

# **What Will Economic Regulation Look Like?**

## **Top Tips to prepare for the new Value for Money Standard**



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***The Tenant Services Authority recently launched its consultation on proposed revisions to the regulatory standards for social housing from April 2012. Here we set out the basis of regulation on the economic standards, what it will probably look like, and provide some key tips to help organisations prepare for it.***

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## **So whose assets are they?**

That was the subtext of a presentation given by Peter Marsh, former Chief Executive of the Tenant Services Authority (TSA) at the National Housing Federation (NHF) annual conference back in 2007 – outlining that government, the regulator, boards and tenants of existing organisations all had a common, shared interest and stake in the effective use of assets which were wholly or part funded with public money. In effect, identifying housing association boards as joint custodians, not necessarily owners, of assets.

It followed an at the time contentious 'Unlocking the door' Housing Corporation publication which outlined the need to 'sweat' existing assets more effectively to support reduced grant levels and unlock investment in new and existing homes.

It also followed the 2007 Cave Review of regulation , and it's finding that '*(taxpayers) have an interest in ensuring that their investments in the supply of social housing (cumulatively more than £100bn) continue to generate satisfactory returns in the public interest*', and recommendations that '*the regulator should support the supply of new social housing by.. unlocking development capacity*' and '*play an important role in maximising the capacity of regulated bodies to meet their objectives*'

Fast forward to 2011 and we have similar themes of unlocking capacity , generating satisfactory returns on investment for the taxpayer and meeting regulated bodies objectives in the new value for money standard - extended and expanded to take into account the changed political (*new government, abolition of the TSA*), economic (*public spending cuts, welfare reform, minimal grant for new developments and a stalled economy*), and social (high unemployment and record levels of housing need/a broken housing market) operating context.

As the government outline in the recent housing strategy, "*the current fiscal environment and the need to address the public deficit means that the former model of funding affordable housing, with its heavy dependence on public grant, is no longer sustainable*"

In the intervening years, analysis of global housing association accounts by the TSA revealed;

- The value of the sector's housing assets exceeding the £100 billion mark, supported by £43 billion of private finance and £38 billion of government grant
- Rental Income of £10 billion p.a. from social housing lettings – funded at up to 65% from Housing Benefit
- Operating surplus of the sector increasing by 35% in 2009-10 to £2.2 billion, and surpluses after tax rising by over £200m to £609 million (forecast to be £1 billion in 2010-11)
- The sector as a whole remaining comparatively lowly geared; with smaller providers (1,000-2,500 homes) having an adjusted net leverage of just 27.2% in 2009-10, while
- of the 1,500 active housing providers owning or managing nearly 2.5 million homes, those with 2,500 homes or fewer held around 20% of the sector's financial capacity, but contributed only around 3% of new development

Research on operating costs across the sector by the TSA also found that even with detailed regression analysis, it could not account for up to 37% of cost variances between landlords, and L&Q/ PWC outlined in this report that every £1 saved on operating costs could generate an additional £3 billion in borrowing capacity to deliver new homes, or improve existing homes and services.

It is against this backdrop that Grant Shapps announced in the review of regulation in October 2010 that *"We expect in future the regulator to be more proactive than is currently the case on ensuring value for money in the sector in order to achieve better returns for the taxpayer and support new affordable housing supply."*

### **What will economic regulation look like?**

The government's Housing Strategy, launched on the same day as the TSA's consultation on the new regulatory standards, provides a useful context.

It details how the government intends to *'challenge the established complacent consensus around social housing, which has plainly contributed to an inefficient system'* through *'a more proactive approach to value for money regulation to encourage increased focus on operating costs and using assets effectively'* to *'help free up financial capacity for investment in new and existing stock'*.

While that sets the context, the tone is clear in the standards consultation itself, which outlines how *'the proposed standard has been set with the objective of ensuring providers' boards maintain, and are transparent about, a view in the round of the optimum sustainable performance of all their assets – including for example financial,*

*social and environmental returns - in the context of meeting their organisation's purpose and objectives"*

### Continuity?

The incoming chair of the HCA's regulatory committee which will oversee economic regulation (Julian Ashby) has also recently clarified how he sees regulation progressing, outlining in this interview that landlords will experience a great deal of continuity under the new system, and that ' *if they know why they are doing something, and it is a coherent reason and they can afford it, it is not an issue for the regulator*', but ' *if they are simply not using their assets very well, or are making substantial surpluses and they are sitting in the bank doing nothing, we would start questioning whether they are fulfilling their objectives*'

Continuity will not just come from existing staff that are transferring across from the TSA when it closes to the Homes and Communities Agency (HCA) in April 2012, but as the standards consultation outlines, from the existing economic standards – particularly financial viability. Ratios of growth, profitability and debt servicing ability, as the three key measures which are currently used to assess financial viability in existing regulatory reviews and judgements, are likely to continue to provide the backbone of economic regulation.

### The Value for Money Standards Compared

The existing Value for Money standard, in operation since April 2010, outlines requirements for registered providers, in meeting all TSA standards including their local offers, to;

1. have a comprehensive approach to managing their resources to provide cost-effective, efficient, quality services and homes to meet tenants' and potential tenants' needs.
2. set out in an annual report for tenants how they are meeting these obligations and how they intend to meet them in the future, and
3. meet the commitments it has made to its tenants

Specific expectations are of setting out to tenants in an annual report

- how expenditure has been prioritised in relation to each of the standards and in meeting other needs such as investment in new social housing provision,
- how value for money has been secured and tested, and
- plans and priorities for delivery of further value for money improvements

The proposed **new Value for Money Standard** instead requires registered providers to:

1. articulate and *deliver* a comprehensive approach to achieving value for money in meeting objectives,
2. take into account the interests of and commitments to *stakeholders*
3. manage resources economically, efficiently and effectively to provide quality services and homes, and
4. plan for and deliver year on year improvements in value for money

The new standard emphasises a focus on *delivery* of a comprehensive approach built around the three E's, replaces the responsibility for demonstrating value for money from 'tenants' to 'stakeholders', and outlines much more detailed specific expectations of;

*'a robust, annual self assessment of performance which sets out in a way that is transparent and accessible to stakeholders how value for money is being achieved in delivering the organisation's purpose and objectives, and in doing so, demonstrating':*

- an understanding of the cost of delivering specific services, which underlying factors influence these costs and how they do so, and how costs relate to appropriate benchmarks
- the efficiency gains that have been and will be made and how these have and will be realised over time
- a robust approach to making decisions on the use of resources to deliver objectives, including an understanding of the trade offs and opportunity costs of decisions
- clear evidence of delivery which may include: new supply, improved services and housing stock, and neighbourhood and community investment
- an understanding of the return on assets, and a strategy for maximising the future returns on assets, measured against the organisation's purpose and objectives
- that performance management and scrutiny functions are effective at driving and delivering improved performance with outcomes and outputs clearly demonstrated
- a rigorous approach to assessing options for value for money improvement, including where there are potential benefits in alternative delivery models that may involve partnerships, mergers and/or contracting with third parties
- how assurance in reaching the view on value for money has been gained

#### Self assessment and measurement through OFR's?

It's probably fair to say that annual reports produced under the existing value for money standard have not been the road to continuous improvement the original standards intended. As the first year review report by involved tenants highlighted *'Many landlords did not compare their services (or costs) at all, and ... large associations generally only compared themselves with each other –enabling one large association to mask some poor performance. We were concerned that many landlords seemed to equate Value for*

*Money solely with cutting costs, as opposed to establishing greater efficiency or effectiveness'*

The TSA/HCA have committed to issuing practical information about the regulation of economic standards once they have been finalised, and this will probably be focussed on the delivery method for the annual self assessment. Given no desire on the part of government to add to operating costs, and the principle of light touch regulation, we think the method for self assessment is likely to be via enhanced Operating and Financial Reviews (OFRs) published as part of the audited financial statements for the sector.

The TSA have already identified significant variation in OFR's across the sector – with some including results against targets and commentary on variances, but benchmarking information rarely being included. OFR's are therefore likely to serve a dual purpose in future – as an enhanced self assessment tool setting out the board's analysis of the business and view of how value for money is being /will be achieved which the regulator will use to inform it's regulatory judgements, and a clear outline of performance, direction of travel and future potential for investment partners.

#### Key areas for focus

The key change to focus on in moving forward is the 'robust self assessment' and what is expected to be demonstrated.

There are clear and new specific expectations on operating costs; investment decisions and risk management; the value for money of neighbourhood and community investment; asset management; performance management and scrutiny; evaluating partnerships, mergers or stock rationalisation; and ensuring that the approach and view on value for money has been widely reviewed with stakeholders.

Below we set out some key tips to help prepare the ground for these.

### **Tips to Prepare for and Survive The New Value for Money Standard**

#### **Understand Your Operating Costs - & how they compare to benchmarks across the sector**

##### Likely approach to operating costs

The HCA's initial approach to operating costs is likely to be informed by analysis of operating costs drawn from 2010-11 financial returns. As the standards consultation outlines, *'the regulator will carry out and publish sector and provider level analyses of*

*the performance of the sector as a whole, with the aim of adding to the available body of contextual information that can inform boards and stakeholders'*

Initial work carried out on 2009-10 sector wide data by the TSA on a regression analysis basis found that it was a valuable tool to understand sector costs, with 22 measured variables explaining at least 63% of unit cost variation each year, and a handful of key variables explaining at least 50% of variation.

It found there was good evidence on how supported housing, regional wages, deprivation, decent homes work, and geographical dispersal of stock affected overall unit costs on average, and, of specific relevance, that:

- Associations in group structures had lower overall costs than average (12% lower operating costs per unit).
- Stock transfer associations (LSVTs) had higher costs than traditional associations in their early years, but beyond the first six years' this cost differential disappears
- There was little difference between the unit costs of small, medium-sized or large associations on average for managing general needs properties, though there was some evidence that general needs stock held in dispersed pockets of 100 or fewer per local authority had up to 50% higher costs – with the 83,000 General Needs stock units held in local pockets of less than 100 associated with additional costs of circa £100m per annum
- There was no clear evidence (although the evidence was limited) of any savings from contracting out management of General Needs stock.

### What you'll need to do

Given that up to 37% of operating cost variations were inexplicable through the TSA's regression analysis, it will be incumbent on organisations to demonstrate they know their operating costs by service or activity, and to have used any existing sector wide benchmarking (such as Housemark) to review and improve the value for money of services on an 'in the round' basis.

You need to understand how your costs compare with the best in the sector across the board and in specific service areas such as general needs on a sector wide but (given the TSA findings on costs) a comparable regional basis. Given the specific value for money expectations of reviewing potential benefits of alternative delivery models, and the government's aim outlined in the housing strategy of driving up competition across the sector, the focus on this is likely to be why operating costs associated with traditional Housing Associations', Large Scale Voluntary transfers (LSVT's), councils, Arms Length Management Organisations (ALMO's) and private sector providers aren't comparable.

This especially when there is evidence that stock held in dispersed pockets had up to 50% higher costs, and to ensure that organisations respond to the challenges of localism.

You will need to know which quartile, centile or decile your costs are in, and (particularly if they are below average)

- what you are doing to improve them (which will be expected to include a review of alternative delivery models such as partnerships, joint ventures, mergers, contracting with third parties etc – or whether to continue at all with some services)
- what the trade off decisions on costs may have been in terms of performance or quality of service;
- how they link to your corporate objectives; and
- demonstrate how your stakeholders have been involved in shaping and coming to any decisions you have taken or intend to take moving forward.

### A suggested approach

Our previous article on benchmarking outlines the approach we believe should be taken. The best organisations will choose and identify with their stakeholders which are the key cost, performance and quality measures that dovetail with their corporate plans or objectives, and then have mature discussions about the type and frequency of benchmarking, outcomes, and what to do with them.

The approach to be taken under the new value for money standard need be no different - utilising benchmarking as the catalyst for ongoing improvements in outcomes and making it an integral part of the business planning and performance management process to deliver a climate for change and continuous improvement.

As the standards consultation document outlines, *'Boards will be expected to develop and deliver a strategy to achieve continuous improvement in their performance on running costs and the use of their assets'*

## **Review your corporate objectives, mission and vision**

### Value or Values?

The emphasis in the revised value for money standard is as much about values as it is value – focussed on how value for money is being achieved *'in delivering the organisation's purpose and objectives'*.



Much has been written in recent months on how the sector needs to reconsider its values, role, and purpose in light of the significant changes which have taken place over the course of the last year – public sector spending cuts, changes to capital subsidy, welfare reform, localism and the move to affordable rents representing the biggest change to housing policy in over a generation.

While the Chartered Institute of Housing (CIH) recently launched the Change Network to help the sector review and manage the strategic changes ahead, the revised value for money standard gives renewed momentum to reviewing values, purpose and corporate objectives - by clearly linking the assessment of value for money to them.

For example, if your existing organisational objectives include (as many across the sector do) growth of the business by xx number of units per year, your value for money judgement will be based on assessment of performance against that objective. And if your objectives include (as many do) increasing efficiency, your judgement will be based on assessment of performance against any specific targets within that.

The value you deliver will be measured against the values, purpose and objectives of your organisation and you need to ensure these are aligned.

### *Optimum financial, social and environmental returns*

The housing strategy leaves no doubt of the government's wish to see an expansion of affordable and market rents, and alternative delivery models including partnerships, mergers or contracting with third parties with the aim of reducing costs and constraining rents.

However, the revised standard also outlines that value for money will not just be judged by the number of new homes developed, but by *'the optimum sustainable performance of all ... assets – including for example financial, social and environmental returns'*.

This leaves clear room for those organisations that may not have as hearty a risk appetite as others, and also wish to invest in sustaining their local neighbourhoods and communities, to redefine their objectives around a shared vision developed with stakeholders of financial, social and environmental returns. For example, investing in 'greening' existing stock, better services, or being a provider of alternative services such as financial inclusion or employment and training, and investing in community assets or neighbourhood planning envisaged under the localism bill.

### Which gear to choose?

If you do decide to scale back development, invest in existing stock or pursue social objectives, expect pressure from the government and the regulator if that leads to your gearing ratio being lower, and operating margins or financial capacity being higher than sector averages or what are considered acceptable levels. The key will lie in providing, as the specific expectation outlines, '*clear evidence of delivery*' in whichever direction you take. Providing clear evidence of delivery for areas such as neighbourhood and community investment is covered further below in the social return on investment section.

In reviewing corporate objectives, also bear in mind it will be expected they should include being open to and exploring partnership, merger or shared services opportunities with other organisations – particularly where improvements in the value for money of other corporate objectives could be demonstrably achieved.

### Key questions and answers

Ultimately setting the organisation's purpose and objectives remains each organisation's prerogative, as '*the regulator must have regard to the desirability of registered providers being free to choose how to provide services and conduct business*' in line with Section 193(3) of the Housing and Regeneration Act 2008, as amended by the localism bill.

The key questions the regulator will be looking for answers to in relation to value for money in your self assessment will be what it is that you are trying to achieve, that you really understand your operating environment and how it is changing, and how your choices and investment decisions reflect those.

### **Improve Transparency, Accessibility & Scrutiny to Gain Assurance**

Transparency, accessibility, and scrutiny by stakeholders are key themes running through the new standard. How you have obtained assurance on your self assessment and the validity of your approach to value for money is also a key specific expectation of the standard.

### No proactive regulation of scrutiny

The dichotomy within the new economic approach is that the regulator will have no role in monitoring delivery of the consumer standards which include the tenant involvement standard and the specific requirement for tenants to have the ability and be supported to

scrutinise performance - unless there is 'serious detriment'. Serious detriment as defined in the standards consultation is likely to mean serious risk of harm or injury, so there is no real regulatory threat of intervention on any perceived lack of tenant scrutiny, as the lack of it is unlikely to directly lead to harm or injury.

The only specific requirement in the value for money standard is to ensure *'that performance management and scrutiny functions are effective at driving and delivering improved performance with outcomes and outputs clearly demonstrated'*. The key issue here being to ensure that expenditure on scrutiny delivers genuine performance improvement outcomes, and isn't scrutiny for scrutiny's sake.

### Independent Shareholders?

On the other hand, the legitimacy of business planning decisions and self assessment of value for money may be questioned on the basis of whether organisation's boards have effectively taken into account the *'interests of and commitments to stakeholders'* as part of co-regulation. The recent ResPublica: 'At the Crossroads' report sums up the potential for this as follows:

*"Whilst most housing associations now have tenants on their boards and have mechanisms for tenants to scrutinise and influence their services, organisations where tenants or communities are a central feature of governance and accountability remain the exception. There is no equivalent to an independent shareholder interest, holding Boards to account. The pre-eminent accountability mechanism remains upwards towards government and its agencies.*

*There is a pressing need for housing associations to develop new forms of accountability,...to give legitimacy to strategic business decisions that will increasingly have a profound impact on the future shape of their offers to the communities they work within"*

As identified in the ResPublica report, the key to improving transparency, accessibility and scrutiny, as well as providing assurance of your view on value for money to the regulator, probably lies in extending scrutiny beyond existing tenants to encompass a wider community or neighbourhood perspective and issues beyond housing management and maintenance.

This would develop the equivalent of the 'independent shareholder interest'; be a key aspect of identifying and delivering priorities which meet the *'interests of and commitments to stakeholders'* and, as the standards consultation outlines, meet

regulatory expectations of 'a plan for improving VFM that has been developed in a transparent way with input from stakeholders'.

## **Develop an approach to identify the Social Return on Investment**

Housing organisations are important agents of economic change in communities – with the NHF's last complete neighbourhood Audit in 2008 identifying that housing associations invested approaching £272 million a year in neighbourhood projects, including employment, education and skills programmes. The L&Q/PWC report outlined that through regeneration and neighbourhood initiatives, housing organisations are long-term investors in the Big Society.

Given the economic situation and public sector cutbacks, many organisations will be considering increasing spend on such activities – particularly employment and skills training in light of rising unemployment and the impact on existing tenants yet to come through welfare reform. This on the basis of at the very least, protecting their existing assets and revenue streams.

### Value for money of neighbourhood and community investments

Many organisations struggle to quantify the value for money of such investment though – often identifying clearly what the £ cost is, but not necessarily being able to gauge outcomes which benefit either their existing customers or the communities and neighbourhoods in which they work. As a result, there is often a dilemma within organisations on whether they exist principally to provide good services to paying customers or for a wider social purpose.

In this context, the value for money standard also contains helpful guidance for those who wish to fund improvements to existing stock or a wider social purpose - via the specific expectation of clear evidence of 'delivery' for improved services or stock and neighbourhood and community investment.

### SROI

Social Return on Investment (SROI) is an established and growing means of calculating clearly and transparently the actual value of social, economic and environmental benefits which follow from a direct investment in, for example, 'greening' existing stock or investing in employment and training opportunities. This can be either via a ratio; for example a ratio of 3:1 indicates that an investment of £1 delivers £3 of social value, or an actual total £'s value to demonstrate the efficiency gains a project generates for the

state, local government or the third sector by reducing their expenditure via involvement in cases. For example, reduced levels of intervention from probation and youth offending teams through Family Intervention Projects.

The methodology involves scoping the cost of the initial or planned investment, then mapping, evidencing and giving outcomes from the investment a value in partnership with stakeholders, and is readily understood by government and regulators – having been endorsed under the previous government’s office for the third sector and Scottish Office. There are already many examples of SROI being used across the sector, particularly in regeneration specialists such as Trafford Housing Trust, and worldwide it has begun to be utilised not just for specific services, but for whole areas such as community housing in Australia.

With the sector in the UK struggling to evidence it’s social purpose, SROI offers the opportunity to evidence delivery of ‘value or money in the round’ for investment aimed at improved services, stock, or neighbourhoods and communities activities.

### **Review your Asset/Risk Management & Value for Money Strategies/plans**

The current chair of the TSA sums up the need for these to be reviewed in his introduction to the new regulatory standards consultation document, stating that;

*‘In future, the regulator expects boards to have a clear view of their risk appetite and associated risk management strategies, an informed view of their cost base and the factors affecting it, a strategy for making best use of their assets, and a plan for improving VFM that has been developed in a transparent way with input from stakeholders’*

If your organisation is one which has been successful in the 2011-15 bidding round for HCA funding, is actively engaged in developing affordable rent without grant via the HCA’s Short Form Agreement programme (detailed guidance on which is eagerly anticipated by some), or has already taken the decision to diversify into market rent, it is likely that you have already reviewed your asset and risk management strategies, and you’ll have a head start on obtaining a green light in your next regulatory judgement on value for money – because you will be able to demonstrate the proactive approach to risk and asset management the government and regulator are seeking. L&Q, as ever of late, is providing a leading light approach as outlined in this article – particularly in its approach to reducing costs.

If neither of the above applies, you should review your strategies to ensure they dovetail

with the reviews of costs, corporate objectives, transparency and social returns on investments we recommend – particularly if you are planning on scaling back or not pursuing development.

Given the importance being attached to value for money under economic regulation, your value for money strategy or plan should be the overarching approach which links your objectives and purpose to all other plans or strategies – focussed on meeting the standard's overall requirements and specific expectations.

If that isn't the case, you should begin to review it now in advance of April 2012 - presuming based on recent experience that the consultation process on the standards due to close on the 12th February will not materially change the draft product, and that the TSA manage to recruit to key financial posts to enable regulatory visits and judgements to proceed from April 2012

### **Align Financial Viability with Value for Money**

While changes to the value for money standard are steering organisations into a more commercially focussed approach to how value for money is achieved, the bottom line will remain the main element of economic regulation's focus.

Whatever your value for money self assessment says you have achieved will be expected to be replicated in key financial viability measures. The year on year improvements expected in value for money will ultimately be judged by year on year improvements and changes in areas such as your operating margin, SBIT, EBITDA, adjusted net leverage and debt per home etc.

Expect pressure from the government and the regulator to maximise use of your assets further if operating margins move to higher than sector averages or what are considered acceptable levels – so make it your business to know what 'top quartile' financial variability indicators are, and build the review or development of value for money and risk strategies around those.

## About this article

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We can also help with establishing or reviewing Social Return on Investment measures (which can also be incorporated into V3a), with undertaking Vfm healthchecks, or preparing your asset management, risk or value for money plans and strategies in conjunction with your stakeholders.

For further details of what we do, who we are and what we have done , and for free advice or a discussion on how we could help your organisation prepare for economic regulation, visit [the home page of our website](#), or call us on 01202 233214.