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Finance and Risk blogs by Sue Harvey

Learning to love the corporate risk map

At Campbell Tickell we have reviewed a huge number of corporate risk maps. We've seen some excellent examples and far too many poor ones. Here are our six tips for getting it right.

1. **Keep the map presented to your board short.** Faced with a long list in a tiny font most board members will barely register what it contains and stand no chance of picking out what has changed since last time. This sorry situation will be made even worse if what was designed for an A3 page is presented on the screen of a small tablet. It follows that the trickiest bit of agreeing a risk map is walking the line between being too granular and too vague.

   If 'government policy' is one of your top risks, there will inevitably be many different impacts and it will be hard to shape the most appropriate mitigations. But if the definitions are too granular, the board will be back looking at a very long list. Hence you need a clear framework for delegation and escalation to give the board confidence that it can let go of risks ranked (say) 9 to 59.

2. **The impact assessment should calibrate the relative scale of each risk,** showing for example that the inability to raise £25 million in six months to fund growth ambitions is a far greater risk than a social enterprise subsidiary failing to match last year's operating surplus of £10,000.

   Once evaluated, the risks should be ranked by the residual risk. By all means map the key risks to the strategic objectives somewhere, but that main list must show the biggest risk at the top.

3. **Accountability. Clearly identify who is accountable to the board for the management of each risk.** That responsibility should lie with a single role, not with a group of people. If nobody or everybody is accountable, then that risk will not be effectively managed.

4. **Use the risk map to drive a conversation between the board and the audit committee.** Boards: ask your audit committee for assurance that the key risks are being effectively managed in line with your risk appetite.

   Audit committees: use internal audit, specialist advice and regular deep-dives to provide that assurance. And prioritise poking a stick at those controls which are doing more of the heavy lifting, as indicated by the gap between the inherent (gross) and residual (net) risk.

5. **A personal bugbear, please avoid relying on 'monitoring' as a mitigation.** You won't mitigate a car crash by observing closely as it happens. An action is required to reduce either the likelihood or the impact or both. A control that reduces neither the likelihood nor the impact is not an effective control. In a similar vein, a control that is

not yet in place cannot impact on the residual risk. You haven't reduced the risk of a car crash today by booking in an MOT for tomorrow.

6. **Triangulation. Are there clear links between your strategic risk map, your stress testing and the contingent liabilities that appear in your asset and liability register?** Have you stress-tested the relevant swap rate falling to zero, the housing market shutting down, the DevCo getting into a pickle or the failure of a significant contractor?

Today anybody that wants to build more homes must manage increased risk, and the board's risk competency is a critical enabler of those objectives. Short, precise, prioritised risk maps enable boards to relate key decisions and strategies to their risk appetite. The resulting high-quality debate will enable the confident delivery of those ambitions.

Turbo-charging your audit committee

When I first joined the social housing sector (no, don't ask), audit committees were places where those with a penchant for the detail of obscure accounting standards were sent, along with tedious board members that needed to be kept well away from the exciting business of development and funding.

Over the intervening years the role of the Audit Committee has risen up the agenda as assorted corporate collapses and scandals have fed into successive iterations of both the Financial Reporting Council's Corporate Code and our own NHF Code of Governance. Then four years ago the social housing regulator announced its intention to interview chairs of audit committees as part of their new in-depth assessments, and the spotlight was turned full-on.

Through our work reviewing audit committees' effectiveness and our IDA preparation assignments, Campbell Tickell has been privileged to meet over 70 chairs of audit in recent years. It is clear to us that the top-performing audit committees have raised their game, facilitating the step-up in risk management that today's challenges demand.

The nerd with a deep understanding of FRS 116 is still adding considerable value. Not least when that clever structured finance deal threatens to come back on balance sheet to haunt you, but other characteristics are also in evidence.

Top Class Committees

Our six top characteristics of top class Audit Committees are:

1. Exceptional audit committees engage in dynamic conversations with their Boards. Those conversations are built on Terms of Reference that are simple, understood by all and used as the basis for regular committee effectiveness reviews.

2. The dialogue develops with the Board determining a short, prioritised strategic risk register and asking the audit committee to provide assurance that the identified controls are reducing exposures to levels consistent with the Board's risk appetite.

3. The committee deploys internal audit, specialist advisors and rotating deep-dives to provide that assurance, and formally reports to the Board following every meeting, highlighting any matters of growing concern.

4. Great audit committees bring the right skill mix to those conversations, reflecting their responsibilities to give assurance on accounting standards, internal controls and risk management. Members with up-to-date accountancy skills are definitely present, alongside colleagues with risk management experience. Robust independence of thought, appropriate scepticism and curiosity are sort-after skills that are in evidence in every discussion.

5. Top class audit committees never forget. They are forensic about tracking all agreed actions from minuted matters arising, through internal audit recommendations to recommendations stemming from the External Auditor's annual management letter. They insist on responsibilities and timescales being attached to all actions, and at each meeting they gatekeep decisions to delay, defer and remove completed or redundant actions from the trackers.

6. Like the best Boards, the best audit committees plan their activities. Planning assumes a critical role for Audit Committees because they have to bring so many strands of their work together in time to give the assurance that the Board needs to sign the financial statements. That 18-month rolling work plan also timetables any required policy reviews and carves out space for the deep dives into the management of key strategic risks. Chairs of a top-performing audit committees use that plan to distribute the workload throughout the year, to understand the knock-on effects of any suggested deferrals, and to shape their planning meetings with the CRO or CFO.

In short, excellent audit committees exhibit a relentless focus on controls and assurance, and in doing so embed risk awareness, accountability and integrity throughout the organisation.

So please go ahead and turbocharge your audit committee. You will free your Board and executive team to focus on the delivery of your strategic objectives, confident that they are building on a firm bedrock of controls.

Boards: stick to your financial golden rules!

As the environment in which housing associations operate becomes ever riskier, regulatory expectations of boards have risen accordingly. Having a clear view of an organisation's financial risk appetite has become an important control in balancing strategic ambitions with continued financial resilience. We find that using 'golden rules' can really help inform these discussions. How best can this be done?

In-Depth Assessments

We have undertaken more than 300 regulatory In-Depth Assessment (IDA) rehearsal interviews for housing associations. During these we explore how, for example, a board is assured that development aspirations can be delivered without jeopardising financial stability.

Articulating financial risk appetite, by way of clearly defined golden rules or cushions, is a strong first-line response to this question and an effective way to demonstrate how board-level assurance is achieved.

In addition to having robust golden rules, the board must be able to demonstrate their understanding of what these rules mean and their application in the business. Weak finances can see your regulatory viability rating fall. Weak rules or poor board control could call into question your governance rating.

The most common golden rules we have encountered include clear cushions over lenders' interest and gearing covenants. Minimum cash-holdings and floors on levels of liquidity also feature, as do rules about the amount of security available to be charged to lenders or swap counterparties.

Other possible measures include caps on the proportion of income expected from market-facing activities or the amount of working capital locked into the development programme, the share of market tenures in that programme and cushions over other financial covenants, where applicable.

Through our IDA preparatory work, we have distilled **four top tips** for effective golden rules:

1. **Under 10** board-monitored rules. Concentrate on three rules that guard your most sensitive vulnerabilities. Too many rules and only the chief financial officer will understand and remember them.

2. Ensure each rule is **precisely defined**. Everyone must understand these are red lines never to be crossed, rather than goals to be aspired to, or posts that are moveable under pressure.

3. Monitor the golden rules both **forwards and backwards**. This means going beyond monthly compliance assurance, to considering trends and demonstrating that the rules will be met in every cash-flow forecast and iteration of the long-term financial plan.

4. Build **two-way feedback loops** into your stress-testing. Demonstrate compliance or breaches of your golden rules when presenting the 'perfect storm'. Use the results to adjust the cushions to allow time for any mitigation strategies to deliver resolution.

Liquidity

Boards sometimes struggle to understand or appropriately monitor their own rules, particularly around liquidity. Liquidity rules are often defined either as a number of months before new borrowing will be needed i.e. "we will always have enough facilities to fully fund all our activities for the next 12 months", or as assurance that the committed development programme can be fully funded out of available facilities (a simple pass/fail test).

It's when probing these rules that we most often encounter confusion. What is included in the calculation? Does it include facilities that are available but not secured? Does it include any anticipated sales income (clue – it should not)?

How is development spending defined and forward monitored (contracted vs. committed vs. aspirational)? Is the likely impact on the liquidity rules built into every significant new development decision gateway?

Rules are often seen as restricting opportunities, but carefully constructed rules tell you as much about what you can do, as what you can't.

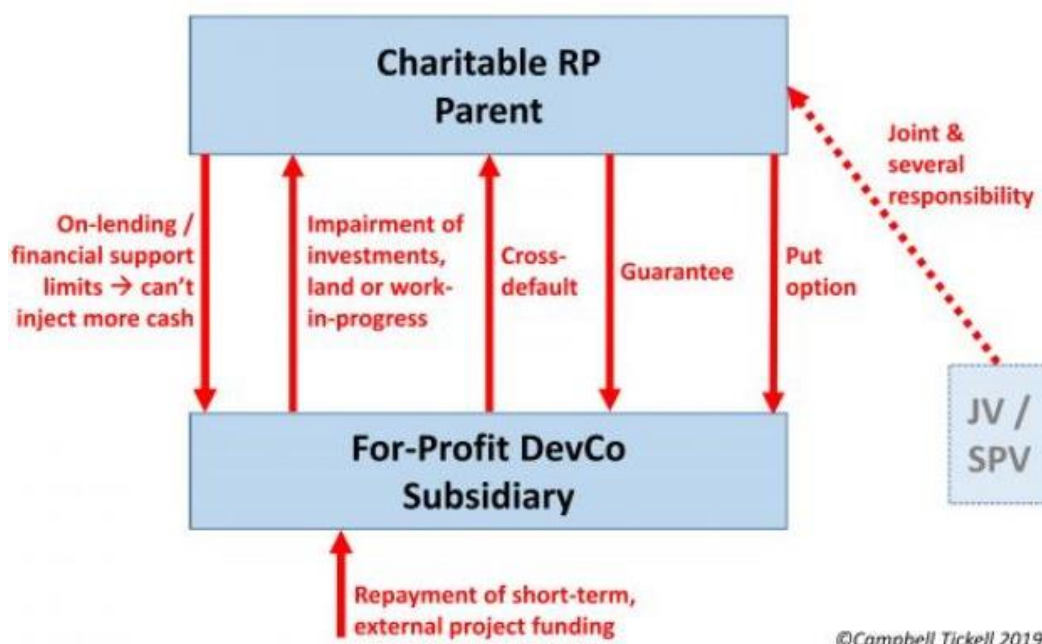
The golden rule in building a more resilient, entrepreneurial organisation? Implement some robust golden rules.

DevCos & Risk Part 1: Dominos and Ricochets

The rationale for registered providers' increasing involvement in commercial activities, such as build for sale, needs little explanation. Housing associations have for many years sought to replace dwindling capital grant with cross-subsidy from profit-generating activities, in order to sustain the development of affordable homes.

Tax issues and charitable rules have seen a proliferation of for-profit development company subsidiaries ('DevCos' for short) to carry out these market-facing activities.

Boards have also often been persuaded that a DevCo has the additional advantage of ring-fencing market risk. However as shown in some recent cases and depending on how they are governed and funded, DevCos can in some cases, create contagion routes for exposures to flow back to the RP, as well as magnifying or disguising other risks.



In this primer in two parts we reflect on lessons drawn from our In-Depth Assessment (IDA) support experience, which includes scrutinising over 70 sets of stress tests and group structure charts. In doing so we map out some of the ways in which existing risk management frameworks may be challenged by the creation of a DevCo.

In this first part, we take a look at those contagion routes, whilst in part two we will examine hidden or disguised risks, and some steps that RPs can take to ensure that their risk culture and processes evolve to adequately control DevCo risks.

With an eye to these contagion risks, the Regulator of Social Housing (RSH) has made the exploration of group structures central to its IDA process. In Regulating the Standards RSH sets out its intent to focus on "*the interaction between the provider and the various organisations connected to it* [and] *how risks flow between them*". The Sector Risk Profile duly urges that "*Boards must assure themselves that a ring fence is secure".*

The number and bandwidth of those contagion routes depends in part on whether the DevCo is wholly intra-group funded, or if it has its own external sources of funding.

Intra-Group DevCo funding

Most DevCos are funded by way of **on-lending** or equity investment from the RP parent. For those organisations the constraint on capacity and first contagion route may well be the financial assistance limits set within the parent's loan covenants. (To simplify things these are often referred to as on-lending limits, overlooking that the wording in the loan documentation may also encompass equity investment and guarantees). When things start to go wrong, organisations quickly discover that those constraints turn out to be pretty hard boundaries, blocking them from getting much needed cash into a struggling DevCo.

The second contagion route is via the potential for **impairment** of the assets in the subsidiary, including debt, land and work-in progress. Should it prove impossible to convince the external auditors that the full value of those assets is realisable, and/or that the debt can reasonably be expected to be repaid, an impairment charge in the subsidiary's accounts may need to be made and will flow through to the parent's Statement of Comprehensive Income on consolidation. If any of the parent's interest cover covenants are not neutral to this non-cash item/charge, covenant compliance issues in the parent may arise.

Externally Funded DevCos

Additional contagion routes, which can magnify risk considerably, are created when DevCos look for external funding to replace or augment the usual in-house on-lending. This step often occurs as DevCos mature, as the appetite of the parent grows and/or as it becomes evident that commercial development of housing for sale is capital hungry.

Chief amongst these, and our third contagion route, is **cross-default** risk. Where problems mount to such an extent that a DevCos' third-party lenders call in their loans, the impact will ricochet through the cross-default clauses in the much larger parent loans. Such a risk may initially seem remote, but a DevCo funded with short-term project finance and reliant on inflows of cash from sales, can be extremely vulnerable to adverse changes in market conditions. Not least because implicit in this cross-subsidy business model is the distribution of any reserves back to the parent as gift-aid, leaving very little fat in the subsidiary to absorb adverse variances.

This absence of 'fat' means that external funding for DevCos usually requires support in some form or another from the parent. This can inadvertently lead Boards to open a direct contagion route to the RP's social housing assets. Indeed, the very comfort that funders are seeking is the assets that the regulator expects RP Board's to protect. Because guarantees

are often caught by restrictions on granting financial assistance, they are occasionally reconfigured as '**put options'**, whereby the parent commits to acquire any unsold units at the lower of cost or market value if market conditions threaten the repayment of the third-party funding.

Since those purchases will necessarily not be at a time or value of the RP's choosing, they still represent a contagion route to the social housing assets, and the regulator will view them as disguised guarantees. Any such guarantees or options must be set out in the Asset and Liability Register and integrated into stress testing.

Other contagion routes that are not directly associated with DevCos are those linked to Joint Ventures and Special Purpose Vehicles, both of which bring third-party funding into a connected legal entity. The regulator expects Boards to seek assurances that JV-created ring fences are secure in the same way that it does for DevCos. And it further urges that due-diligence should identify any counter-party risks in this regard. Some JVs or SPVs, particularly those associated with long-term or large regeneration projects, may involve a form of **joint and several responsibility** for the liabilities of the vehicle.

In this type of arrangement, it is very often the case that the housing association is the party with the deepest pockets meaning that if the JV were to get into difficulties or fail, the RP could find itself responsible for liabilities that far exceed its original investment. It is clearly important that such contingent liabilities are accurately recorded in the Asset and Liability Register of the Parent.

With such a variety of dominos and ricochets, the combination of housing markets softening, and Brexit looming means that there is no better time for Boards to reduce their vulnerability to DevCo contagion. In part two of this primer we will look at some of the control mechanisms that do just that.

DevCos and Risk Part 2: Don’t let your DevCo bite off more than you can chew

In the first part of this two-part primer we drew on our IDA support experience to map out the contagion routes created when a DevCo[1] is established.

In this second part we take a closer look at hidden or disguised risks, and some of steps that RPs can take to ensure that their risk management framework evolves to adequately control new DevCo hazards.

Commercial Interest Rates

Investment by a charitable housing association in a DevCo is governed by charity law. Charity law states, among other things that investments should achieve *“the best financial return within the level of risk considered to be acceptable.”* Once organisations step outside the relatively simple activity of investing surplus cash in appropriately secure institutions, Boards need to seek assurance that the rates of return on those investments are appropriate.

Whilst the interest charged to a subsidiary does not need to equate to the full commercial rate that a speculative builder might pay on its borrowing, (because of the greater degree of control and transparency that the parent Board enjoys), it does need to reflect the risks involved in the activity that is being funded. This interest rate will be higher than the RP’s cost of capital, and independent professional advice should be sought in order to scope an investment policy and to determine appropriate repayment terms and interest rate margins.

Lower Than Expected Returns

With the passage of time, it can be easy to lose sight of the original reasons for establishing a DevCo and undertaking market sale. Those will have included the generation of cross-subsidy to support the core business. In doing so scarce resources will have been diverted from charitable activities in the expectation of returning higher amounts at a later stage. Whether the rates of return were explicit or implicit at the time decisions were made does not detract from the fact that lower-than-expected returns represent a risk crystallisation, as well as an early sign of potential mounting problems. This underlines the need for an investment policy that clearly sets out expected rates of return, as well as close and ongoing performance monitoring by the parent.

Building Reserves

Another oft-observed step in the development of a DevCo is the moment when the subsidiary Board asks to retain some of its profits to build up its own reserves. This is justified in terms of supporting additional third-party borrowing, avoiding on-lending limits and producing higher profits to be returned to the group at some unidentified point in the future.

At its worst this sets up a hamster wheel of an argument, where-by growth in the DevCo absorbs all its profits and the returns to the parent only occur when it ceases to develop. At best this once more diminishes the initially anticipated returns, a change in outcomes which is often over-looked at the time of the retention decision.

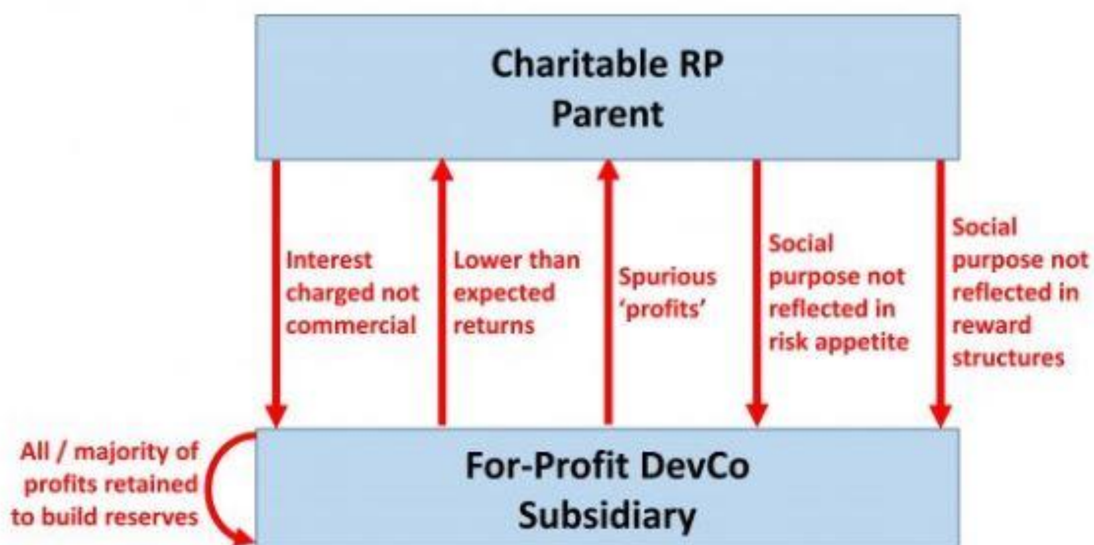
Spurious Profits

We have also seen DevCos being used to undertake certain activities on behalf of the parent for a fee, (such as project managing social housing development). This needs to be treated with great care as it creates considerable opportunity for obfuscation, particularly if the 'margin' charged on those services enhances or creates the DevCo profits that are subsequently gift-aided back to the parent. This is delusional nonsense and can further disguise lower than anticipated returns whilst being quite hard for Boards to spot.

Private Sector Risk Appetite And Incentives

Deliberately setting up a DevCo at arms-length to the RP in order to foster hard-nosed commercial approach can result in heightened risk taking that may be hidden from the parent Board's sight. Independent NEDs on a DevCo Board may well bring valuable private-sector experience, but may also struggle to grasp the full implications of the social objectives of the group and the regulatory constraints within which it operates. This can result in conflict over how the group's risk appetite fits with the DevCo's ambitions.

Furthermore, where key executives leading the market-sale activity are recruited from the private sector with private sector-style incentive packages, such individuals can stand to benefit enormously from the upside of taking more market risk, with limited downside. A downside that could include losses to the RP parent which would divert resources from the social objectives, and which may even result in social housing units being lost to the sector. At worst this creates a form of moral hazard.



Enhancing Controls

Setting up a DevCo may well be the right and best thing for an RP to do, despite these various cautions and strictures. We have set out above some fundamental errors that RPs should avoid. More proactively, there is a range of controls can ensure that any parent Board actively manages the risks of the DevCo. These include:

- Seeking independent, professional advice to shape an investment policy and to benchmark on-lending terms and margins;
- Negotiating impairment-neutral parent loan covenants;
- Developing a suite of well-calibrated golden rules that explicitly control and cushion the on- lending / financial assistance limits, cash-flows and potential impairments embedded in the DevCo;
- Building parent and DevCo base business plans and cash-flow forecasts that demonstrate compliance with those golden rules;
- Stress- testing the domino effect of a housing market shut-down, first on the DevCo and then ricocheting through the contagion routes to the RP and the social housing assets;
- Using the results of those stress tests to re-calibrate the golden rules to articulate the most appropriate risk limits;
- Ensuring that the key investment and development decision are made in the parent (at executive or Board level depending on delegations) rather than in the DevCo, and that the relevant golden rules are hard-wired into those decision-making processes; and
- Strengthening NED and Executive induction programmes to ensure that those with valuable private sector experience are able to quickly adopt the social objectives of the group and understanding how they necessarily limit risk appetite of the DevCo.

To ensure an indigestion-free 2019, Boards must revise their risk management frameworks to deliver close oversight of their DevCo's diet.

[1] An RP subsidiary created to carry out market sale for profit

Achieving accurate regulatory returns

The Regulator of Social Housing (RSH) has been noticeably tetchy of late about the accuracy of data returns it receives from English registered providers (RPs). Data quality has been mentioned as a factor in several recent governance downgrades.

The RSH's anxieties arise from two broad concerns:

- First, if an RP is sending inaccurate or incomplete data to the regulator, what then is the quality of the data provided to the board and thus the potential impact on the quality of board decisions?
- Second, in planning for the resources required for annual stability checks, the RSH depends on data returns being clean and accurate in order to concentrate its attention on areas where there have been significant year-on-year changes.

Campbell Tickell has supported many housing associations as they prepare their regulatory returns; we have also undertaken investigations when submissions have proved inadequate. Each of these assignments concludes with a 'lessons learned' report, and in this article, we bring together that knowledge into some top tips to support your next submissions.

Common Pitfalls

Most organisations will have well established routines and experienced staff providing this information in a timely and accurate manner. In doing so they will have developed a good understanding of the types of queries that RSH is likely to have and will be able to anticipate the supplementary information that should be provided.

So why does it sometimes go wrong? Why is it often such a stressful period for those charged with submitting the returns? And why is the work so often left to the last moment?

We observe three category errors in the management of regulatory returns that lie behind these common unpleasant experiences:

- Thinking of returns as 'simply' the by-product of existing data processes, which can therefore be safely left to the end;
- Considering returns as adding little value to the business and so attributing a low priority, junior responsibility and inadequate resources to their collation and checking;
- Under-valuing the importance of returns to the RSH and therefore the potential for additional regulatory engagement and resource if they are incorrect.

Top 10 Tips

From our experience we have derived 10 top tips for a smooth submission process:

1. Place **ownership** (i.e. answerable to the board) for regulatory returns with a **senior level** role within the organisation.

2. **Define responsibilities** and make sure that the importance of providing accurate or quality data is understood by all concerned;

3. **Prevent single points of failure** by avoiding reliance on one person to complete the returns; inevitably that person will sooner or later be on leave, sick or take up a new job exactly when a return is due;

4. Ensure **careful co-ordination** of the multiple information sources and departments within the organisation and any external agencies involved;

5. Agree with the whole team a **schedule** that provides ample time to chase, collate, check and format all of the required information. Adjust that schedule to reflect the learning from previous years' experience;

6. Think about **tying in returns procedures with others**, for example by linking the reconciliation of stock numbers in the financial statements with the Statistical Data Return. Two purposes will increase the focus on data accuracy and provide additional triangulation;

7. Produce and **update internal guidance** notes that set out sources, calculations, timetables, responsibilities and lessons learned; and

8. Ensure **quality control and assurance** through all data input and handling processes, and check accuracy as frequently as is practical, not just at the year-end;

9. Use the **comments boxes** to provide further information, especially on any material movements from previous returns; and

10. Programme and fiercely protect a clear time period prior to submission for **thorough quality control** by someone at a senior level who has not been involved in the data collation. A review by a fresh pair of eyes at this stage will spot and rectify most of those exasperating errors that will otherwise require embarrassing conversations with the regulator.

If you have experienced issues in the past in this regard, simple changes along these lines can make a huge difference. These will also benefit your relationship with the regulator in general and in particular help with conversations when it's In-Depth Assessment time.

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