



Homes &  
Communities  
Agency

# GOVERNANCE AND FINANCIAL VIABILITY STANDARD CODE OF PRACTICE

April 2015

# Governance and Financial Viability Standard code of practice

## The role of the code of practice

- 1 This code of practice (the Code) is designed to amplify the requirements in the Governance and Financial Viability Standard (the Standard). It is designed to help registered providers<sup>1</sup> understand what the regulator is looking for when seeking assurance on compliance with the Standard. The Code clarifies the Standard by explaining and elaborating on the content, with illustrative examples where necessary. Registered providers should have regard to the Code when assessing their compliance against the Standard. In considering whether standards have been met, the regulator will have regard to the Code. It is therefore important that registered providers are familiar with its content. However, it is the Standard rather than the Code that the regulator can enforce against.
- 2 The regulator adopts a co-regulatory approach to its work. It sets both economic and consumer standards designed to help it to deliver its statutory objectives. Responsibility lies with the boards<sup>2</sup> of registered providers to meet these standards. The Code fits with the co-regulatory regime by allowing registered providers to innovate and develop their own approaches to achieve the outcomes and expectations set out in the Standard.
- 3 The Code does not elaborate on all outcomes and expectations set out in the Standard, only where the regulator believes that greater explanation will help registered providers. This does not indicate the relative importance of different elements of the Standard. Registered providers need to comply with the entire Standard.
- 4 Examples of how registered providers might achieve compliance are not intended to be exhaustive nor prescriptive. Should a registered provider comply with the requirements of the Standard in a different manner then it is free to do so. If there are any conflicts between the Code and the Standard, the Standard takes precedence.
- 5 The Code is structured so it follows the layout of the Standard. As such, the required outcomes in the Standard, which set out the high-level obligations on registered providers, are considered first followed by the specific expectations. The regulator intends to adopt a purposive approach to interpreting the Standard. This means the regulator will consider the purpose of including the outcomes and expectations in the Standard when assessing compliance with them.

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<sup>1</sup> This document uses throughout the terms “profit making registered provider” and “non-profit registered provider” to refer to the two types of private registered provider designated in the 2008 Housing and Regeneration Act. For brevity the term “registered providers” is used where the reference is to both types of registered providers. Where used, this term excludes local authority registered providers. Where the document uses the term “the non-profit sector” this indicates both non-profit private registered providers and local authority registered providers.

<sup>2</sup> Throughout this Code references to registered providers' 'boards' should, where a registered provider does not have a board, be taken to include an equivalent management body as appropriate.

## Required outcomes

### Paragraph 1.1: governance required outcome

- 6 The required outcome for governance ensures the delivery of a registered provider's objectives, including being responsible holders and stewards of social housing assets. The regulator considers the reference to compliance with 'all relevant law' in the first bullet point encompasses legislation (including secondary legislation), and common law. In ensuring compliance registered providers should have regard to relevant statutory guidance. To meet the required outcome on adherence to all relevant law boards should take reasonable measures to assure themselves of their compliance.
- 7 The fourth bullet point concerns reputation. Reputation is key in maintaining confidence in the sector. The social housing sector has benefited from being part of a regulated sector with low lending rates combined with the availability of public investment. Registered providers should ensure that they manage their businesses and their risks in such a way that they do not negatively impact on the reputation of the sector.

### Paragraph 1.2: financial viability required outcome

- 8 Registered providers should take all such steps as are reasonably necessary to ensure that any activities they undertake do not place social housing assets, activities relating to the provision of social housing or their own financial viability at undue risk. The regulator recognises that registered providers should have the flexibility to consider risks in light of their individual circumstances. Boards of registered providers have the responsibility to satisfy themselves and provide assurance to the regulator that:
  - they have considered the requirement appropriately in relation to their own external and internal operating environment
  - they are satisfied they will comply with regulatory requirements now and in the foreseeable future
- 9 Examples of what the regulator considers to be unacceptable outcomes resulting from social housing assets being put at undue risk are outlined below. These examples are not intended to be exhaustive but rather to give context to registered providers in considering the risks within their business:
  - loss of social housing assets and/or tenants losing their home or the benefits of being within a regulated sector due to lenders or others enforcing their security or insolvency
  - loss of social housing assets where the sale of those assets is the result of poor business planning and decisions or where the reason for the sale is to make good an unplanned cash shortfall
- 10 The regulator recognises every business decision will carry risk and sometimes those risks will crystallise. There is, however, a difference between managed risk and uncontrolled loss. The regulator expects boards to manage the business to promote the former and avoid the latter. In addition, the regulator does not intend that all social housing assets should remain in the sector for ever. However, the value in the assets

should not be lost to the sector. Under the Value for Money Standard, registered providers are expected to consider how to make best use of their assets.

## **Specific expectations applicable to all registered providers**

- 11 The specific expectations set out in the Standard are obligations with which registered providers must comply. Registered providers must demonstrate compliance with **both** the required outcomes and the specific expectations in the Standard. This section of the Code will help registered providers understand what the regulator is looking for when considering compliance with the Standard.

### Paragraph 2.1: expectations on the effectiveness of governance arrangements

- 12 Registered providers should demonstrate their actions are consistent with both the principles and relevant provisions of their code of governance and overall contribute to sound governance.
- 13 The regulator anticipates that an assessment of the effectiveness of governance arrangements may vary in terms of depth and scope in line with the internal and external environment within which the registered provider operates. Some parts of a governance review may be carried out to a different timescale than an annual review where this helps ensure the quality and effectiveness of the review. Where this is the case, the annual assessment of the effectiveness of governance arrangements should give assurance on the timescale and progress of work on these areas.

### Paragraph 2.2: expectations on the management of registered providers' affairs

- 14 Paragraph 2.2 of the Standard complements the board's responsibilities to act lawfully and responsibly. Compliance will include both behavioural aspects, such as ensuring that the board and executive foster a culture of constructive challenge and debate, and good governance practices.
- 15 To ensure that registered providers have the requisite skills and capability to perform their functions, the regulator would expect them to:
- have an appropriate skills strategy to address the needs of the business
  - regularly assess whether boards and management have the right competencies, experience, and technical knowledge appropriate to the size, scale and risk profile of the organisation<sup>3</sup>
  - ensure that all material decisions are made with appropriate internal/external expertise or advice and should satisfy themselves of the impartiality of any support or advice

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<sup>3</sup> This should include the business it is currently involved in or is going to become involved in the future as well as the external operating environment.

- have plans to address any skills gaps identified (including through bringing in external skills), and such plans should be monitored to ensure that they are followed through
- 16 In order to determine the appropriate level of independence, registered providers should have regard to their adopted code of governance, relevant legal requirements, e.g. charity law and to their business model. In some businesses, influence is inherent in the corporate structure of the registered provider (for example a profit making registered provider which is a subsidiary of a group). In other cases, influence may not be inherent in the corporate structure but result from close associations the registered provider has with other organisations or individuals.
  - 17 In managing their affairs with an appropriate degree of independence, board members should exercise independence of judgement and act at all times in the best interests of the registered provider. There should also be appropriate mechanisms in place to manage any conflicts of interest to demonstrate probity and value for money.
  - 18 Registered providers should not be subject to undue influence from third parties that could reasonably be expected to lead to non-compliance with regulatory standards.

#### Paragraph 2.3: communication with the regulator

- 19 The regulator requires registered providers to tell it at the earliest opportunity about any material issues that indicate there has been or may be a breach of the standards. This might include, for example, material frauds, liquidity issues, breaches of lenders covenants or failures of governance. This transparency is a fundamental pillar of the co-regulatory approach.
- 20 In deciding what is material, registered providers should be mindful of the regulator's role in the consumer standards. The regulator may only intervene where there has been a breach of the standard which has, or may cause, serious detriment. In relation to the consumer standards registered providers are only obliged to disclose those matters which have or may relate to such a breach.

#### Paragraph 2.4: expectations about business planning, risk and control frameworks

- 21 Registered providers need to ensure their business planning, risk management and control framework is effective. It should cover all areas of the registered provider's business. This should demonstrate the registered provider fully understands and has considered its operating environment, so it can deliver its business plan and organisational objectives. It does not need to be captured in a single document.
- 22 Registered providers should have a clear understanding of their risk tolerances and ensure that they are appropriate to the scale and nature of the activities they are undertaking and their role as a registered provider. Registered providers should be able to identify the capital at risk from any investment activities, and ensure that investment is priced at such a level with a rate of return which is commensurate to the level of risk presented. Where a registered provider is a charity they should consider this alongside

their objects and duties under charity law. Registered providers should consider the potential aggregated impact of risks, as well as their impact at an individual level.

- 23 Registered providers should ensure that they have access to sufficient committed and available liquidity at all times. They should understand the timing of cash flows and any conditions for a drawdown so they can manage cash flow risk. This means registered providers should understand the receipts and outgoings of the business, for example, rental income, investment in existing stock, the costs of development, receipts from sales and other business, financing costs (loan capital and interest payments) and build sufficient prudence into their plans to cope with changes. In particular, boards should assure themselves that they put funding lines in place in sufficient time to cope with major cash outflows. Boards should ensure that they effectively identify and manage any risks of re-financing whether planned or in reaction to changes in the operating environment.
- 24 Registered providers should also look at the relationship between operational and capital cash flows. Non-discretionary expenses, including all major repairs (whether capitalised or not) and interest costs, should be met from operating income. When using capital income (for example, receipts from disposals) to meet operating expenses, boards should ensure there is a plan that ensures operating cash flows fully cover operating expenses in the future. While this is not the case, registered providers need a plan to ensure that exposures are managed.
- 25 Registered providers need to build their business on robust and prudent assumptions. Registered providers should assure themselves the assumptions used are reasonable. For example these may be based on:
  - past performance
  - market conditions
  - deliverability and forecasts of possible future conditions
- 26 The regulator expects these assumptions will be kept under review and updated in the light of changing circumstances. It is important that registered providers ensure their plan enables them to meet lenders' covenants. Registered providers need to ensure sufficient headroom to allow them to take remedial action if assumptions within the plan significantly change or (potentially) if they are not delivering against the plan.
- 27 The regulator expects registered providers to identify the impact of significant business decisions (for example, major changes in development appetite, a new major scheme, moving into a new business stream or taking on new sources of funding) on viability (including continued covenant compliance). It also expects registered providers to report these to the board and take remedial action where necessary. Registered providers should think about their covenants in the broadest sense (financial and non-financial), set target measures of financial performance which provide headroom over covenants, and ensure they monitor all covenants.
- 28 The boards of registered providers should also be aware of the risks posed where separate companies are in effect controlled by others (through common or shadow

directorships) and liabilities may be attributed to the registered provider putting social housing assets at risk. These risks should also be identified and mitigated.

Paragraph 2.5: expectations about risk management

- 29 Boards are the custodians of social housing assets and the financial viability of the registered providers that hold those assets. The responsibility for managing risks, and specifically risks to social housing assets, lies with boards. As social housing is a long term asset, normally funded by long-term debt, it follows that boards need to maintain a long-term perspective on managing risk. They need to ensure that their decisions do not put short-term gains ahead of the long term sustainability of the business and the security of their social housing assets.

Paragraph 2.5.a): expectations about assets and liabilities

- 30 The primary purpose of this requirement is to ensure that registered providers understand their housing assets and security position and have swift access to this information in decision making and risk management. Such information needs to be readily available in the event of a potential or actual failure of the registered provider. This will enable the regulator to draw up resolution strategies and aid a potential rescuer to value the social housing assets. The asset and liability register should contain sufficient information to enable a potential buyer to accurately price the value of the business and/or the value of the social housing assets in the event of distress.
- 31 It is for registered providers to ensure such information is accurate and up-to-date. They should be able to produce an overview for the regulator at short notice. The records need to cover the breadth of the registered provider's activities (including activities carried out in subsidiaries, joint ventures and SPVs) and identify its assets and liabilities. The regulator does not prescribe the format of such records. The approach taken is likely to vary according to the size and complexity of the registered provider. The regulator expects that a registered provider's board will oversee the maintenance of these records and that they are readily reconcilable and regularly reconciled.
- 32 Asset records should clearly identify social housing assets and where these assets are encumbered. Such records would normally include, but are not limited to, treasury arrangements, key contracts, title information and any restrictions on that title (for example planning obligations, charitable or other restrictions), valuations, stock condition and lender covenants.
- 33 Registered providers should consider and record their liabilities in the widest context. The regulator considers the liabilities should include items which relate directly to the social housing assets and those which might have an impact on the business as a whole. This may include, but is not limited to:
- loans including borrowing from other group companies or related undertakings
  - guarantees, indemnities etc. including those provided to subsidiaries and SPVs, whether secured or unsecured
  - leases, sale/lease and leaseback transactions
  - mark-to-market exposures on derivative positions

- cross default provisions (for example, a provision in a loan agreement which provides that a default on one loan agreement gives rise to a default on another one, including where these potentially cross between entities)
  - a duty or responsibility that obligates the entity to another, leaving it little or no discretion to avoid settlement<sup>4</sup>
  - the potential for any impairment particularly in relation to investments in non-core activities
- 34 Within group structures, boards should ensure they have full understanding of where liabilities exist between all entities (both registered and unregistered). This should include understanding of how a failure in one part of the group may affect other members of the group. Registered providers in a group should ensure they have an appropriate methodology to model and communicate the impacts of risks crystallising in one entity on other entities within the group, in particular where there would be recourse to social housing assets.

Paragraph 2.5 b): expectations on stress testing

- 35 The regulator expects registered providers, as part of their risk management approach, to stress test their plans against different scenarios across the whole group. The scenarios used will vary according to the size, type and structure of the organisation. Registered providers should go beyond simple sensitivity testing and include multi-variate analysis which tests against potential serious economic and business risks. Registered providers should explore those conditions which could lead to failure of the business, even if planned mitigations and controls are successfully implemented. They should assure themselves that the scenarios are consistent with what they consider to be acceptable levels of risk and their obligations. Stress testing should employ scenarios that are designed to assess resilience.
- 36 In designing the stress testing, boards should consider both the long term, cyclical nature of economic factors that impact on the business as well as internal business risks.
- 37 Two potential examples are offered by way of illustration:
- a) The board of a developing registered provider with a shared ownership and outright sale programme that is raising external debt will need to think about how key variables in the business plan would move during a housing market slowdown or crash. This would include, for example:
- what is happening to sale prices and volumes
  - how lenders would be operating in that market
  - the potential for impairment
  - what might be happening to variable rate debt and the costs of working capital
  - other costs of holding the asset such as increased security costs and the movements in nominal and real inflation rates

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<sup>4</sup> This could include where defaults of a subsidiary or other group members gives rise (either directly or indirectly because of an accounting consequence) to a default under loan agreements secured by social housing assets



- b) The board of an organisation with significant supported housing business, but little new development, will need to think about for example:
- what might happen to corporate overheads and contract-specific costs if the registered provider lost key contracts
  - unsustainable price inflation or wage growth that removed margin from the business
- 38 Managing and addressing risk should involve developing plausible scenarios that test the business plan against adverse movements in the operating environment. Doing so will help underpin boards' understanding of where the risks lie and inform their consideration and planning for remedial action if the risks crystallise either singly or in combinations. Registered providers should consider the implications of this stress testing for its existing business including how the business may need to respond, whether business streams may need to be altered or stopped, whether it has sufficient headroom, what controls they have in place and how those controls are implemented.
- 39 As long-term businesses, registered providers need to ensure that they can withstand the long-term cycles in the economy and that short term decisions do not constrain their ability to cope with risk. This does not prevent registered providers from taking on measured risk to deliver their objectives. It means that when taking on risks, boards should fully understand the impact on their business in the round, as well as on their social housing assets. Boards should have appropriate mitigations and controls in place as well as a strategy to protect those assets during the long term.

Paragraph 2.6: expectations relating to arrangements with third parties

- 40 Registered providers should act in good faith appropriately advancing their own interests and those of their tenants. The focus here is on transactions which, for example, over-price services received so the contractor receives an inflated price or, where services are given without a suitable charge being levied.
- 41 For the avoidance of doubt, the regulator does not intend that transactions undertaken to promote charitable or social objectives, nor appropriate dividend payments by profit making registered providers will be caught by this expectation.
- 42 Where there are conflicts or perceived conflicts of interest, registered providers should clearly set out how they effectively manage these. They should ensure that, for example, parent companies, other entities or individuals who have control or influence (or whom the regulator reasonably believes has such control or influence) cannot or do not exert influence which would have a damaging effect on the registered provider or its compliance with standards. This could be, for example, charging unfavourable prices for the provision of services.
- 43 Third parties are any person or body which is not the registered provider. This includes, for example, directors and board members and may also include individuals or organisations that have close links to the registered provider.

#### Paragraph 2.7: returns to the regulator

- 44 The regulator requires registered providers to communicate with them in an accurate and timely manner. This includes provision of information, for example data returns. The regulator will clearly articulate its requirements for regulatory returns to the sector and, where appropriate, will consult on these. It is the responsibility of registered providers to ensure that they submit required data returns in a timely manner and the information provided is of a good quality. This includes for example ensuring that returns such as the Financial Forecast Return are fully complete with no missing information, that the data is accurate and submitted by the deadline required. It is not the regulator's role to correct or fill in incorrect or missing data and we will view such returns as evidence of a weak control environment.

#### Paragraph 2.8: expectations on reporting requirements

- 45 In addition to assuring themselves of compliance with standards on a yearly basis, boards need to assure themselves of their continuing compliance when taking on significant new risks. This could be, for example, when undertaking a new development or entering a major contract. Registered providers' boards shall certify their compliance in the narrative report which accompanies their financial statements. When certifying compliance with the Standard, registered providers shall ensure that they consider compliance with regulatory standards in the round as set out in the required outcomes of the Standard.

### **Specific expectations applicable to specific categories of registered provider**

- 46 This section applies only to specified classes of registered provider where the regulator considers additional controls to protect social housing assets are needed.

#### Paragraph 3.2: use of social housing assets to support other parts of the business

- 47 Where a registered provider has an unregistered parent, the social housing assets should not be used to support non-social housing activity in other parts of the business to the extent that it may have a material negative impact on, or material recourse to the social housing assets. The regulator would also expect the risk to the social housing assets to be low. Registered providers would not be expected to enter into, for example:
- formal agreements such as guarantees or cross default clauses in loan agreements
  - less formal or indirect arrangements such as making investments which lead to impairment, or which, in the event of insolvency, might allow recourse to the social housing assets

#### Paragraphs 3.1 and 3.3: assistance

- 48 Paragraphs 3.1 and 3.3 seek to ensure that where a registered provider is part of a group, it can look to other entities within that group for assistance with achieving

compliance with regulatory requirements. If a registered provider is part of a corporate group, the regulator expects the registered provider will ensure that other entities within the group are aware of the regulatory requirements placed on the registered provider and understand the implications of them.

- 49 Pursuant to paragraph 3.1, in groups where the parent is a registered provider, the parent is required to provide support or assistance to ensure the group's compliance with regulatory standards. This includes, where appropriate, ensuring the ongoing viability of the group, and may require assistance to one registered provider from other registered providers to ensure continued compliance with regulatory standards.
- 50 Paragraph 3.3 means if a registered provider has an unregistered parent company, the registered providers must put in place mechanisms to ensure the parent company concerned will assist the registered provider to comply with regulatory requirements. Also, to ensure the parent company or another part of the group does not do anything that compromises the registered provider's ability to meet regulatory requirements. In some circumstances it may be appropriate for the regulator to be a party to such agreements.

Paragraph 3.4 & 3.5: separate legal entities for profit making registered providers

- 51 Profit making registered providers should separate any activities that do not relate to providing social housing from those that do. The regulator is concerned that any potential recourse to the social housing assets from other non-social housing parts of the business is minimal. Profit making registered providers should manage their affairs in such a way that this is the case.
- 52 A small amount of activity that does not relate to providing social housing is permitted within the legal entity. This is to allow for situations where the activity is undertaken for both social and non-social housing reasons, for example, mixed tenure developments. In such circumstances, the registered provider should ensure the non-social housing activity within the entity does not place social housing assets, activities or its own financial viability at undue risk. The regulator considers, where it is necessary for non-social housing activity to be carried out in the legal entity, the amount of non-social housing activity should be in the region of no more than 5% of capital or turnover. Registered providers should include within the calculation of the amount of non-social housing activity any agreements entered which relate to non-social housing activity by others, which could have a material negative impact on the social housing assets.
- 53 Boards of profit making registered providers should consider what are social housing or non-social housing activities and should approve the final designation. The regulator may seek assurance on the robustness of the processes and challenge if it considers the conclusions are inconsistent with the required outcomes contained in the Standard. The designation of activities should be considered by boards and updated as activities start or stop or when the organisation enters into new ventures. To aid boards, the regulator lists below some activities which are not considered to be related to the provision of social housing:
- management/maintenance services to other organisations

- management/maintenance services for own non-social housing
- care services
- development and letting of market rent housing and provision of any associated services
- development and sale of outright market sale properties
- development and letting of student housing and provision of any associated services
- development activity (other than affordable/social housing development)
- estate agency services

## Legal status of the Code

- 54 This Code is issued by the Homes and Communities Agency, as the regulator of social housing, under section 195(1) of the Housing & Regeneration Act 2008 (as amended) (the Act). It relates to the Governance and Financial Viability Standard set by the regulator under section 194(1) of the Act (the Standard).
- 55 Section 195(2) of the Act provides the regulator may have regard to the Code when considering whether the Standard has been met.
- 57 The Code applies to all registered providers who are subject to the Standard (i.e. registered providers and not local authority providers of social housing). Some paragraphs of this Code relate to parts of the Standard that only apply to specified classes of registered provider.

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