



# Independent review of regulation

Report prepared for the Housing Corporation

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## **Summary and recommendations**

### **Summary**

In April, the Housing Corporation's new Regulatory Code came into effect. This document is the report of an independent review of the first year of its operation. The sector has grown rapidly and now has over 2 million homes. Housing associations provide a wide range of services as well as social housing.

The Corporation's objectives are to: protect taxpayers' money; promote the reputation of the sector thereby sustaining lending; protect the interests of residents and tenants; and ensure that the sector provides good value for money. It regulates the sector to ensure that: associations are viable, properly governed and properly managed and the sector delivers government's social housing policies. Its regulatory work includes: registration; monitoring compliance; intervening if an association's performance causes serious concern and, in extremis, enforcing remedial measures. In April 2003, the responsibility for undertaking inspections of housing associations transferred to the Audit Commission.

This report has the following sections.

Section 1 - Introduction, background and review method

Section 2 - The new approach to regulation. This summarises the main features of the Corporation's new approach in terms of: principles, organisation and resources, implementation and the various outputs of the regulatory process.

Section 3 - The new approach in practice. This summarises the views expressed by those we interviewed about the Corporation's intention and what it has done in practice.

Section 4 - Analysis and conclusions. This section contains the findings from our review and sets out the conclusions we have drawn under the following headings: Comparison with other regulatory regimes; Sector analysis of comparative performance; Best value; The Corporation's response to poor performance; Application of the Corporation's regulatory principles; Implementation of the new approach; Management arrangements and resourcing.

### **Recommendations**

The Corporation's commitment to independent scrutiny and transparency is likely to improve the regulation of the sector and better regulation is capable of substantially improving sector performance.

The Corporation has sought to enhance existing regulation by introducing service inspection, the publication of the Corporation's assessments, promoting continuous improvement and giving more attention to governance issues. These represent valuable additions to the Corporation's regulatory toolkit.

Nonetheless, there is potential for further improvement and we recommend that the Corporation should

1. develop and publish the results of a sector wide analysis of the comparative efficiency and performance of associations
2. challenge the extent to which associations apply best value principles to exploit the potential for efficiency and performance improvements
3. on the basis of the above, make more challenging regulatory judgements thereby driving improved performance (higher housing standards) and greater efficiency (higher return on taxpayers' investment).

To refine its approach to regulation, the Corporation should

4. develop a top-down risk assessment for the sector and use it to categorise associations for the purpose of proportionate and consistent, and transparent regulation
5. use this assessment<sup>1</sup> to determine
  - a. those associations that warrant no regulatory activity, over and above universal submissions and reliance on external auditors, subject to reactive enquiries as issues arise
  - b. those associations that warrant minimal regulation, subject to reactive enquiries as issues arise
  - c. those associations that warrant tailored regulation in addition to the above, and why
6. design and implement packages of regulatory work appropriate to each of these segments
7. review the above from time to time.

On some of the more detailed aspects of regulation, the Corporation should

8. review all documentation (advice notes, supplementary guidance, etc) and clarify their status, including which are mandatory, for the purposes of compliance with the Regulatory Code
9. distinguish more clearly between reviews, and other interventions, that are policy driven and those that arise from regulatory concerns about individual associations and ensure that this is understood by stakeholders
10. review experience under the MOU with the Audit Commission, paying particular attention to the arrangements for following up the findings from inspections and taking regulatory action.

In terms of organisation and resources, the Corporation should

11. consider whether the roles of lead regulator and lead investor could be combined to make better use of the senior people available to the Corporation and gain the benefits for the Corporation and associations of the account management model
12. consider how to achieve the best match possible between its staff the people and issues in the associations they are regulating; the process should include senior people in the Corporation's head office
13. review the portfolios of all lead regulators in the light of experience to date, the results of the HCAs and the outcome of the work on risk and, if appropriate, reallocation of resources to give better value for the Corporation's expenditure on regulation.

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<sup>1</sup> This new structure would replace the current distinction between RASA and lead regulated associations.

To improve the effectiveness of the delegated management model for lead regulation, the Corporation should take steps to

14. improve communication internally and make sure it has been effective
15. provide the necessary support, infrastructure and development for regulation staff in the fields; consequent on other recommendations this will require an up-dating of the skill and training requirements of regulation staff against appropriate competencies.

To fully implement a number of the improvements proposed above the Corporation will need additional powers to deal with poor performance.

## **1 Introduction, background and review method**

### **1.1 Introduction**

In 2001, the Housing Corporation (the Corporation) developed proposals for a new approach to regulating housing associations. In January 2002, following consultation, the Corporation published its new Regulatory Code. It came into effect in April 2002, when the Corporation also introduced the inspection regime.<sup>2</sup>

The Corporation committed itself to regular scrutiny of whether it was meeting its objectives and in August 2003, the Regulation and Supervision Committee (RSC) commissioned Indepen to undertake an independent review of the first year of the Code. The Committee asked us, when making recommendations for improvement, to pay particular attention to how the Corporation could promote the efficiency of the sector.

### **1.2 Background**

#### **1.2.1 The social housing sector**

The sector has 2,000 housing associations<sup>3</sup> and over 2 million homes, increased from 720,000 in 1992/93. In large part, the increase has resulted from transfers from local authorities. The balance sheet of the sector shows housing assets of £54 billion, financed by government grant of £26 billion and over £26 billion of long-term debt<sup>4</sup>.

Associations provide housing and other services to many tenant groups. As well as social housing, they provide market rented accommodation, care homes and housing for key workers and for students. Group structures often contain associations operating in different markets. Different associations face different pressures. In some regions, lack of demand is a problem, whereas in others there are shortages of affordable housing. Some associations face threats to their viability from rent restructuring and future reform of housing benefit could add to the difficulties of rent collection.

Since the Code came into effect, Government policy has set challenging targets for new build, regeneration and the quality of the social housing stock and there is increased emphasis on the efficiency of the sector. The Corporation has changed its approach to investment in social housing and this will have implications for regulation.

#### **1.2.2 Role of the Corporation**

In addition to regulating associations, the Corporation funds social housing investment, undertakes research, collects and disseminates performance information, promotes good practice, develops policy and gives policy advice.

The Corporation's objectives are to: protect taxpayers' money; promote the reputation of the sector thereby sustaining lending; protect the interests of residents and tenants; and ensure that the sector provides good value for money.

Regulation seeks to ensure that: associations are viable, properly governed and properly managed and the sector delivers government's social housing policies. Regulatory work includes: registration; monitoring compliance; intervening if an association's performance causes serious concern and, in extremis, enforcing

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<sup>2</sup> Regulation and inspection were covered in the documents: *The Way Forward – Our Approach to Regulation and Inspection: our approach*, The Housing Corporation, January 2002

<sup>3</sup> Also known as Registered Social Landlords (RSLs). In this report, we usually refer to them as associations.

<sup>4</sup> Numbers in this paragraph are from *Housing Corporation Annual Review, 2002/3*

remedial measures. In April 2003, responsibility for inspection moved to the Audit Commission. The Corporation did not reappraise others parts of its regulatory approach.

### **1.2.3 Form of regulation**

Before it introduced the Code, the Corporation monitored associations against approximately 60 performance standards and undertook monitoring visits. Respondents in this review described this as “process driven”, “box ticking” and “one size fits all”.

The purpose of regulation generally is to improve the performance of regulated entities above what they would achieve if left to their own devices. The nature of the incentives to improve is a key factor. In unregulated sectors, incentives stem from competitive pressures in the market for goods and services and the capital market. In social housing, however, most tenants do not have a free choice of housing and associations do not face the stimulus of effective competition. Associations do not distribute dividends and so shareholder pressure does not stimulate performance.

Associations seeking funding for development compete to obtain investment grant and loan capital and there are various other incentives that can apply to associations.<sup>5</sup> The Corporation’s new approach makes use of a number of these.

Social housing rents are subject to the government’s rent restructuring policy and the Corporation monitors them. The rent formula is similar to that used in utility regulation but its incentive properties were not central to the policy and the Corporation does not use rent restructuring as an incentive.

### **1.3 Review method**

We based our report on information gained from reviewing documents supplied by the Corporation and a series of interviews and discussion groups with

- two members of the Regulation and Supervision Committee, a number of staff in the Corporation’s head office and regulation staff in two fields (London, Central)
- association chairs, members, chief executives, directors and other managers and a meeting of the National Housing Federation regulation panel - some 70 people in all
- meetings with senior representatives of the Housing Inspectorate, the Chartered Institute of Housing, the Council of Mortgage Lenders, HM Treasury and ODPM.

By a Corporation press announcement, we invited input by correspondence from other parties.

We have treated all contributions as non-attributable.

We thank all who contributed to the review.

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<sup>5</sup> See Appendix II for a summary of these.

## **2 The new approach to regulation**

This section summarises the main features of the Corporation's new approach.

### **2.1 Origins of the Regulatory Code**

The Corporation's Financial Management and Policy Review in 2000 was the catalyst for change and the Prior Options Report<sup>6</sup> defined regulation's remit as including: supporting the best; addressing a weak competitive environment; ensuring a return on taxpayer's investment; compensating for a lack of market choice for tenants and residents; and delivering government policies.

During its strategic review in 2001, the Corporation rethought its work including regulation. It saw a need to communicate more effectively with association boards and to improve its skills and capacity in some areas. It recognised that its procedural approach to regulation was unlikely to drive improved sector performance.

### **2.2 Principles and features of the Code**

The Corporation started from the principles of better regulation advocated by the Better Regulation Task Force (BRTF)<sup>7</sup> and intended its new approach to be

- outcome focused, promoting viable, well governed and well managed associations
- such as to lead to continuous improvement in associations' services
- based on evidence and the application of judgement
- tailored, appropriate and proportionate to the risks that associations face
- consistent and transparent.

The main features of the approach for the larger associations<sup>8</sup> were: self-assessment of performance and compliance with the Code; a plan for regulatory activity; publication of Housing Corporation Assessments (HCAs); and an inspection regime that examines service delivery to tenants and other customers.

### **2.3 Organisation structure and resources in regulation**

During 2001/02, the Corporation restructured its organisation. It introduced Assistant Chief Executive posts for Investment and Regeneration, Regulation and Best Value, and Corporate Services and created four geographical fields each with separate investment and regulation teams headed by separate directors. Changes to the governance arrangements included separating the Regulation and Supervision Committee from the Registration Committee.

The Corporation created a specialised Stock Transfer Registration Unit and a central team of experienced people to regulate the largest associations (the Lead Regulation Unit). The latter developed the "lead regulation" approach, entailing a single point of contact for each association for all regulatory matters. The Corporation and the associations involved thought that this had worked well and the Corporation decided to adopt lead regulation for all large associations.

Each field had separate lead regulation, financial appraisal and inspection teams established principally from existing regulation staff following assessment against the

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<sup>6</sup> DETR, June 2000.

<sup>7</sup> These are transparency, accountability, proportionality, consistency and targeting. *Principles of Good Regulation*, BRTF, December 1997

<sup>8</sup> The Code includes a regime of simplified regulatory arrangements for small associations (RASA) defined as those with fewer than 250 homes.

competences required. External recruits filled the remaining vacancies in these teams and most of the jobs in the inspection teams.

There are two grades of lead regulator: Lead Regulators and the more senior Regulation Managers. Regulation Managers are not always responsible for line management but each is responsible for advising field colleagues on particular aspects of the Code. There are 678 lead regulated associations and, on average, lead regulators have responsibility for eleven.

The Regulation Management Team (the RMT) includes the Assistant Chief Executive (Regulation and Best Value); Director of Regulation Policy, Director of Regulation Performance, the four field Directors of Regulation and the Assistant Director (Supervision). RMT is responsible for implementing relevant aspects of Housing Corporation policy and it plans and manages regulation operations. There are panels for lead regulation, financial appraisal, supervision and RASA which meet<sup>9</sup> to consider policy implementation and consistency across the fields. They do not have line management responsibility. The lead regulation panel has a field director of regulation as chair and membership drawn from lead regulation assistant directors and central regulation.

## **2.4 Implementation of the new approach**

### **2.4.1 Preparation**

The Regulatory Code came into effect in April 2002, by when the reorganisation was largely complete. The Corporation's management expected it would take a year for the new approach to bed in and knew that the data needed to support the new way of regulating was not immediately available.

The Corporation developed the framework for financial analysis and guidance for the fields with consultants, FMSD and rolled it out in July 2002, together with training for the financial teams. It developed the HCA with KPMG and launched it in spring 2003.

Training for field staff consisted of a two-day programme to explain the rationale of the Code delivered by members of the lead regulation unit and training on topics such as governance, business planning and risk management. It was evident at the time that more would be needed<sup>10</sup> but there was a desire not to over-specify processes for fear this would discourage the exercise of judgement and the adoption of tailored approaches.

At the outset of the new approach, the Corporation reviewed all of its previous guidance, advice, circulars and good practice notes. It withdrew redundant documentation and consolidated other material. This reduced the volume of material considerably.

### **2.4.2 Internal review**

In September 2002, the RMT commissioned a consultant to review progress on the fields' implementation of the new approach. The main conclusions were that field staff should have more guidance and training and that the lead regulator role was causing confusion. The Corporation did not change its organisation but decided to create supplementary guidance for regulation staff, to develop more training for them and to involve field staff to a greater extent in these processes. It had already decided to establish the Lead Regulation Support Unit.

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<sup>9</sup> Monthly in the case of Lead Regulation, less often in the other cases.

<sup>10</sup> In 2002/03, the Corporation piloted its advanced certificate in regulation, accredited by Nottingham Trent University.

At about the same time, an internal quality assurance review sought feedback from 20 associations: 14 of the 15 that replied “were positive in their responses”. The review concluded that the approach was generally bedding in, despite evidence of inconsistency among lead regulators and delays in communication with associations.

Most of the guidance for regulation staff became available during the summer of 2003; 15 months after the Code came into effect. Good Practice Note 6 “Our regulatory engagement with housing associations”, which integrated the approach and clarified the process outlined in the Code, came out in June 2003. The Corporation informed us that it had deferred guidance on Continuous Improvement pending the results of our review.

## 2.5 Housing Association Assessments

The HCA is the central document in the Corporation’s regulation of lead regulated associations. Completing the first round of HCAs proved to be a major effort. By October 2003, HCAs were on the Corporation’s website for almost all lead regulated associations. The planned completion date had been August but it proved necessary for field directors and central staff to assist lead regulators more than anticipated. One is still awaiting a finalised inspection report.

The HCA incorporates a traffic light system assessing an association’s compliance with the Code and its development performance. The Corporation’s intention was that “... over time, this will lead our relationship with successful associations to become less intrusive.”

In aggregate, the results of the traffic light assessments in the first round of assessments of lead regulated associations were as follows.

	<b>Viable</b>	<b>Properly Governed</b>	<b>Properly Managed</b>	<b>Development</b>
Red	1%	4%	2%	1%
Amber	5%	9%	9%	22%
Green	95%	87%	89%	78%

The Corporation had not finalised its policy on how associations can challenge its judgements during our review. In September 2003, RSC considered responses to its consultation on this subject. The Corporation published a document setting out its appeals process on 1 March 2004.

## 2.6 Inspection

Between September 2001 and April 2002, the Corporation’s field teams carried out 47 pathfinder inspections to develop its approach. It issued the Inspection Tool Kit in August 2002. The intention was to publish reports on all lead regulated associations over three years (roughly 130 a year) and to conduct a programme of inspections of smaller associations. Between April 2002 and March 2003, when inspection moved to the Audit Commission, the Corporation published 59 inspection reports.

The transfer involved 38 people and went as planned. The Corporation and the Commission agreed a Memorandum of Understanding (MOU) to coincide with the transfer and published a summary of this in September 2003.

The Corporation told us that the effort required to plan and implement the transfer distracted key managers in the Corporation from work on the new approach to regulation.

Under the MOU, follow up and implementation of the recommendations arising from inspections is the responsibility of the Corporation.

## **2.7 Supervision and enforcement**

When the new regime began there were 62 associations under supervision.<sup>11</sup> Some of these had been in supervision for a considerable time or had been in supervision more than once in the recent past.

The RSC has emphasised the importance of resolving supervision cases without unnecessary delay and responsibility for all, except those where enforcement is needed, has been delegated to the fields. As at March 2004, there are 20 enforcement cases handled centrally and in the interests of transparency and accountability, the Corporation relies less on informal strategies.

A recent consultant's review of supervision revealed some inconsistencies in the criteria used in the approach to supervision adopted in the fields and this is subject to further consideration in a second review phase.

The Corporation is seeking additional powers to take action in cases where an association's performance is giving cause for concern. These might take the form of the ability to appoint a special manager with executive powers or making the Code statutory and enforceable through the courts.

The existing power, to make Statutory Appointments to an association's Board, is not always effective quickly. It allows some unsatisfactory situations to endure for too long and, in the process, take up a lot of the time of Corporation staff, often at a senior level. The Statutory Inquiry process is also a time consuming and cumbersome process.

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<sup>11</sup> Including intervention and enforcement cases. Source: Housing Corporation: Annual Review 2002/03

### **3 The new approach in practice**

This section summarises the views expressed by those we interviewed about the Corporation's intention and what it has done in practice. Our analysis and evaluation of the issues arising are set out in the next section.

Appendix I summarises respondents' feedback on some specific aspects of the Corporation's regulatory engagement.

#### **3.1 Context**

Insufficient time has elapsed for a robust evaluation of the outcomes of the new approach. Our focus has therefore been on inputs, processes and regulatory outputs.

The interviews and discussions we held were non-attributable. Our terms of reference related to the first year of operation of the new Code but it is reasonable to assume that the views expressed by respondents were those that they held when we met them (October and November 2003). In the case of association representatives, the views expressed could reflect experience of the Corporation over an extended period, not just recently.

Association respondents were self-selecting. It is not obvious that this led to any particular bias. All our discussions seemed to be open and honest. Unanimity was rare, and we heard a range of views about most issues and were able to understand the circumstances and form an opinion on the questions we needed to answer.

The Corporation and associations had been doing things for the first time and it would have been surprising had there been no transition problems and inconsistencies. A number of respondents on both sides expected improvement with experience.

#### **3.2 Regulatory intention**

There was general agreement that the new approach was "the right way to go" and that the focus on governance and service delivery was desirable. Lenders believed the Corporation should augment this by more emphasis on the early identification of adverse financial situations. Many associations acknowledged that the new approach was challenging for the Corporation.

On self assessment, association executives were positive about the intention to adopt a "more grown up approach" and some observed that it had helped to get Boards to focus on their responsibilities - "dragged the Board into the 21<sup>st</sup> century". Chairs and Board members were less positive. They thought that too much detail came to the Board.

Forming a judgement based on the self-assessments was a challenge for the Corporation's staff. They expressed a range of views, probably reflecting, the variability of the statements submitted. The Corporation has subsequently issued guidance on self-assessment, including a format for the compliance statement. Associations did not welcome what they saw as "one size fits all".

While many associations felt that lead regulation was working well, some of them still observed that the information burden had not diminished. They said they had been disappointed that the "light handed regulation" that they thought they had been promised had not materialised. Frustration about this was heightened when it was not clear how the material submitted had been used.

Associations and fields alike claimed it was a struggle to keep up with the material they received and to interpret it. Many associations said that field staff treated guidance, supplementary guidance and advice as mandatory.

Associations said that the total burden of information submissions to regulatory bodies was out of control and not co-ordinated, and that they wanted it rationalised.

### **3.3 Outcome focus and transparency**

Respondents noted that not all of the changes following from the Code are outcome focussed.

The Corporation publishes its regulatory judgements in a more structured form than before and this met with approval from all respondents. They were less positive, however, about the transparency of the rationale underlying regulatory activity and judgements in practice relative to the directed approach presaged in the Code.

### **3.4 Proportionality and risk assessment**

Associations did not believe that regulation followed risk. Associations spoke of a lack of appreciation by some lead regulators of the risks to associations' businesses and their ability to manage them. They observed that many associations are facing novel and increased risks, such as those arising from the provision of student accommodation and care homes, but that associations with traditional stock in areas of low demand could also be at risk. Associations reported instances where regulators had judged new areas risky irrespective of the ability of the association to manage them. Some suggested that the Corporation's role in implementing government policy meant that some matters of importance to the Corporation were of little concern to associations.

### **3.5 Lead regulation**

Associations saw the management of all regulatory engagement for an association by a single individual as beneficial in principle. A single point of contact had the potential advantages of increasing familiarity with the association's business (but recruitment and retention issues can undermine this) and the ability to build better relationships (but if this does not happen, then the outcome is probably worse with a single contact).

Some associations, generally it seemed the more pro-active ones, were complimentary about their lead regulators and their delivery of the new approach. Relationships were dependent on the individuals and this could lead to inconsistent application of regulatory policy.

In terms of the capability and experience of lead regulators, associations made unfavourable comparisons with the original Lead Regulation Unit that had developed the model.

The fact that the lead regulator did not cover the investment content of the HCA was seen as a dilution of the concept of the single point of contact and increased the prospect of inconsistency between the two sides.

### **3.6 Inspection**

Association respondents welcomed the idea of inspection. In practice, those that had experience of inspection had mixed views about it. As far as we could determine, the negative views related to the earlier efforts. None of the associations who expressed a view about inspection by the Corporation had found the process to be particularly challenging. Some associations reported, and others were anticipating, a challenging inspection by the Audit Commission.<sup>12</sup>

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<sup>12</sup> The reports on some Corporation inspections have not yet been published by the Audit Commission, possibly suggesting that their conclusions are controversial.

Lead regulation staff had found inspection helpful and some saw the transfer to the Audit Commission as a loss that could affect the Corporation's ability to make judgements about compliance and performance and take the appropriate regulatory action. The Audit Commission's view was that the MOU was working well and that the added formality that resulted from the separation was an advantage.

Some of the Corporation's field staff told us that parts of the Memorandum of Understanding between the Corporation and the Audit Commission were not working well. They cited difficulties in ensuring involvement in preparation meetings and discussions about reports. Some said they were acting more pro-actively than they thought the MOU implied in order to make it work better.

Some respondents questioned the effectiveness of the arrangements for follow up and implementation of the recommendations arising from inspections. Others observed that it was too early to judge this as the arrangements are still relatively new.

### **3.7 Supervision**

Few of the association respondents had first hand knowledge of the Corporation's supervision but some reported a view, not based on personal experience, that the supervision team at the Corporation's head office was impressive. A number observed that the fact that no association had become insolvent weakened the incentives for associations to manage their affairs effectively.

Corporation staff felt that the available processes could be excessively long-winded and that they wanted additional powers to make executive interventions.

## **4 Analysis and conclusions**

This section contains analysis of the findings from our review and sets out our conclusions.

### **4.1 Comparison with other regulatory regimes**

#### **4.1.1 Commitment to change and scrutiny**

The change entailed in the new approach represented a significant challenge for the Corporation and its staff in policy, culture, organisational and management terms.

The Corporation's genuine attempt to implement the principles advocated by the Better Regulation Task Force is laudable. Many regulatory agencies pay lip service to the principles with few concrete changes observed by the entities they regulate.

We are not aware of other UK regulators that have volunteered themselves for independent scrutiny of the kind reported here. The Corporation's commitment to this and subsequent reviews is a virtue and will be instrumental in improving the regulation of the sector.

The onset of new regulatory regimes in the utilities has been associated with significant and sustained efficiency improvements. These have occurred at the same time as improvements in the quality of outputs and customer service. Given the nature and history of the social housing sector, we would expect there to be substantial scope for efficiency improvement stimulated by better regulation.

We conclude that the Corporation's commitment to independent scrutiny and transparency is likely improve the regulation of the sector and that better regulation is capable of substantially improving sector performance.

#### **4.1.2 The role of incentives**

There are well-developed models of regulation that apply to public bodies on the one hand and private utility businesses on the other. The independent status of housing associations, somewhere between public bodies and private companies, has implications for how the Corporation can position itself to drive performance improvement.

Arguably, the economic incentives that underlie utility regulation in the UK are less relevant in the social housing sector, given the absence of pressure to create value for shareholders. Interestingly, however, there are entities whose constitutions are similar to those of housing associations and that are subject to this model of regulation. The most notable of these are Glas Cymru, a non-shareholder company limited by guarantee (CLG) that owns Welsh Water, and Network Rail, the CLG operator of the national rail network. Each of these adopted substantially modified governance arrangements when they ceased to be investor owned, quoted companies and rely on other incentive mechanisms<sup>13</sup> in place of shareholder pressure, variously applied in other public services.

We have considered the possible causal mechanism linking the Corporation's approach with the intended improvements in sector compliance and performance. Appendix II contains a number of these and indicates their potential applicability to housing associations.

The Corporation's new approach sought to enhance the existing mechanisms by introducing service inspection and the publication of performance information and the Corporation's assessments; promoting continuous improvement; and giving more

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<sup>13</sup> Comparative competition and league tables, competitive tendering of operations and capital schemes, management incentive schemes.

attention to governance issues. In the absence of the high-powered incentives that come from product and service market competition and shareholder pressure, these represent valuable additions to the Corporation's regulatory toolkit.

Nonetheless, we believe there is potential for further improvement in the effectiveness of the Corporation's regulation. This should begin with an enhanced analysis of the comparative performance of associations. We also believe that it will be useful to build the principles of best value into the Corporation's work on continuous improvement.

These developments will make possible more challenging regulatory judgements which will in turn lead to more effective regulatory action. Ultimately, these approaches would support a clearer position for the Corporation on sector restructuring, for example to have fewer associations in order to exploit scale or scope economies.

The following subsections consider these two developments.

#### **4.2 Sector analysis of comparative performance**

An improved understanding of efficiency and performance will improve the ability of lead regulators to make their regulatory judgements in a consistent and proportionate way and will address some of the issues we have reported about the application of these regulatory principles to date.

Currently, the Corporation analyses housing association performance indicators (PIs) and publishes the results. The indicators represent a number of aspects of performance including some indicators of efficiency. The results inform the HCA assessment of management and planning for inspections.

We believe there is potential for the Corporation to improve its effectiveness by focusing more explicitly on the efficiency of HAs. Appendix III describes a possible approach to developing a better understanding of housing association efficiency and performance. Soundly based efficiency judgements will enable the Corporation to challenge associations more effectively.

#### **4.3 Best value**

In common with other areas of public service provision, the sector has not applied best value principles effectively. These principles require explicit consideration of: market conditions, potential economies of scale and scope; a full range of service provision options; the associated investment requirements and risks; and a clear specification of the intended benefits. These might arise from the economies of scale or scope, examples are competitive tendering for certain services or partnerships or joint ventures between associations. Supported by improved understanding of efficiency across the sector, best value could support a more effective challenge by the Corporation.

#### **4.4 Application of the Corporation's regulatory principles**

The Corporation's principles are outcome focus, proportionality, consistency and transparency. On the last of these, we note the Corporation's considerable efforts to improve transparency in particular by publishing the HCAs.

##### **4.4.1 Outcome focus**

The Corporation sought an outcome regime although its corporate objectives are a mixture of ends and means.<sup>14</sup> The focus differs in different parts of the Code.

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<sup>14</sup> The "provision of affordable and sustainable housing" and "meeting the needs of people in ... vulnerable groups" are sector outcomes that can be only partly affected by the achievement of the Corporation's regulatory outcomes - financial viability, good governance and good management.

Financial appraisal has moved from being outcome based (historical measurements of viability) to input based (forecasts and business plans). Similarly, regulating governance is mainly about process. Judgements on the quality of housing association management could be outcome driven but currently the emphasis is on policies and plans. Continuous improvement also has the potential to be outcome focussed, but the Corporation's work on this is still in progress.

Appendix IV gives some examples of input and output focused approaches in the key areas of regulation.

There are contradictions between the advertised approach and the practice although the mixture of outcome and input focus appears reasonable in the circumstances. Where the Corporation identifies and mitigates risk, with supervision as the safety net, it would seem excessively risky for the regime to become entirely outcome focused.

In Appendix I - Reviews, we refer to a concern among associations that "reviews had been hijacked by government's agenda". The Corporation is clear that its regulation reflects the promotion of government policy<sup>15</sup> and that some reviews are part of the regulatory "theme" for any year. Themes reflect the political and social significance of issues and any risks to the reputation, viability or performance of the sector and entail reviews across the sector or the relevant part of it. This is part of a wider issue about the independence of housing associations from government. As the risk based approach to regulation develops it will be important for the Corporation to distinguish more clearly between reviews, and other interventions, that are policy driven and those that arise from regulatory concerns about individual associations and ensure that this is understood by stakeholders.

#### **4.4.2 Proportionality and consistency**

The Corporation seeks to make its regulatory activity proportionate to assessments of the risks associations face. It also seeks consistency in the treatment of associations. This should mean that the Corporation: is systematic in determining the regulatory treatment of HAs; gives similar treatment to associations in similar circumstances (i.e. facing similar types and degrees of risk); and gives proportionately different treatment to those in different situations (i.e. facing different types and degrees of risk).

The perception of a significant proportion of the housing association representatives at all levels to whom we spoke was that, to date, this process has not been proportionate and consistent. We would add that analysis of efficiency across the sector would improve consistency and proportionality.

Evidently, if the regulatory work of the Corporation is to improve the performance of housing associations and the sector, then it needs to be challenging albeit, normally, in a constructive way. The sorts of challenge that lead regulators can and should be in a position to mount on risk matters include

- challenging the association's information in terms of its relevance, completeness, accuracy and presentation and also the uses to which it has been put
- challenging the association's interpretation of its circumstances and the materiality of the risks it is facing
- challenging the mitigation and management arrangements adopted by the association and the capability of the management and staff to apply them.

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<sup>15</sup> See *The way forward*, op cit, para 2.3

To make such challenges effective will require lead regulators to be capable of making the sophisticated judgements that are needed and sufficiently aware of what is happening across the sector and elsewhere in the Corporation to make these judgements in a well-informed and consistent way. Improved sector analysis will help lead regulators to see the situation of any housing association within a broader context.

Given the number of associations in the sector, some form of segmentation will be essential in deploying resources to maximum effect and making regulatory judgements that are proportionate to risk.

One possible segmentation follows conventional risk management thinking and would permit a proportionate and consistent regulatory response to the risk situation of each housing association defined in terms of

- the *likelihood* of risks<sup>16</sup> occurring
- the scale of the *impact* a risky event would have (determined by the nature of the risky event and the scale of the activity it affects)
- the scope for mitigation and the capabilities of management to deal with the consequences of the risky event.

This would give a sector-wide risk assessment and a justification for regulatory activity, association by association, that would reflect the Corporation's stated intention.

As noted in 3.2, many associations had expected a reduction in the regulatory burden following introduction of the Code. In fact, *The way forward* did not refer to light-handed but said that less intrusive regulation would be dependent on performance and occur over time.

To date, some associations have received less intrusive regulation than others. It was not possible in our review to tell whether these were associations with good HCAs. Presumably, all of the associations that received four green lights will expect less regulation in future.

## **4.5 The Corporation's response to poor performance**

### **4.5.1 Efficiency targets**

Comparative efficiency and best value would, together: make for a more effective challenge to the efficiency of associations; add rigour to the HCA traffic lights; and identify, with evidence, specific areas of underperformance by individual associations. This process would mean that the "soggy middle" would be regarded as under-performing.

It is not clear that the Corporation should or could set efficiency targets for associations. Experience in other sectors suggests that the publication of enhanced performance data will have an effect on performance.

### **4.5.2 Inspection**

It will be helpful to consider how clear and effective the arrangements are for following up the findings from inspections, taking regulatory action and communicating progress to the Audit Commission. This should be consistent with the Corporation's approach to performance across the board.

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<sup>16</sup> The main risk dimensions might be: risk of financial loss (possibly taken as risk to the association, to the public purse and to lenders), risk of reputational damage (possibly to the association, the Corporation and the sector), risk of development projects not being delivered, risks to the condition and value of the association's assets and risk to tenant security and services.

This should be considered as part of a review of all the arrangements between the Commission and the Corporation and we understand from the Corporation that a review will take place in 2004, once the Commission has concluded the review of its inspection methodology.

#### **4.5.3 Intervention powers**

The question arises as to whether the Corporation should have the powers it is seeking (see 2.7) to press for changes in areas where existing powers would be inappropriate. A swifter and more certain mode of intervention would be necessary if the Corporation were, in line with the considerations discussed in 4.4.2 of this report, to reduce the routine regulatory attention it gives to associations that it judges to be relatively low risk. Without powers to intervene quickly and effectively, it would be hard to implement the proportionate approach we are recommending.

#### **4.6 Implementation of the new approach**

The general picture is one of an organisation that set itself a substantial challenge in changing its regulatory approach, restructuring the organisation and introducing the inspection regime. The transfer, after one year of operation, of the inspection team to the Audit Commission made this more difficult.<sup>17</sup>

Even so, it seems to us that the Corporation could have anticipated the need for better preparation for the changes and have provided more support to those who had to make them.

The Corporation was slow to deliver some important aspects of the new approach.

- Much of the supplementary guidance was not available until the summer of 2003, some 15 months after the launch of the new approach, and some is not yet available. As a result, regulation staff struggled to come to grips with their new roles.
- The inspection function began work in April 2002. It began with a large number of pathfinder and pilot inspections and the inspection toolkit was not available until August 2002. In retrospect, it does not seem likely that the Corporation would have completed the full cycle of inspections according to the planned timetable.
- The substantial completion of the HCAs, the basis underlying the regulation of each association did not occur until October 2003.

#### **4.7 Management arrangements and resourcing**

The Corporation operates a devolved management model and, in the circumstances, we support this. There is, however, scope for making the devolved model more effective.

The field offices and the individuals within them have substantial discretion about what they do and how they do it and there are instances where this discretion has led to inconsistency. The policies developed in the centre are reasonably clear but different lead regulators have interpreted them differently. This suggests that the centre should pay more attention to communicating with regulation staff in the field, making sure that communication has been effective.

The Corporation under-estimated the staff capabilities and the support needed for lead regulation to work well. Having tried the model with experienced staff at the centre, there seems to have been an assumption that other less experienced staff

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<sup>17</sup> The Corporation told us that there was a period of some six months during which its capability to develop the framework and support field activity was “seriously reduced” and that there were adverse effects on staff morale.

would be able to perform in the same way and with relatively little training or development. In our view, this was unlikely.

Additionally, as we have emphasised in 4.5.2, the devolved model would work better if the lead regulators had a better understanding of the picture of risks across the sector as a whole.

The concept of account management is to bring together the work of different parts of an organisation and create a pool of corporate knowledge of each customer's affairs. The fact that investment is separated dilutes the concept and might need to be reconsidered in future.

The relationship between lead regulators and the Chairs, other Board members and senior executives with whom they have to deal is, in a significant number of cases, somewhat unequal. Respondents on both sides raised this as an issue. It will be particularly problematic where the regulatory agenda includes matters that are especially complex or controversial.

Evidently, it is not possible for the Corporation to recruit large numbers of people who would otherwise be operating as Chairs or Chief Executives of large housing associations. We believe, however, that the Corporation should seek the best match possible between its resources on the one hand and the people in the associations and the issues on their regulatory agendas on the other. The matching process should include senior people in the Corporation's head office who should be deployed according to priorities.

Over time, the Corporation will gain a better understanding of the resourcing issues. In the meantime, it will be helpful to review the portfolios of the lead regulators in the light of experience to date, the results of the HCAs and the outcome of the work on risk considered in 4.3.2. This should permit a reallocation of resources, giving better value for the Corporation's expenditure on regulation and a reduced regulatory burden on the sector as a whole, although not for the associations assessed as high risk. It should include withdrawing from existing regulatory work with some associations.

Without a coherent approach of this kind, regulation will fail the tests of proportionality and consistency.

## **Appendix I - Views on specific aspects of regulatory engagement**

### ***Regulatory plans***

Associations that had good relationships with their lead regulators appeared to find these plans and the associated process helpful in managing their regulatory work and the relationship with the Corporation. Others complained of plans not followed. Some found the plans unhelpful with the link between the discretionary items in the plans and the risks facing the business not evident.

### ***Annual Viability Reviews (AVRs)***

Most of the comment on these was positive. Some associations made the point, strongly, that the reports were too detailed for the Board. Lenders pay attention to AVRs and find them useful.

### ***Housing Corporation Assessments (HCAs)***

Most associations were content with their HCA and the process of arriving at the assessments. Most had four green lights but few claimed to understand the basis of the judgements. They thought that the prevalence of green lights undervalued good performance. We were told that lenders did not pay attention to the HCAs.

Where associations had questioned judgements in draft assessments, the Corporation had changed its view in some cases and in others it had not. There was a degree of rumour and supposition about this process and whether or not it might serve an association's interest to challenge the Corporation. Some respondents were nervous about doing so and criticised the Corporation's delay in finalising its policy on how associations can challenge its judgements.

### ***Reviews***

The rationale for reviews was not clear to associations. Some thought that it was inappropriate that rather than reflecting risk to associations, some reviews were in response to the government's agenda. Many associations saw reviews as not sufficiently searching to be helpful and some spoke of regulators still appearing to focus on process. Some commented on good preparation by Corporation staff for reviews but others cited cases in which they had not read advance information. Field staff were uncertain about when and how to do reviews and inconsistency resulted. Supplementary guidance (on governance and management) was helpful when it arrived but did not help to interpret the answers given. There is no guidance to staff on continuous Improvement and training on this topic had not been useful.

### ***RASA***

Few association respondents had experience of RASA. Some commented that small did not necessarily mean not risky and others that some aspects of social policy would suffer without small specialist associations. There were different approaches to RASA between the fields we visited. In one case there was a full financial appraisal (a lengthy process due to system difficulties) was undertaken. In the other there was not. Considerable reactive effort was required in some cases and the value of some of this was widely questioned.

### ***Bank of good practice***

Associations linked the requirement for continuous improvement to the bank of good practice. Some thought that progress had not been rapid and some were critical of the web site. Others, despite the Corporation's statutory function to promote good practice, believed that this was an area in which the Corporation should not intervene.

**Appendix II - The range of incentive mechanisms**

<b>Pressure to improve</b>	<b>Relevance to sector</b>	<b>Comment</b>	<b>Carrot, Stick, Not present (N/P)</b>
Market competition	Limited	Almost by definition, there is no effective market in social housing Tenants and residents, however, are not without influence	S
Profit motive	No	No shareholders, no pressure The absence of shareholder pressure means that there is no inherent mechanism promoting the optimal sector structure	N/P
Comparative efficiency	Yes	This is dealt with in the main report	C/S
Threat of insolvency	Limited	The processes surrounding this are not transparent. No association has been declared insolvent. The Corporation has resolved problem cases in private and by appointing new Board members. In severe cases, the stock of a failing association has been transferred, by agreement, to a stronger association.	S
Fines for poor performance	No	These would only be rational if there was shareholders' equity to bear the cost	N/P
Customer compensation for poor performance	Yes		S
Competitive contracting for operations and investment	No.	To date, contracting is strangely undeveloped by Housing Associations	N/P
Loan covenants	Patchy	Pressure to get access to new funding Pressure to meet existing loan covenants Absent for non-investing associations – the soggy middle But, not clear what would happen if a breach became likely	S
Access to development grant	Patchy	Grant is administered by the Corporation No pressure if no investment or no grant needed	C
Laws and standards	Yes	Corporation is equivalent, for example, to the quality regulators in utilities	S
Reputational pressures	Yes	Publication of performance assessments by the Corporation puts pressure on execs and Boards Traffic lights are not sufficiently differentiated to provide strong incentives Some Boards, however, are not shamed even if named	C/S
Governance arrangements	Yes	This works via independent and representative directors. To some extent influenced by the Corporation.	S
Executive incentives	Yes	To some extent influenced by the Corporation.	C
Other rewards – “deals” for problem solving	Yes		C
Service ethos	Yes		C

### **Appendix III – Efficiency – regulatory approaches and techniques**

An enhanced approach to analysing housing association efficiency could entail

- agreeing measures of efficiency
- improving data quality
- identifying significant cost drivers and making the adjustments necessary for the analysis to focus on efficiency differences
- making efficiency judgements and assessing the need for regulatory action.

We discuss each of these in turn in this Appendix. How the Corporation should use the results of the analysis is dealt with in the main report.

#### *Measures of efficiency*

In general, the measure of efficiency is the ratio *output/input*. The higher the value of this ratio, the more efficient is the organisation to which it relates. To be useful, comparisons require standard definitions of outputs and inputs but there are complicating issues to do with both of these.

Social housing outputs are numerous and to varying degrees amenable to quantification or assessment. The outputs of each of the main streams of activity<sup>18</sup> differ substantially and any efficiency analysis should allow for this. At a more disaggregated level, any of the activity streams are still complex. In housing management for example, the overall output measure used by the Corporation - social housing units managed - while relevant for some purposes would result in misleading conclusions on comparative efficiency if, for example, the mix of type of unit or tenant differed markedly between the comparators. This suggests that detailed measures of the outputs of social housing for each of the main activities of HAs<sup>19</sup> are a necessary condition for drawing reliable conclusions on efficiency.

On inputs, efficiency assessments require data on expenditure, cost and quantity of resource inputs that match the complexity of the outputs. In principle, this presents little difficulty but in practice, there are substantial data recording and quality issues.

#### *Improving data quality*

Regulatory efficiency assessments are invariably contentious and the data can be a major source of contention. Unless the data are soundly based, the assessments will lack credibility and become the subject of endless disagreement. At the same time, the regulated entities will resist any increase in the regulatory information burden and the right data specification is critical.

The data underlying the main efficiency ratios in the PIs<sup>20</sup> have been “the subject of doubts raised from a number of sources ... and in consequence the Housing Corporation is undertaking a review aimed at clarification and improving their value”.<sup>21</sup> The Corporation is conscious of the need to review the coverage and definition of the PIs. It would be helpful if the Corporation’s review had regard to the requirements of the comparative efficiency approach we have suggested.

The review should consider the approaches to comparative competition that the regulators of the privatised network industries, electricity, gas, water and telecoms,

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<sup>18</sup> A possible top-level categorisation is: development, asset ownership, housing management, provision of landlord services, provision of tenant services and other activities.

<sup>19</sup> See previous footnote

<sup>20</sup> Weekly cost of management and weekly cost of repairs.

<sup>21</sup> Quoted from the executive summary in *Page Source 65 Research Report, Housing Associations in 2003 Performance Indicators*, prepared by TIAA Limited for the Housing Corporation, September 2003

have adopted. Experience suggests that reliable efficiency analysis will pose important questions about data definitions, sources and methods of analysis including the following.

- How to establish the starting point for comparisons - it is often easier to compare changes in cost and efficiency than absolute levels, but this requires a reliable set of initial output and input data.
- How to attribute costs (including direct attribution, allocation and apportionment) to correspond to the complexity of the outputs of housing association activities.
- How to allow for differing policies on the capitalisation of expenditures.
- How to estimate capital costs representing the consumption of capital assets during the analysis period. This is in two parts, the return of capital as measured by depreciation and the opportunity cost of capital tied up in a particular use.
- Adjustments for one-off events, housing association specific factors and factors outside the control of management.

*Identifying cost drivers and making allowances for external factors*

One purpose of performance analysis is to identify where efficiency improvements are possible. A performance difference between two housing associations is only an efficiency difference if the causes of the difference are actually or potentially under the control of housing association management. A key purpose of the analysis is to identify and distinguish between those factors affecting costs that are potentially controllable by housing association management (controllable cost drivers) and those that are not (sometimes referred to as exogenous or external cost drivers).

Table A lists some cost drivers regarded as controllable and some that are not.

Table A – Examples of controllable and exogenous cost drivers

<b>Controllable factors</b>	<b>External factors</b>
Staff utilisation	Market conditions
Procurement effectiveness	Regional differences in input prices
Mix of activities and services provided	Inherited density or condition of housing stock
Optimisation of maintenance work	Inherited maintenance backlog

Statistical cost analysis can identify cost drivers and evaluate their significance using output and cost data for a representative sample of businesses. Initially, relationships are estimated between total cost and a range of explanatory variables, usually including scale, regional factors, types of service, types of customer, etc, to identify the significant cost drivers.

*Making efficiency judgements*

A range of methods has been utilised by utility regulators to establish a standard against which to judge the actual performance of industry participants. In brief, the most useful of these are as follows.

- Statistical analysis of historical data. This can take two forms each aimed at assessing scope for improvement: regression analysis and frontier analysis.
- Establishing trends in aggregate cost, output and productivity. The trends can be extrapolated to provide efficiency targets for the future.
- Aggregate benchmarking comparisons within the UK and internationally.
- Disaggregated analysis including econometric analysis of cost and output data for individual functions and activities across sector participants and benchmarking of activities that are comparable across dissimilar organisations doing some similar things.

## Appendix IV - Examples of input and outcome based regulatory activity

<i>Item in the Code</i>	<i>Input focused (forward looking)</i>	<i>Outcome focused (backward looking)</i>
Financial Viability	Review of financial policies and forecasts (AVR) Review of business plans	Accounts and returns
Governance	Processes – governance review <ul style="list-style-type: none"> <li>• Board procedures</li> <li>• Board membership</li> <li>• Board meeting attendance</li> <li>• review of Board minutes</li> <li>• interviews</li> <li>• review of risk management</li> <li>• etc</li> </ul>	Performance of the Board e.g. evaluation of past decisions Effectiveness of the ring fence
Management	Policies and procedures Asset management strategies	Performance indicators Tenants views via inspection reports
Continuous Improvement	Process models	Performance indicators Efficiency analysis Review of compliance with rent restructuring