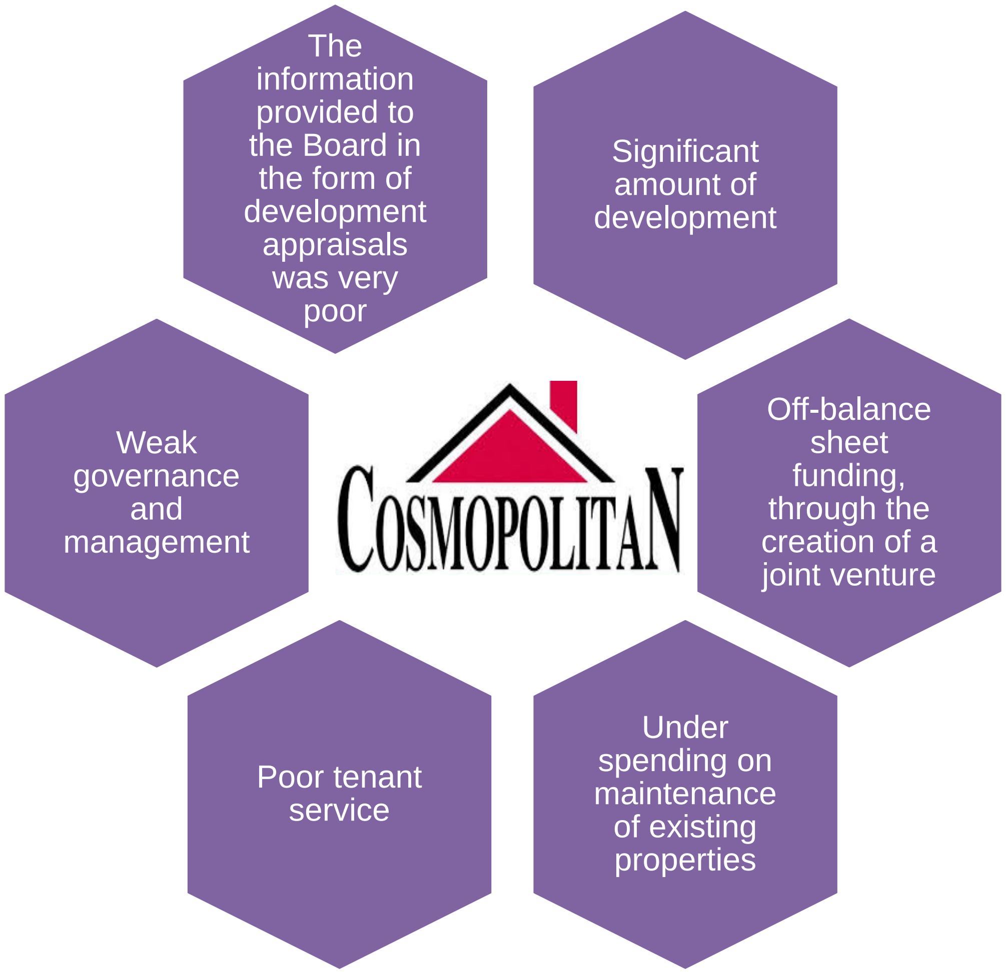
Cosmopolitan Housing Group was first formed in 2003 to separate student housing activities from the Cosmopolitan Housing Association. This was done through the creation of different subsidiaries.

This was in line with the then regulator, Housing Corporation’s (HC), policy requiring that “diverse activities” be removed from the main housing organisation.



At this time Cosmopolitan Housing Association was already undertaking a significant amount of development. It was funding the development of student accommodation through sale and leaseback or lease and leaseback arrangements.

Learning from Cosmopolitan



In May 2012, Cosmopolitan Housing Group was experiencing cash flow problems as expected funding for its ‘overly ambitious’ development programme was not in place. The gearing loan covenants had been tight for some time, with potential breaches

The parent company have given guarantees against a number of leases which meant that the social housing assets of CHA were at risk. There was an overly complicated Group structure, which made it difficult to monitor performance of subsidiaries

This was the beginning of the crisis that brought the whole Cosmopolitan Group to the brink of insolvency

Cosmopolitan was then bought over by Sanctuary Housing Group

Learning from Cosmopolitan

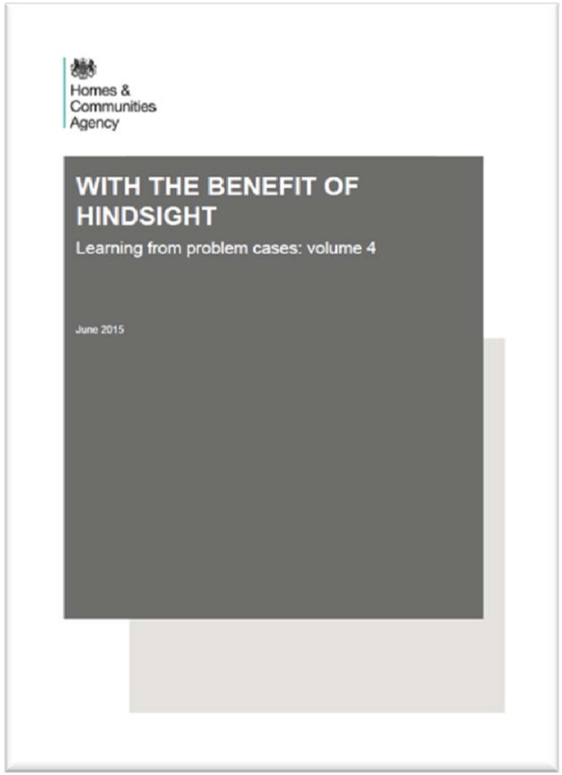
The lessons learned for the sector and regulator focus on five themes:

Themes	Recommendations and Comments
Skills and Resources	Boards should have the right people with the skills and experience to govern well
Information Requirements	Housing Associations are to communicate to the HCA key information such as their assets and liabilities in a timely and accurate manner
Risk Management	The risks that the organisation faces should be clearly understood
Mergers	The Board needs to be in the control of the merger process, understanding the importance of due diligence
How Housing providers and the Regulator should act in a crisis	The new regulatory framework takes into account the recommendations of the report

Learning from Problem Cases Volume 4

10 Key recommendations

- Drive out unnecessary complexity
- Understand the risks that could be fatal
- Always have a Plan B
- Be ambitious, but keep perspective
- Focus on the skills and competence of Board members
- Create the conditions for effective challenge
- Engage positively with the regulators
- Keep an iron grip on performance and compliance
- Empower and value the Audit Committee
- Never forget the tenants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Learning from problem cases: volume 4

June 2015

What are the key issues that could impact on organisational viability?

Where are we now? Sector risk profile

- Managing a housing development programme
- Diversification
- Housing market sales exposure
- Welfare Reform
- Existing stock
- Assets/liabilities
- New/existing debt
- Accounting issues
- Pensions
- Reduced government grants
- Complex ways of financing development

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HCA regulatory judgements

Summary of published judgements as at the end of April 2015
(compared to 2014)

Governance			Viability		
	2014	2015		2014	2015
G1	200	204	V1	208	206
G2	37	33	V2	34	41
G3	6	10	V3	1	0
G4	0	0	V4	0	0
% G2	15%	13%	% V2	14%	17%

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Thoughts on the English Viability ratings

There has been a recalibration – V2 is now the new V1

In an era of stress testing, economic turbulence, fears about the property market and further cuts to welfare, how can the HCA give a V1 rating?

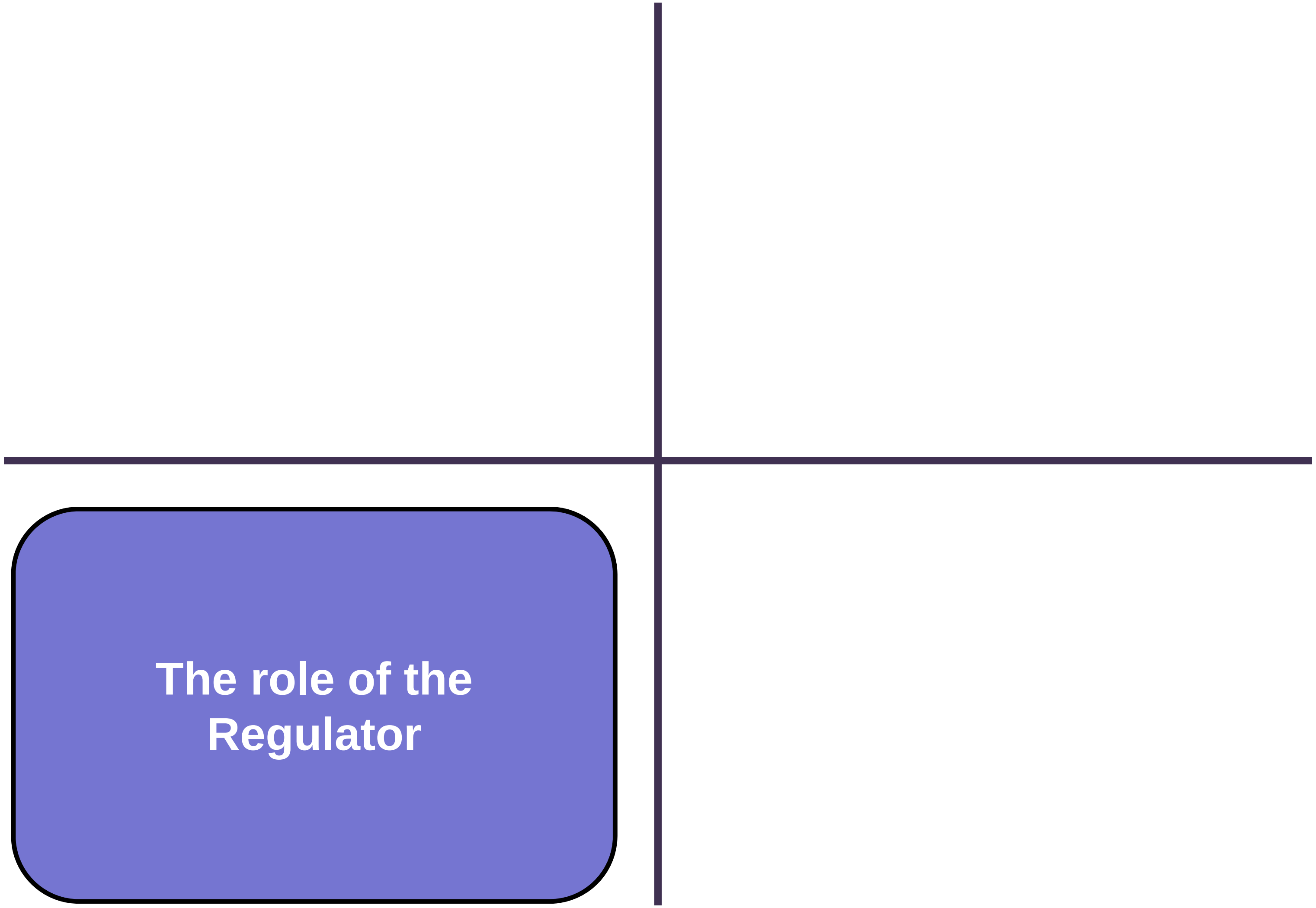
V2s should not be seen as a badge of shame as more landlords push their assets harder to deliver homes without grant

Welsh Government regulatory judgements

Summary of published judgements as at the end of June 2015

Financial Viability	
	2015
Pass	30
Pass with closer regulatory monitoring	5
Percentage pass with closer regulatory monitoring	14%

The role of the Regulator



Welsh Government approach to Regulation

- Proportionality
- Transparency and openness
- Consistency
- Promoting improvement and learning

Risk based approach

WG will prioritise risks in terms of:

- The **likelihood** a risk will materialise
- The **impact** - scale and significance - if it did
- The **ability** of the housing association **to manage** and deal with the risk

When considering "impact", the Welsh Ministers will take into account:

- Impact on tenants and service users
- The vulnerability of affected tenants and service users
- The extent to which the community relies on the association for services and amenities
- The association's size - the number of homes it manages and the number of tenants it has
- The amount of public money the association receives
- How long the association has been operating
- The amount of private loan finance provided by lenders and committed for the future.

Risk based approach

Views on the ability of a Housing Association to manage and deal with risks will be informed by:

- The Association's track record in managing change and improvement, handling challenging issues and making difficult decisions.
- Confidence in the Board and the senior management team.
- The Association's track record in dealing with other issues that have been raised as a result of previous contact.

Regulator Stress Testing

Stress and scenario testing

- Important area of focus for the Regulator
- Not prescriptive
- Multi-variant analysis
- Test potential serious economic and operational scenarios
- Leading to failure of the business - tests should effectively “kill” the organisation
- Then recovery of the business
- Designed to assess resilience
- Mitigation strategies tested

What will you test?

- The big things that would stop you achieving your objectives / break your business

What questions will you ask?

- Stop development - how long would it take and what are the costs?
- Redundancy / restructure – how much would it cost, do we have the cash?

Financial Plan

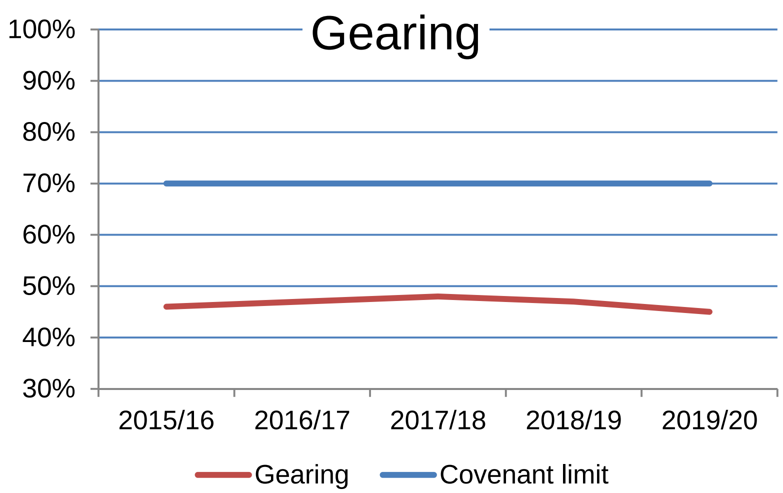
The role of your financial plan

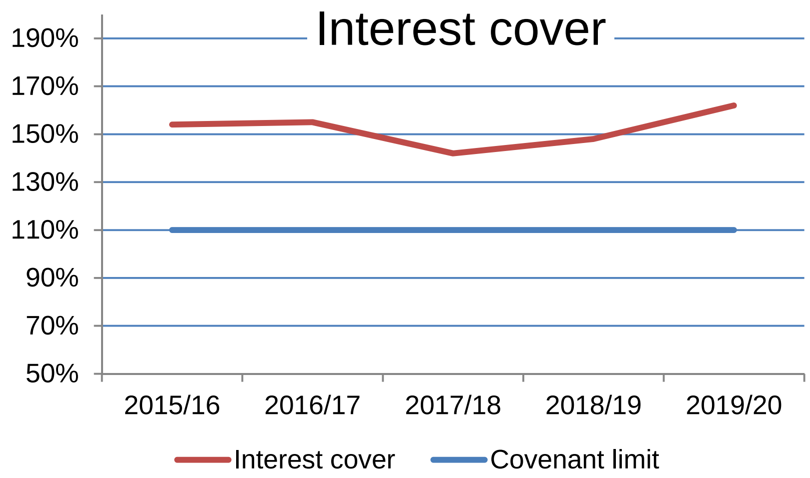
Elements of stress testing

- Develop base plan
- Test individual plan sensitivities
- Model combined (multivariate sensitivities)
- Develop operational stress tests
- Look at what will break the plan

HCA requirement for Associations to have: '*a clear understanding of what would cause their business significant financial distress and plan mitigating strategies to deal with any exposures*'.

Example 5000 unit Association
Base plan easily meets covenants





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Individual Economic Scenarios

The following individual key risk scenarios were considered by the association:

- Rents down 2% on CPI for 5 years
- Costs rise 2% above rent increase levels
- LIBOR up 2% years 2 – 4
- Management expenses up 10% years 2 – 7
- Repairs up £750k in years 2 – 7

Interest cover has been identified as the tightest covenant

Results – Individual Scenarios

Scenario	Impact	Results
Rent increase -2%	Reduced income year on year £1- £2m in short term, increasing to £5m by year 20	Reduced surplus results in pressure on interest cover covenant.
Cost inflation 2% above rent	Increased costs year on year £1- £2m in short term, increasing to £5m by year 20	Further worsened by borrowing requirement increase at higher cost
LIBOR up 2%	Higher interest costs	Higher interest cost puts pressure on interest cover
Management Expenses +10%	Additional costs of £1m each year	Worsened cashflow results in increased debt and small impact on asset cover / gearing / debt per unit
Repairs increase by £750k	Additional costs of £750k each year	Plan can cope any individual scenario

How would the plan get "broken"?

What do we mean by broken?

Reduction in Surplus?

Out of Cash?

Breaching loan covenants?

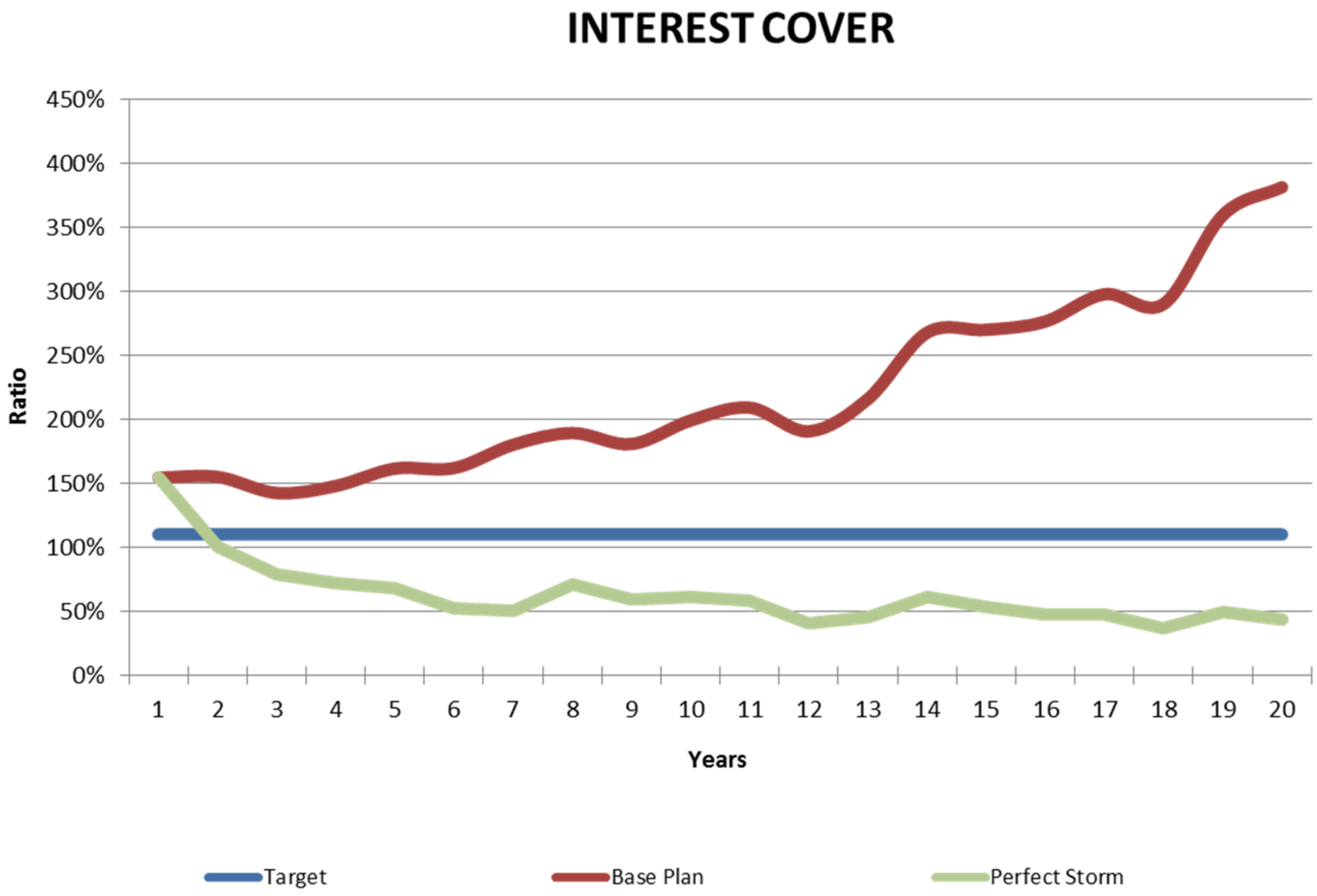
Breaking the Plan – "The Perfect Storm"

- Individually, **NONE** of these result in a breach.
- However, **IN COMBINATION**, these movements together result in:

Scenario	Impact	Result
Perfect Storm 	Very high impact as costs increase significantly and income decreases. Net impact £5m 2016/17, rising to £50m as interest costs spiral. This assumes development continues at the planned rate which would not be possible.	Breach interest cover covenant as surplus reduces and interest costs increase Breach debt covenants as debt increases Due to increased borrowing to cover cashflow issues The Plan is broken…..shown in the following graphs

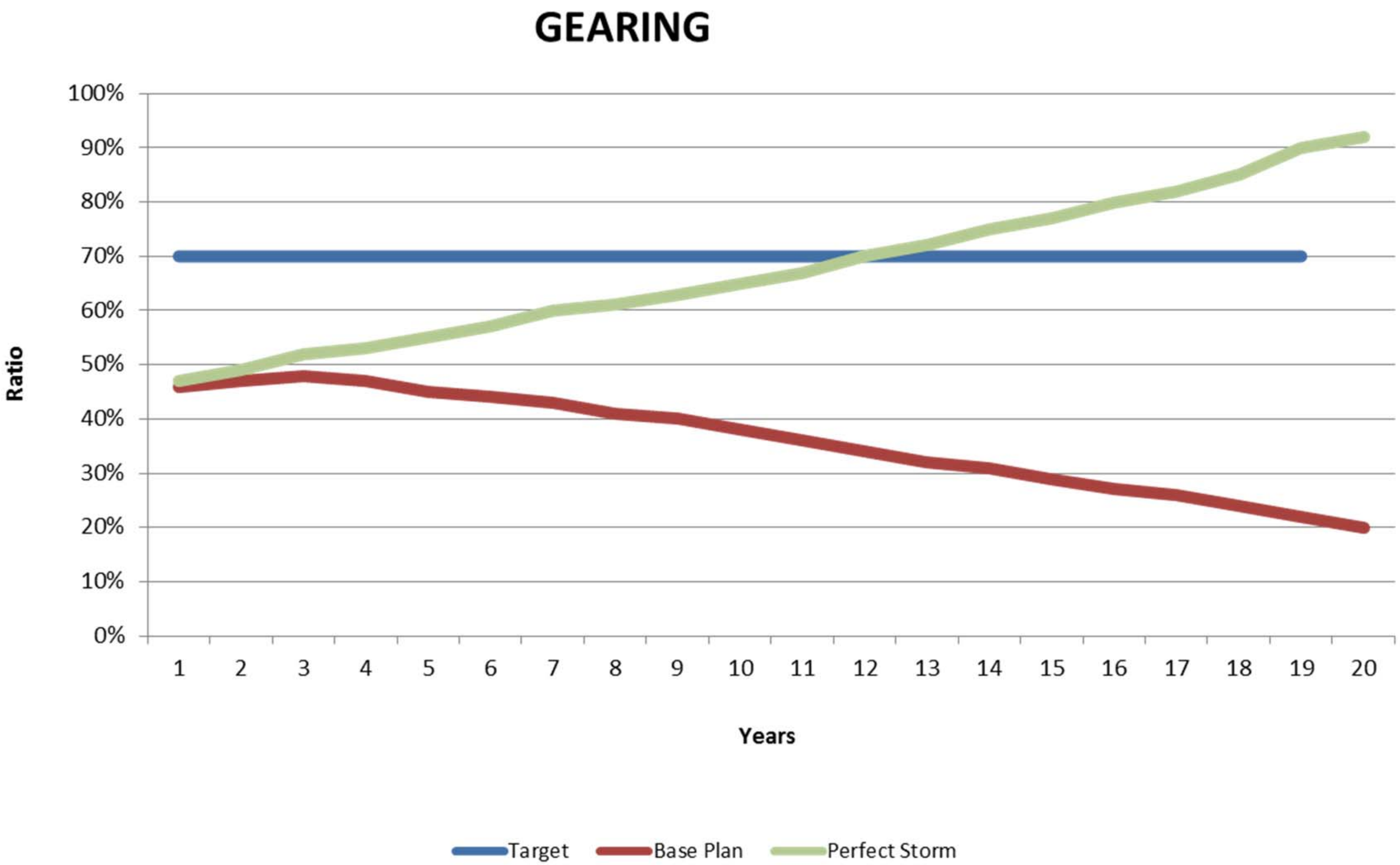
Scenario Results

- Combined costs and reduced income mean additional borrowing is required due to cashflow issues. This increases interest costs and interest cover breach in year 2.



Scenarios Results

- Increased debt results in the gearing covenant being breached in year 12



Possible stress-testing issues

Housing market	Outright sale & shared ownership	Social rent policy and market rents
Security valued at EUV	Security valued at MV-T	Costs of working capital
Interest rates	Stand-alone swaps	Cross-default
Funding market disruption	Counterparty failure	Contract performance
Loss of major contract	Joint venture failure	Welfare reform
Welfare cap	Volatility of cashflows	Costs
Values & volumes	Wages and costs	Low inflation
Pensions	Impairment incl. Investments	Housing Finance Grant and security

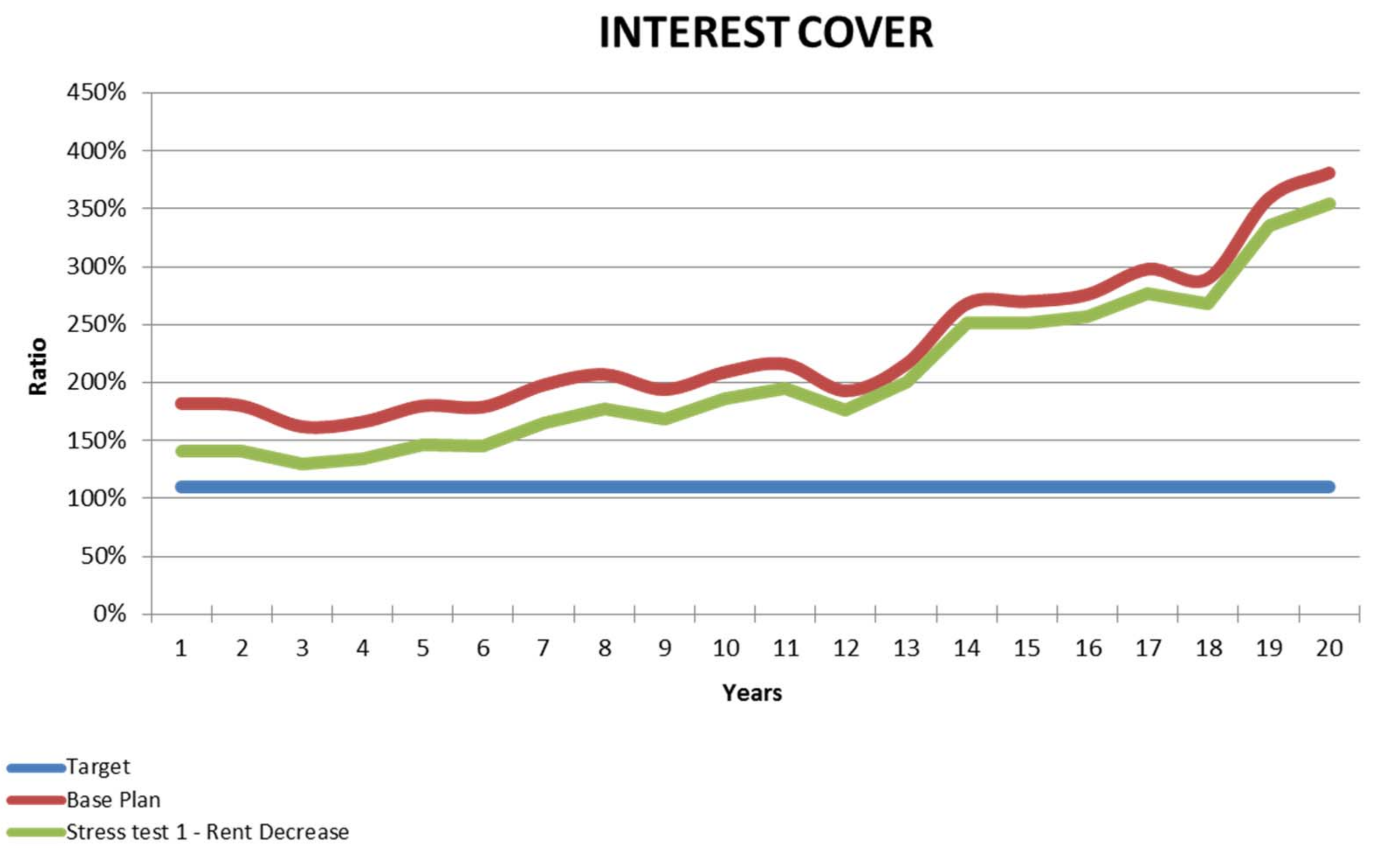
Stress Test 1

The Impact of Welfare Reform – Loss of Income

- Universal credit impacts on rent collection
- Increase bad debts
- Employ additional staff to improve collection rates
- Voids increase
- Lose Supported People Income and reduce staffing
- All of these steps result in a reduced cashflow and a reduced surplus……

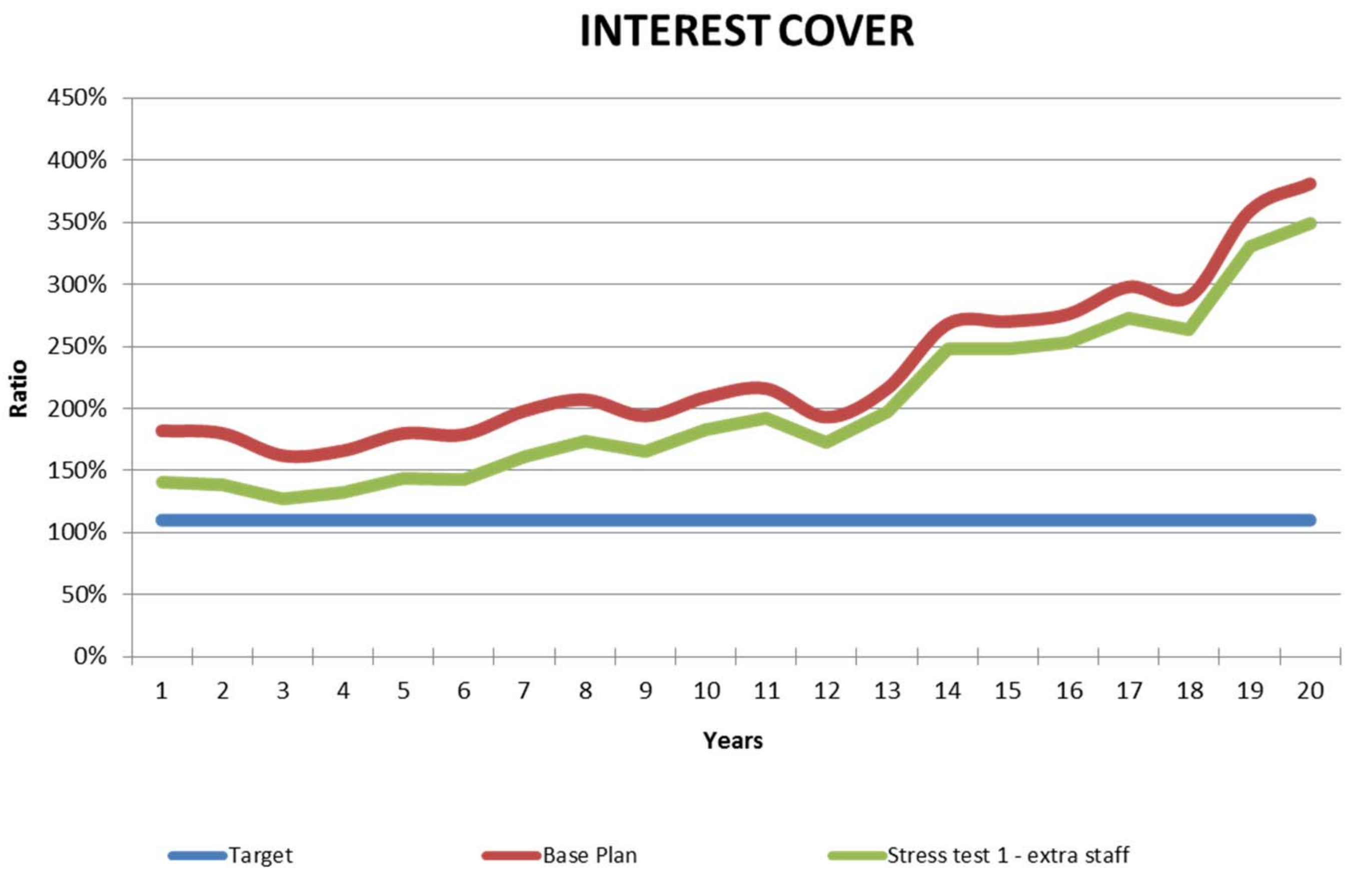
Stress Test 1 – Loss of Income – Step 1

- Universal Credit – rent collected reduces to 96% (bad debts increase to 4%) - reduction in surplus (Bad Debts increase 900k p.a)



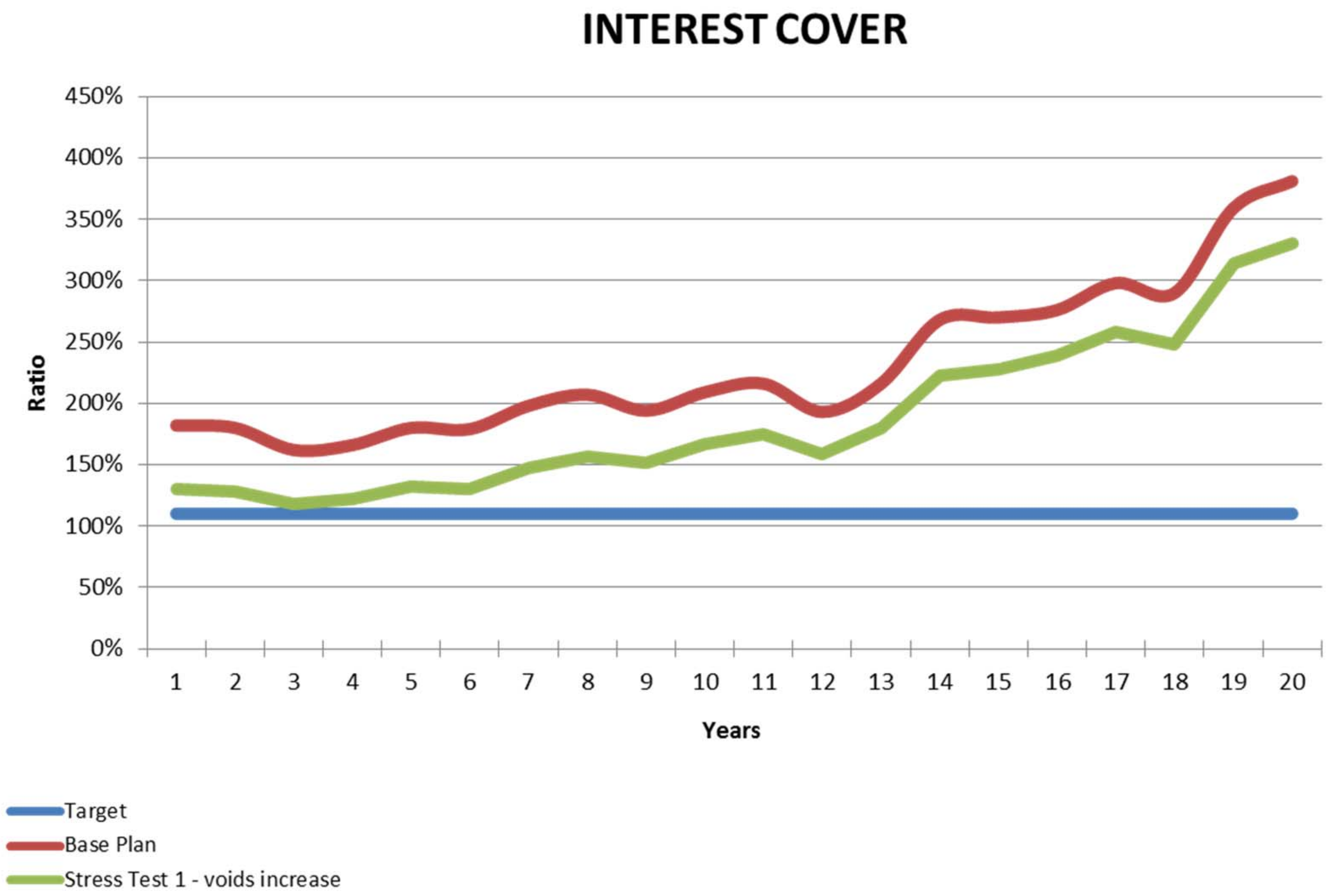
Stress Test 1 – Step 2

- Additional Staff Costs – small further reduction (c£200k per annum)



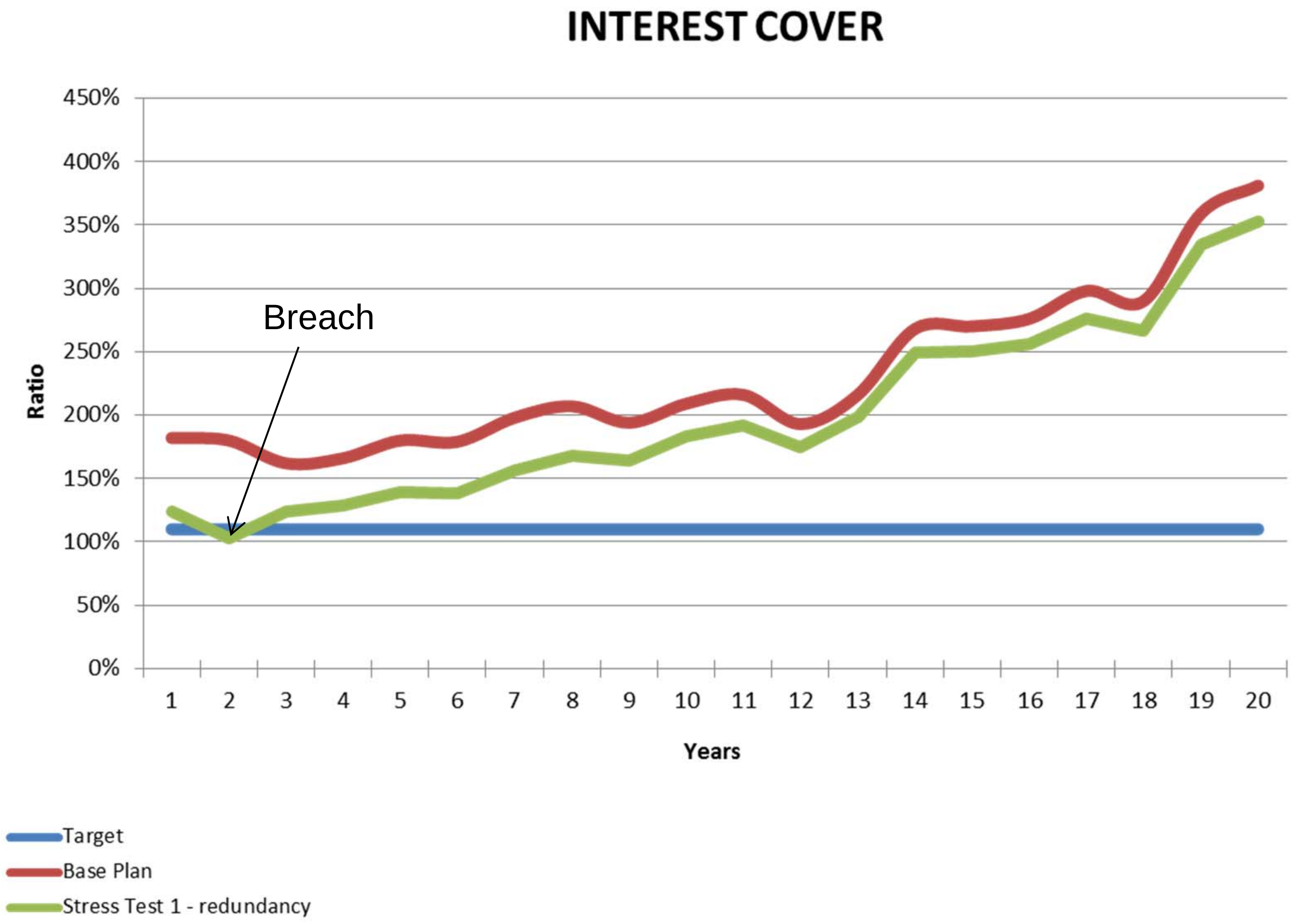
Stress Test 1 – Step 3

- Increased Voids – further surplus reduction (600k p.a)



Stress Test 1 – Step 4

- Redundancy Costs and loss of income results in breach in year 2 (total net impact an additional £1.2m). Overall impact over £3m



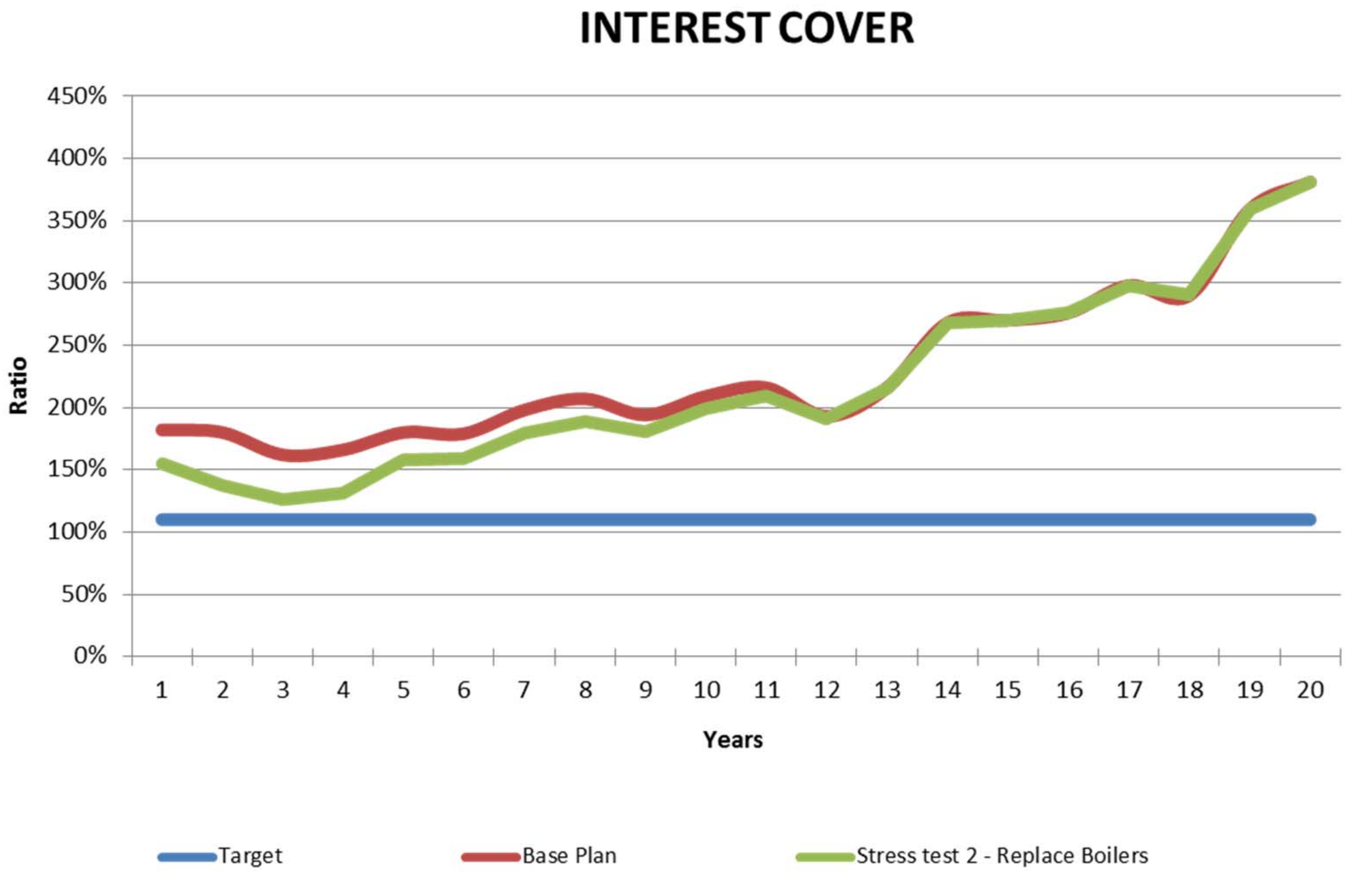
Stress Test 2

The Impact of Legislative Changes – Increased Costs

- Gas boilers need to be replaced – impact on cashflow now and surplus in future years (depreciation)
- CPI decreases to -1%, an all time low – reduces income and reduces cash
- As rent income reduces, property value reduces – this reduces asset values and the surplus (through impairment)

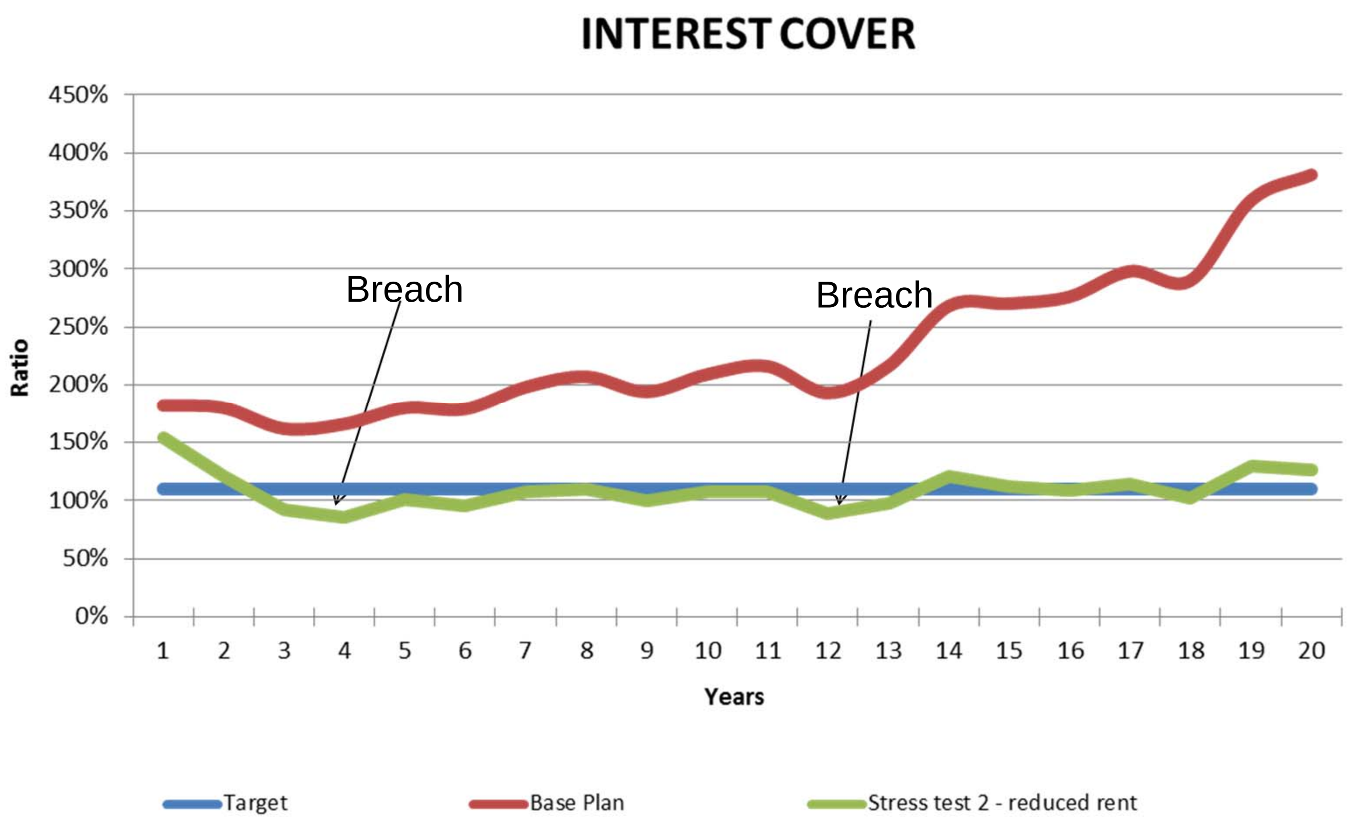
Stress Test 2 – Increased costs – Step 1

- Legislation requires boilers to be replaced (capital expenditure means cash impact of c£1m, depreciation impact on surplus 100k p.a)



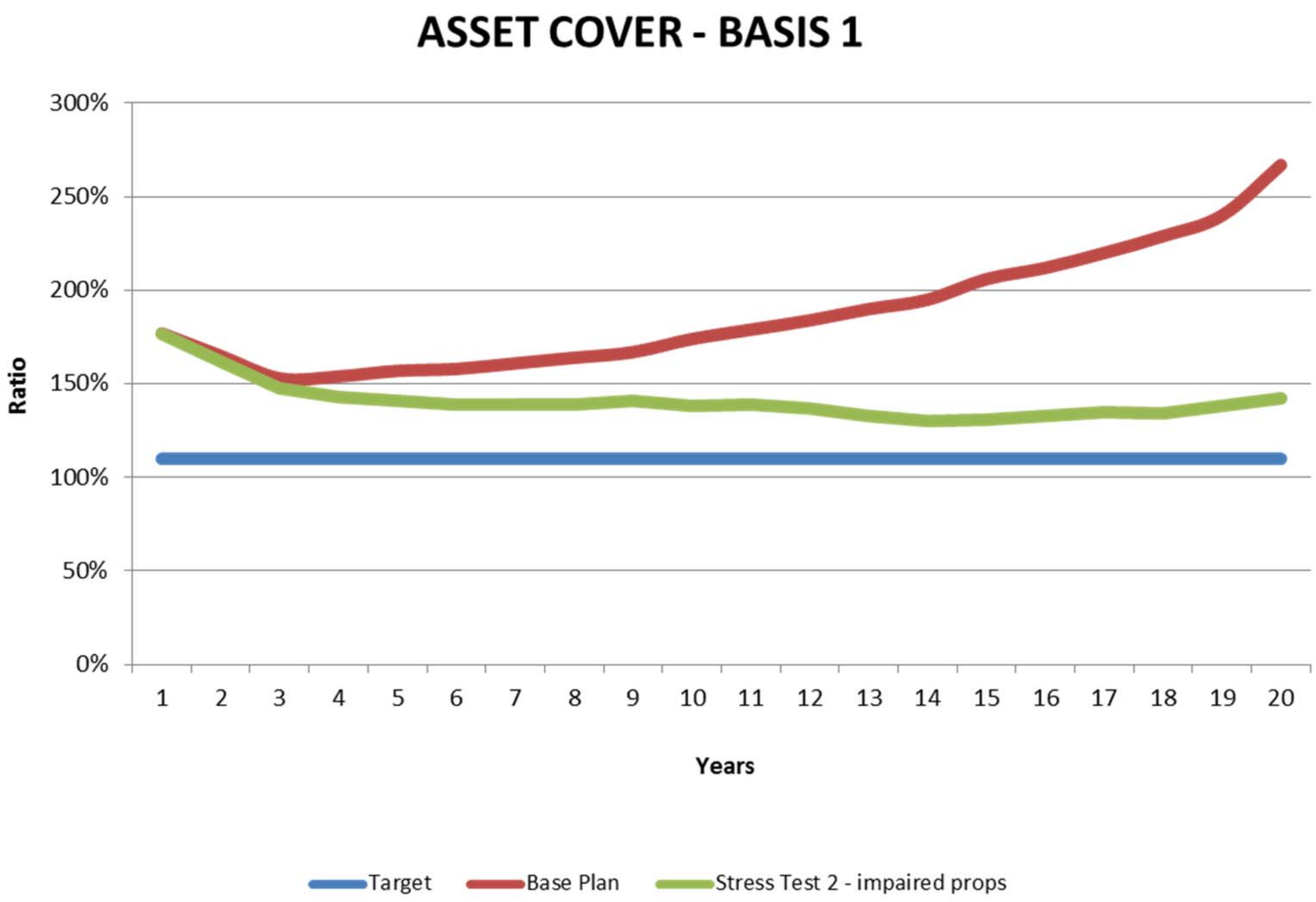
Stress Test 2 – Reduced Income – Step 2

- CPI decreases resulting in significant rent income reductions (£1-2m short term rising to £5m by year 12). The covenant is breached several times.



Stress Test 2 - Valuation – Step 3

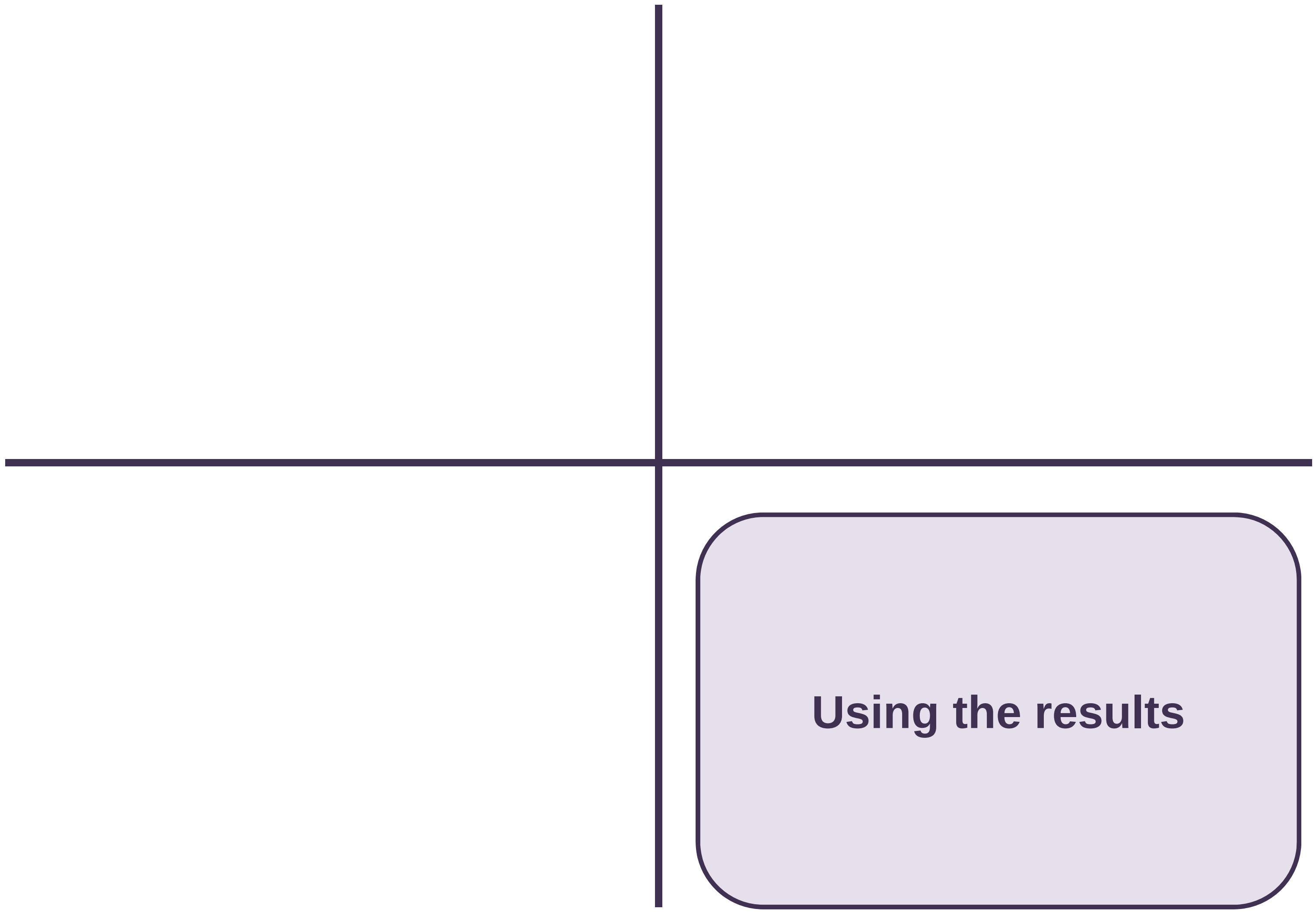
- Reduced rents results in impairment of properties, reducing balance sheet value - impacts on Gearing / Asset Cover



Breach Implications

- Lenders could call in debt and seize assets.
- Most likely implication would be an increase in costs
- There would be reputational implications for future borrowing requirements.
- Further pressure on the business plan?
- Long term viability?
- Regulatory action / takeover?

Using the results



Stress testing outputs

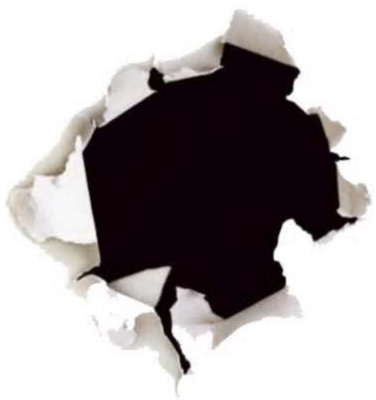
- The stress testing shows an interest cover breach in 12 months time.

- What would you do?

But there needs to be a plan

What is the plan?

- Review Discretionary Spend
- How would it be defined? How would it be prioritised?
- Extent of actions depends on the size of the "hole"?



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Recovery Plan

- Identify the nature of the shock

- What will it affect – CASH? COVENANTS? OR BOTH

- If Cash, RP could:
  - Approach funders for a revolving credit facility.
  - Delay spend on voids, planned maintenance, adaptations.
  - Review management expenses and stop any discretionary spend.
  - Sell properties as uncharged ones become void.
  - Invoke urgency arrangement processes to make swift effective decisions.

- If Covenants, RP could:
  - Sell properties as uncharged ones become void. This would have limited effect but could reduce interest costs.
  - Reduce on-going costs as above.
  - As soon as the RP becomes aware of a potential breach, notify the funders of issues and request a waiver.
  - Inform the regulator.
  - Invoke urgency arrangements procedures to enable fast decision making.

After the modelling - Be prepared

- Set in place early warnings & triggers
- Amend dashboard / KPIs
- Define internal “Golden Rules”
- Build into decision-making processes
- Review Board skills
- Revise delegations
- Check urgency powers

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