



COUNCIL of MORTGAGE  
LENDERS

NORTH WEST WING, BUSH HOUSE,  
ALDWYCH, LONDON WC2B 4PJ

tel: 0845 373 6771

fax: 0845 373 6778

website: [www.cml.org.uk](http://www.cml.org.uk)

## **Independent review of regulation of social housing**

### **Response by the Council of Mortgage Lenders**

#### **to the Department for Communities and Local Government**

**16 February 2007**

#### **Executive summary**

- The CML supports the better regulation agenda; any proposals for regulatory change should be subject to full cost benefit analysis.
- Lenders are a key stakeholder in the HA sector with over £35 billion of lending committed. Private finance is of greater financial importance than government grant going forward.
- By reducing risk to lenders and by raising standards of financial management and governance, estimates suggest that regulation saves £200-400 million per year in lower lending costs to the HA sector compared to normal commercial lending rates.
- It is essential that the terms and conditions of existing lending are not retrospectively changed by dilution of regulation.
- Regulation must be risk based and reflect risk from a lender perspective, further blanket reductions in the level of regulation for whole categories of HA would not be acceptable; an efficient HA active in new development may be more at risk of default than an inefficient but inactive one.
- To sustain lender confidence the regulator must be independent of HAs themselves and of government. Self regulation is not an option except for some aspects of service delivery outputs.
- Core elements of regulation for lenders are finance and governance. These underpin the present trade-off of risk and return.
- HAs lack the structural drivers such as shareholder discipline that normally make for efficiency and financial viability in a PLC. Fundamentally, this is what makes regulation necessary from a lender perspective.
- Key regulatory activities for lenders are registration, gathering of financial information, monitoring financial performance, intervening when problems of governance or finance are identified and taking an active role in resolving problems when financial default is threatened.

- There are real advantages in co-locating the regulatory and investment functions as currently is the case with the Housing Corporation, when financial difficulties arise.
- Regulation should not be confused with accountability to tenants. The latter is output focussed and does not presuppose knowledge or interest in the governance, management or delivery processes of an HA.
- Contractual regulation can be effective in regulating the outputs of an organisation such as service delivery. It cannot adequately deal with elements of the organisation itself such as governance and financial performance however. For the latter a different type of regime underpinned by statute is essential.
- It is not appropriate for the regulator to impose penalties for poor service delivery by HAs by imposing lower rents. This is incompatible with debt finance and HAs would not respond to such a sanction in the same way as a PLC.
- The concept of a common contractual regulatory regime for service delivery across the social housing sector deserves further exploration, though without prejudice to the need for a distinct statutory regulatory function for HAs covering financial performance and governance.

## **Introduction**

1. The Council of Mortgage Lenders (CML) welcomes the opportunity to respond to the call for evidence issued by the Cave Review of social housing regulation.
2. The CML is the representative trade body for the residential mortgage lending industry. Its 160 members currently hold over 98% of the assets of the UK mortgage market. In addition to lending for owner occupation and private renting, CML members have lent over £30 billion to housing associations (HAs) in England for new build, repair and improvement to social housing.
3. This response has been prepared following consultation with the CML Social Housing Panel of members.

## **General remarks**

4. The CML accepts the principles set out in the report of the Hampton Review *Reducing administrative burdens: effective inspection and enforcement* (HM Treasury March 2005). In particular, the CML supports the principle of risk assessment as fundamental to regulatory systems and this perception underpins the response as a whole. In addition, the CML and its members support the need to eliminate regulatory overlap and remove unnecessary regulatory burdens and costs where this is consistent with sound risk assessment and management. The assessment and monitoring of risk is, after all, key to prudential lending.
5. The CML also subscribes to belief that any proposals for regulatory change should be subject to full cost benefit analysis; a cornerstone of the better regulation agenda.
6. This response by the CML inevitably focuses heavily on the regulation of the finances and governance of HAs. It is these aspects of regulation that have the most serious impact upon lenders and where, correspondingly, they have the most to contribute in terms of accumulated experience. Nevertheless, this response will put these matters into a broader perspective and suggests approaches to the regulation of the social housing sector as a whole. Within this context the CML explores the different nature and application of statutory and contractual regulation, and the all important distinction between regulation of finance and governance and regulation of service delivery.

## **Lenders and regulation**

7. While the call for evidence does recognise that lenders are a significant stakeholder in relation to regulation they are not accorded the same prominence as residents and Government. This is unfortunate. Lenders have a historic investment in the HA sector of over £35 billion. Private finance has now overtaken grant as the prime source of funding for HA maintenance, improvement and development. Together with residents and Government, lenders are one of the three key stakeholders.
8. The present level and nature of lender involvement in the sector has been predicated on the regulatory regime administered by the Housing Corporation (HC). In particular, regulation has enabled lenders to offer wide access to private finance at rates which are acknowledged to be highly competitive and significantly lower than those prevailing in the wider commercial lending markets. It has been variously estimated that the saving in lower interest rates alone made possible by the existence of regulation is £200- £400 million per annum, representing margins for RSLs of rates as low as 30 basis points over the London Inter-Bank Offered Rate (LIBOR) compared to rates of 90- 200 basis points for comparable

unregulated commercial lending. While such estimates are inevitably imprecise the fact of the saving must be set squarely against the direct and indirect costs of regulation itself. The key features on which pricing and availability are predicated are:

- A focus on governance and issues of financial viability.
- Powers resting with an independent regulator to monitor the HA sector, intervene when problems of governance or finance arise and to broker solutions in the event of default or insolvency.

9. While regulation does not eliminate risk for lenders (and while Government does not underwrite the HA sector) it does limit risk associated with financial exposure by establishing minimum standards of governance, financial management and performance. It also provides mechanisms to supervise RSLs that fall short of required standards in key respects. Were regulation to become less effective from a lender perspective lenders would effectively revise their rating of the sector and both the price and the availability of private finance would suffer as the risks of some projects became unacceptable in terms of lenders' own risk/return ratios and overall exposure.

10. It is likely that the maturity of lending would shorten also; leading to higher refinancing costs for the sector and some additional liquidity risk. Maximum gearing would also be reduced. This would not simply be new conditions applied to new lending. Significant dismantling of regulation could be a prepayment event in respect of existing lending also (see below).

11. It is possible that a proportion of the diminishing group of HA lenders would exit the market entirely and, given the increasing risk profile and intense competition in the sector it is by no means clear that new players would move in to replace them. Nevertheless, there would still be lenders engaged in funding, it is the terms of that funding that would be significantly different.

12. The capital markets would react also to a perceived dismantling of the existing regulatory regime. The rating agency Standard and Poors has already alerted the markets to the possibility that changes in regulation may be in the offing:

- "The current strong investment-grade ratings in the sector are supported by the existing system of regulation and the stability and predictability associated with it. Given the changes that have occurred across the sector in recent years, however, it is fair to say that the upcoming review of social housing regulation is timely in ensuring that the system of regulation remains effective for the future. The impact of any change in regulation will have to be taken into consideration when assessing potential credit implications."

(Standard and Poors November 2006)

13. A further consequence of a reduction in regulation could be reconsideration by the FSA of the 50% capital weighting for loans registered HAs recently obtained under the Basel 2 capital accord. This low weighting rested heavily on the existence of the present regulatory regime. The major lenders would immediately adjust their internal capital adequacy models in relation to both new and existing lending. Were the weighting to rise, loans pricing would be forced up as lenders would be required to hold more regulatory capital. The attitude of the FSA to any proposals to significantly alter the present regulatory regime is thus most important.

## **Regulation – key aspects for lenders**

14. The HC is to be replaced by a new agency, Communities England. In addition the Cave Review has a wide remit to enquire into the structure and purpose of social housing regulation. Change is therefore inevitable. In this situation it is incumbent upon lenders to articulate clearly the key features of regulation that are important to them and for the continued health of the social housing finance market. Those key features are set out below:

### **Protection of existing investment**

15. Over £35 billion of lending has been committed on the basis of the existing regulatory regime. Were Government to retrospectively reduce the effectiveness of the regulatory regime in relation to existing lending the loss of confidence amongst lenders would be very serious and could lead to some lenders leaving the market. The effects on capital market investors could potentially be even more serious given the relative lack of day to day involvement such investors have with the HA sector and their consequent reliance on "headline" information. In respect of banks, any material decline in the level of regulation could be a prepayment event, triggering immediate adjustment to the terms of lending. The quotations below from a typical lender loan agreement illustrate the importance of HC type regulation and registration as set out in its statements of regulatory policy as integral components of lending on present terms:

### **REPRESENTATION AND WARRANTY**

Status and Due Authorisation: It is a housing association within the meaning of the Housing Associations Act and is a registered social landlord within the meaning of the Housing Act and registered under the Industrial and Provident Societies Act 1965 and it is duly established under the laws of England with power to execute and deliver the Finance Documents and to exercise its rights and perform its obligations thereunder and all corporate and other action required to authorise its execution and delivery of the Finance Documents and its performance of its obligations thereunder has been duly taken.

### **COVENANTS**

Status: The Borrower shall maintain:

- 1.1.1 its registration as a Registered Social Landlord;
- 1.1.2 its registration under the Industrial and Provident Societies Act 1965;
- 1.1.3 [its non-charitable status/its status as an exempt charity;] and
- 1.1.4 its entitlement to receive Public Sector Grants.

Business: The Borrower shall carry on its business in accordance with its rules and the guidelines of the Housing Corporation

### **EVENTS OF DEFAULT**

Breach of Housing Corporation Guidelines: The Borrower fails to carry on its business in accordance with:

1.1.1 the publication of the Housing Corporation entitled "The Way Forward Regulation" and "The Way Forward Inspection"; or

1.1.2 any guidelines published by the Housing Corporation or other body from which the Borrower receives or might receive Public Sector Grant

and, as a result there is a significant reduction in the amount of all or any Public Sector Grant receivable by the Borrower, or the Housing Corporation indicates that such a reduction will take place, which reduction, in the opinion of the Bank, might be expected to have a material adverse effect on the Borrower . . .

### **Action by the Housing Corporation:**

1.1.1 Any person is appointed by the Housing Corporation under paragraph 20 of Schedule I of the Housing Act to conduct an inquiry into the affairs of the Borrower.

1.1.2 The Housing Corporation presents a petition for the winding-up of the Borrower under paragraph 14 of Schedule I of the Housing Act.

1.1.3 An order is made by the Housing Corporation under paragraph 23(2)(b), 23(2)(c), 24(2)(c) or 24(2)(d) of Schedule 1 of the Housing Act.

1.1.4 The Housing Corporation directs the Borrower under paragraph 27 of Schedule 1 of the Housing Act to transfer land to the Housing Corporation or any other registered social landlord or person.

### **Risk based**

16. Regulation must continue to be risk based from a lender perspective. This means that the regulatory activity must reflect both the potential financial losses given a default and the probability of a default for different HAs. This militates against measures to impose a higher blanket minimum size limit (eg, 1,000 homes) before full regulation is applied or by offering a light touch regulatory regime to some HAs purely on grounds of their "efficiency" An HA that is efficiently pursuing an ambitious development programme and is highly geared may represent a greater risk from a lender perspective than an inactive HA with little borrowing.

### **Independence and clarity**

17. Lenders are clear that the key regulatory functions of monitoring, standard setting and, crucially intervention must be exercised by a regulator that is genuinely independent of the social housing sector. Self regulation in the areas of financial viability and governance whether by a trade body or panel of HAs themselves would not command the confidence of lender credit committees and would potentially lead to withdrawals from lending in the sector. This is not to deny a limited role for self regulation in the area of service delivery outputs. The regulator should also be independent of Government. Government has interests (such as obtaining the highest transfer price in a Large Scale Voluntary Stock Transfer (LSVT) that could conflict with the need for a viable new landlord. Lenders have taken comfort from the distance from Government provided by the Non Departmental Public Body (NDPB) status of the HC, and in Scotland Communities Scotland, though an executive agency has a regulatory board with an independent majority, constituted in response to lender concerns. The CML has consistently warned of the risks inherent in the situation in Wales where the Welsh Assembly Government directly regulates HAs.

18. As already indicated, were significant changes to be introduced in the above areas lenders would continue to lend but at different rates and on different terms

### **Core elements: finance and governance**

19. For lenders the crucial focus of regulation is finance plus governance. This is not to deny the importance of regulation of service delivery outputs within the broader picture; such regulation is clearly important in promoting efficiency and in ensuring that services meet the needs and aspirations of tenants and in monitoring the efficiency of development programmes. It is also important that the regulator ensures efficient use of public funds on behalf of government. Nevertheless for lenders, finance and governance remain the key areas.

20. Lenders have observed that financial problems within an HA are almost always preceded by governance problems. Indeed, on some occasions an HA brought under HC supervision because of issues of poor governance have subsequently been discovered to have financial problems also. HA governance is thus an area of ongoing concern to lenders and those concerns constitute one of the key reasons why regulation of the organisation rather than simply its outputs is necessary in relation to an HA but not for a PLC of similar size:

- HA boards are not chosen to ensure a proper matrix of relevant skills and experience; up to 2/3 of a board may be tenant or local authority nominees and there has long been a recognition that such representatives need not possess skills in risk management, finance and accounting or the management of homes.
- When boards do seek relevant skills and experience they frequently have a limited pool of potential recruits because most board positions are still unpaid.
- Boards are not incentivised to pursue development or to manage risk effectively.
- There is no shareholder discipline exercised on boards as would be the case for a PLC. This is a crucial difference.
- Tenants are unable to offer the sort of pressure towards efficiency as consumers that would be possible in other industries. The under supply of social housing makes the exercise of choice of landlord extremely difficult in most areas of England and tenant perceptions of value-for money are blunted by the housing benefit system.

21. For lenders therefore, HA regulation is a substitute for the effective drivers and disciplines that would be found in an otherwise comparable PLC. While excessive regulation can undoubtedly stifle innovation and efficiency, the HA regulatory regime that has developed and changed over a thirty year period is essentially a reaction to the experienced shortcomings of HAs and is not fundamentally the cause of those shortcomings.

22. A review of regulation committed to a wide-ranging examination of HA regulation should be prepared to focus on the shortcomings of HA governance that make such regulation necessary. The recent discussions surrounding a proposal that Place for People might become a PLC suggest that some HAs may be beginning to think about these issues for themselves.

### **Key regulatory responsibilities**

23. It is most important for lender and investor confidence that there are clear answers to key questions:

- Who undertakes the initial assessment and registration of HAs including those established for LSVT?
- Who collects financial information for HAs across the sector? Such information provides a common platform for competitive assessment for lending purposes by lenders and is valuable for monitoring. There would be significant additional costs were lenders to have to augment their own monitoring and to generate comparisons across HAs in the absence of the present common platform.
- Who monitors the financial state and governance of an HA? Who would enforce financial disciplines (such as production of 30 year business plans) that raise prevailing standards of financial management? While some of the requirements on HAs (such as those relating to the Housing Act 1996 s.9) are unnecessary proper detailed consultation with lenders would be most important in formulating proposals for simplification. Certain HC activities such as development audits involving financial appraisal are seen as becoming more important.
- Who exercises powers to intervene when an HA is perceived to failing in its governance or finances? Such intervention (eg, very importantly, the statutory power to appoint board members) allows lenders to have lighter touch and greater confidence. The HC is also able to intervene over matters of governance that are difficult for lenders to identify and address.
- Who has the power to act in the event of a default and on what legal basis? At present the regulator sits at the centre of a ring of creditors, and, with the assistance of the 28 day moratorium, can broker a solution that will save direct lender intervention to realise their security. With HAs merging into larger organisations and with development risk increasing the significance of these powers will increase.

24. The above functions are at the core of regulation from a lender perspective. Any dilution would affect loan pricing and availability.

The answers to the above questions must involve reference to a single identifiable and coherent body; the responsibilities involved in decisive regulatory action in fields such as HA governance and finance cannot be shared amongst different bodies or exercised by a loosely constituted panel or committee.

## **Wider issues**

### **Location and co-location**

25. With the forthcoming demise of the HC the location of the regulatory function must be a matter of discussion. Where ever the function is physically located it will be important that it is able to draw on the accumulated skills and experience of the HC staff to as great an extent as possible, so that there is no temporary loss of effectiveness on transfer.

26. Clearly two of the prime candidates to host regulation are Communities England and the Audit Commission (AC) which already has the HA inspection role. At present the AC has a very public sector culture, and this would need to change significantly if it were to effectively regulate HAs.

27. One significant argument in favour of Communities England concerns the desirability of co-location of financial regulation and investment in order to facilitate close



communication and co-operation. When HAs have fallen into significant financial difficulty the HC has been able to facilitate takeover or merger by diverting a limited amount of grant in the direction of the ongoing body and assisting to broker a new arrangement. The HC has a successful track record in this regard and its intervention has helped to ensure that there has so far not been a default in the sector. In addition the regulatory function has the opportunity to feed back to investment in a situation where pressure from the latter to keep to ambitious grant aided development plans could threaten the viability of an HA. While such arrangements would not be impossible to engineer without co-location they would be more difficult.

### **Regulation v. accountability**

28. It has been suggested that a substitute for regulation could lie in increased tenant accountability. This is to miss the key differences between regulation and accountability. An HA is rightly accountable to its tenants for service delivery standards. Such accountability is essentially that of any industry to its consumers, however, and focuses on the relevance and quality of outputs to the individual consumer. It does not presuppose expertise in the management of the industry or its processes, or indeed even an interest in them. Being a tenant, for instance, does not imply an interest in housing management or HA governance, any more than being a mortgage borrower presupposes expertise or interest in managing the mortgage provider.

### **Statutory v. contractual regulation**

29. Since the HC regulatory regime was established the social housing landscape has become more complicated. Grant is now given to developers, who may, in the future choose to hold and manage as well as build properties. In addition the old binary division between local authorities and HAs has been further eroded by the development of Arms Length Management Organisations (ALMOs). In this context contractual regulation has been seen by some as a panacea, allowing for a common regulatory platform across sub sectors promoting common standards and outputs. This view has been given additional weight by the widespread recognition that private developers are unlikely to wish to submit to the type of statutory regime that applies to HAs.

30. In the view of lenders contractual regulation would not be appropriate for financial regulation of HAs. There are several reasons for this view:

- Contractual regulation in the area of finance and governance would apply where grant is involved and it is difficult to see how HA borrowing where grant was not involved would be regulated in these respects, or how existing investment by HAs that are no longer using grant would be safeguarded.
- Contractual regulation by its nature regulates outputs rather than organisations themselves. Issues of financial viability and governance fall clearly into the latter category and would not sit easily within a contractual regime. Nevertheless, these elements are central for lenders. While contractual regulation may provide opportunities for effective regulation of service delivery, finance and governance will require a statutory approach.
- It is difficult to see how HC powers in relation to intervention/supervision and in relation to default and insolvency could be replicated in a new regime without appropriate statutory backing. These powers are at the core of the risk/return equation on which lending to HAs is predicated.

- Ultimately a regulatory regime must be appropriate for the type of organisation to be regulated and the reasons that justify that regulatory intervention. As already discussed above, there are fundamental differences between the governance and drivers of an HA and those of a PLC. Contractual regulation can regulate the outputs of a PLC which has its own mechanisms to ensure efficiency, sound governance and profitability, it cannot ensure sound governance and financial viability of an HA.
- Recent examples of contractual regulation of developing non HAs exhibit a significant shift of risk in the direction of the developer, notably in relation to subordination and recovery of grant. Such requirements would not support lending to HAs on prevailing terms.

31. The CML and its members believe strongly that a distinct statutory regime to secure sound governance and financial viability is essential if the social housing finance market to HAs is to be promoted on the present basis in terms of lending and access to funding. In the absence of such a regime a conventional commercial lending market would prevail.

### **Rent levels as a regulatory sanction?**

32. In enforcing standards of service delivery, regulators in some other sectors have recourse to price as a regulatory tool. Provision of poor service can lead to an enforced reduction in charges. Conversely, high quality deliverers may in some circumstances be able to charge more. There has been some discussion of the possibility of a regulator using HA rent levels to promote standards in this way.

33. While lenders are alive to the possibility of using incentives to promote high standards, there are difficulties in applying the notion of rent reductions straightforwardly to the HA sector:

- PLCs are predominantly equity funded, if prices are cut and profitability deteriorates equity investors take a loss in share values but can enforce changes on an organisation to improve service delivery and restore profitability. HAs by contrast are debt rather than equity funded; for debt investors deteriorating profitability simply means that risks increase leading ultimately to default or breakage of loan covenants in extreme cases. Such a scenario would undermine the present fine pricing of lending within the sector and could mean that poorly performing HAs would not receive funding.
- As not-for-profit bodies without shareholder discipline, it is not clear that an HA has the drivers to ensure that it would respond by taking concerted measures to restore profitability in the dynamic way that a PLC would be likely to do.
- Reduction in price would not affect tenant (consumer) behaviours in the same way as in other sectors since tenants have little choice of their landlord given chronic under supply of social housing.
- Consideration could be given to rewarding high performing HAs with rent rises. It is not clear however, whether such rises would feed through into further efficiency savings. Also, some tenants would also be vulnerable to sudden upward movements of rent, which makes HA boards reluctant to raise levels unnecessarily. There would, in addition, be Housing Benefit implications for the Exchequer.

## **A common regime for service delivery?**

34. While a distinct regime of financial regulation for HAs is essential there may be scope to consider the possible role of contractual regulation in securing common standards for outputs across the social housing sector as a whole. Tenants have a right to expect the same standards from their social landlord whether that landlord is an ALMO, local authority, housing association, or other body.

35. In these circumstances, there would appear to be the possibility of establishing a common regulator for service delivery and a common regime for service delivery regulation across the social housing sector. Such a regime would be output focussed, would involve inspection and might operate on a contractual basis.

36. Whether such a regime should be co-located with financial regulation and investment is an open question. Clearly the service delivery regulator would need close links with the regulator dealing with finance and governance. There is always the risk that demands from a service delivery regulator for improved outputs could cause an HA's costs to rise with a consequent threat to its viability. Nevertheless, the recent experience of the Audit Commission (AC) and HC where the AC undertakes the HA inspection role suggests that where adequate protocols for communication exist potential problems can be overcome. It may be that the key measures for service outputs developed by the AC for HAs would form the basis of a new intra-sector regime.

37. A move towards common regulation of service delivery would represent a streamlining of regulatory structures and would contribute to a much greater degree of coherence across the social housing sector as a whole. By allowing for a specific regulatory role in relation to HA finances and governance however, it would also recognise the distinct features of the HA sector in these key respects.

## **Further consultation necessary**

38. The above response represents a broad response to the issues raised by the Cave review. It is important to recognise however, that the review has allowed only a very short period for formal consultation. This inevitably means that the CML response has focussed on key principles and has left the detail of possible new arrangements to be discussed at a later stage. It will, therefore, be necessary to maintain a continuing dialogue with the CML and its members to ensure that proposals emerging within the review or in its aftermath receive the detailed scrutiny that they require.

39. This response has been prepared by the CML in consultation with its members. Comments and queries should be addressed to Andrew Heywood, deputy head of policy at the CML:

Telephone: 020 7438 8933

Email: [Andrew.heywood@cml.org.uk](mailto:Andrew.heywood@cml.org.uk)