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The Financial Implications of Welfare Reform for Social Housing Landlords

Cash is King..?

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Many social landlords are stockpiling cash and increasing bad debt provisions, but just how prepared and able to cope with welfare reform is the sector? Will it push some organisations to the wall and test the viability of the sector?

We took a detailed look at the last full set of the registered social landlord sector's global accounts published earlier this year to find out.

Background

Welfare Reform will have a significant impact on incomes for those in receipt of benefits, but providers within the sector are also facing the prospect of a perfect storm - uncertainties over the financial impact of welfare reform taking place at the same time as banks, the traditional financiers of the sector, reign in their lending and seek to call in or renegotiate terms of existing loans wherever the opportunity arises.

Payment of rent direct to tenants through Universal Credit (UC) from October 2013 is the single most worrying factor for social landlords. In most cases at least 50% of social rental income has been coming in directly via fortnightly or monthly council housing benefit cheques. This kind of guaranteed income provided the cushion from which they have been able to finance delivery of 'decent homes' standards, supply new homes even with reduced capital grant rates, and expand into delivering 'social value' community, economic and financial inclusion work.

Direct Payment Pilots

Early indications from the 6 Direct Payment pilots taking place are that about 20-30% of tenants may well struggle to pay their rent on time under UC (as this NHF study also found), and that arrears have at least doubled for each landlord. This despite the participant tenants having been handpicked and offered intense support to manage the process.

The implications of UC being an entirely online process when many don't have online access have yet to be reviewed, but will undoubtedly have a significant impact, as will underoccupation charges which come in from April 2013, the benefit cap, and changes to council tax and many other benefits (see our previous article on these) – all of which place increased pressure on tenants ability to pay, and landlords ability to collect rent.

Regulation

The Homes and Communities Agency (HCA) regulates all registered social providers with more than 1,000 homes against three key economic standards – financial viability, value for money, and governance.

The last global accounts summary presented a picture of strong and relatively stable sector, with financial performance in 2011 improving to deliver a surplus after tax totalling £1.1 billion (2010: £609 million), and interest cover (measured as EBITDA MRI) increasing to 106.4%, with significant improvements in both the traditional sub-sector (up from 101.5% to 114.8%) and the stock transfer sub-sectors (up from 40.1% to 89.3%).

This analysis does, however, mask significant variations across the sector.

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Our analysis of the dataset that accompanies the global accounts summary reveals that of the 366 organisations' data presented:

- 27% (100) had negative interest cover (i.e. net income did not cover loan interest payments)
- 22% (80) had net leverage greater than what will be considered an acceptable level of 70 by the banks , and
- 15% (55) had an operating margin of less than 10% (i.e. operating surpluses only exceeded turnover by 10%)

Such levels of variation might be expected given the diverse nature of the sector and stock transfer organisations who were still completing their decent homes investment programmes, but not all of those with negative interest cover, excessive leverage or low operating margins were relative newcomers. Several were well established traditional housing organisations that were not part of group structures or accounting systems which could explain poor ratios at the individual registered subsidiary level.

Potential Impact of welfare reform on rental income

We took the total net rent and service charge income outlined in the global accounts for general needs properties (a total in 2010-11 of £7.5bn) and applied a doubling of sector average arrears levels (from 5% to 10%) to this. Across the sector that produces a total of £0.75bn of arrears per year, with the impact varying according to size. The largest landlords being hit by up to £22m of arrears, the smallest by at least £750,000.

We also know from the DWP's own calculations that the impact of underoccupation charges across the sector from next April will be an additional £0.5bn in payments due from tenants. The extent of underoccupation by landlord is still largely unknown, but factor in at least 10% arrears from the £0.5bn across the sector, and that takes the total impact on income up by £50m to £0.8bn for general needs properties

Potential Impact of welfare reform on service charge income

Global accounts data reveals that some £870m of organisations income is derived from service charges. Expenditure on service items across the sector already exceeds income – standing at £1.13bn, producing an annual deficit of £0.25bn. UC regulations are likely to simplify (i.e. slash) eligible service charges as part of an attempt to reduce the overall benefit bill, with organisations expecting that charges for the maintenance of communal gardens, fire safety equipment, communal heating and lighting, lifts, door entry systems, children's play areas, white goods, furniture and rubbish collection will no longer be eligible.

Given that such charges account for at least 50% of service charge income across organisations, an extra £0.5bn will likely need to be found initially from tenants to cover the costs of those too. Arrears at 10% on that will add another £50m to rent arrears, taking total arrears up to £0.85bn.

Again the impact varies according to organisation – with those relying most on service charge income likely to be hit by as much as £6m, while others will be marginally affected.

Potential Impact of welfare reform on Cash Flow

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With rent and service charge income set to drop, it will be imperative that organisations bolster their cash balances to see them through at least initial turbulent times and ensure they can pay bills.

Our analysis of global accounts reveals that the sector held circa £2.4bn in cash and short term investments which could be realised as cash, but 27% (97) of organisations had less than the minimum £750k which will be required to cover cash flow if rent arrears double to an average of 10%. 31% (114) had less than £1m, and larger organisations and those with higher initial arrears will clearly need more than that.

Potential Impact of welfare reform on financial viability

Interest cover, net leverage and operating margins will all be adversely affected by increases in arrears – particularly if a high proportion of those are written off as bad debts unlikely ever to be collected. And why wouldn't they be written off – particularly underoccupation arrears when it's clear there isn't an alternative for the vast majority of two bed underoccupiers go to, and service charges which may be thrust onto customers already struggling with reduced incomes and higher utility costs etc.

Doubling bad debt provisions to £170m across the sector will see an increasing number of loan covenants being breached, and organisations which enter the 2013 or 2014 financial years with a combination of negative interest cover, high net leverage and low operating margins will clearly struggle to keep lenders happy or stay afloat without regulatory intervention or takeover by a larger partner.

Summing Up…

Based on our analysis of general needs data (which is now admittedly some 18 months old) many organisations may still have tough choices to make and frank discussions to be had if they are to avoid both cash flow and financial viability issues. Those with higher proportions of supported and temporary social housing even more so.

The HCA flagged welfare reform as key in its risk profile of the sector in June this year, and business heads will certainly need to overrule social hearts in many cases, with choices not necessarily relating to ideals, objectives or values, but to ensuring survival and viability.

With global accounts data showing the sector spending £2.2bn a year on management, and £3.8bn a year on repairs and maintenance, there is surely scope for cash savings in these areas to ensure ongoing viability - maybe even on Decent Homes now that it is a consumer standard which won't be enforced?

Some could/should also review their activities as part of the £0.5bn the NHF recently showed the sector spending on social value activities, and realise cash from those where there is no demonstrable social return on investment.

The bottom line (as Mr Dando's programme outlines) is that organisations need to be measuring, defining and driving through value for money in all activities , while aligning Vfm with financial viability as we recommended some while back in this article on economic regulation.

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Those who seek to diversify to generate additional cash flow and maintain services and standards as they stand should reflect on comments from Paul Dolan, Chief Executive of Sadeh Lok in this article, where he outlined their experience as a *'cautionary tale for other associations considering business diversification as a means to increase financial and operational capacity. While the vision to do much more for tenants and communities was powerful, so were the risks. Strategic and financial planning must always override the enthusiasm, excitement and appetite for growth that can cloud the business rationale around new ventures.'*

And let's hope that the regulator isn't caught asleep on the job in the same way the FSA was pre credit crunch. With the HCA admitting to currently being under resourced to enable it to fulfil its role, and no regulatory judgements under economic regulation having yet been published, the recent Cosmopolitan viability issue may yet be the tip of the iceberg.

About PHHS

Since 2007 we have undertaken a range of strategic work for organisations, with a particular specialism in Vfm through V^3a, (developed in partnership with the international software company behind Corvu) which can test, measure, demonstrate and transparently help to improve value for money. Further details are available at www.v3a.co.uk.

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About this article

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