Turning it up to eleven
Key highlights

- Average chief executive salary: £212,508. An increase of 7%.
- 87% of associations pay board members with an average salary of £11,387.
- 87% of associations follow the NHF governance code. 13% adhere to the UK Corporate Governance Code.
- 87% of associations pay board members with an average salary of £11,387.
- Welfare reform is the top risk, highlighted by 60% of associations.
- Average board size: 10.2.
- Organisations should define/redefine their purpose and use it to guide decision making.
- 86% of board members are non-executive.
- Sector mergers are increasing.
- Board decisions are receiving increased public and media scrutiny.
- Associations need to be risk mature, not risk averse.
- 34% of board members – and 24% of chairs – are women.
- Stress testing and registers of assets and liabilities help manage risks and maximise social outputs.

- 60%
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Methodology
This report is based on a desktop review of the financial statements of the top 60 (by income) not for profit registered providers of social housing in England.

We refer to our previous report, Housing Governance Review 2015: Eyes on the Horizon, as ‘the 2015 report’ and to this year’s publication as ‘the 2016 report’. References to ‘2016’ therefore relate to results in the 31 March 2015 financial statements, with references to ‘2015’ relating to the 2014 financial statements. Last year’s report is available to download from our website: www.grant-thornton.co.uk/Global/Publication_pdf/Housing-Governance-Review-2015-Eyes-on-the-horizon.pdf

We have based our review on the National Housing Federation’s code of governance – Promoting board excellence for housing associations (‘NHF Code 2015’) – and on best practice guidance from other sectors, such as the Financial Reporting Council’s UK Corporate Governance Code 2014 (‘UK Code’), where appropriate.

Jenny Brown would like to thank Andy Wood, Carol Redgment, David Rogers, Donald Sadler, James Kirkland, Laura Brierley, Louise Hughes and Toby Wilson for their help in preparing this report. She would also like to thank the following for their contributions and insight: Arthur Merchant, Gordon Perry, Ian Graham, Kelsey Walker, Margaret Allen, Richard Petty, Tom Dacey and Tracy Allison.
“Welcome to Grant Thornton's annual Social Housing Governance report.”

Jenny Brown, Head of Housing

Well, this certainly wasn't a year in which we would struggle for things to consider in relation to Governance and the Social Housing Sector! In fact, there were so many possible topics for comment and debate, our report has taken a slightly different approach this year. Whilst we continue to consider the reporting and transparency of Governance reporting in the most recent financial statements (31 March 2015) of the top 60 housing associations we recognise that since many of these sets of accounts were prepared there have been fundamental changes in the sector (starting with the change of Government in 2015). With this in mind our report this year is much more forward looking considering the potential impact of the changes afoot.

Last year we flagged the need for boards to be forward looking and to take full control for the actions of their associations – but it's extremely unlikely that any of us would have been totally successful in our horizon scanning and anticipated the extent and nature of change impacting on the sector in the last twelve months. Where there has been a culture of strong governance, associations have demonstrated resilience: keeping their purpose at the forefront of any change agenda. In other associations, the need for change has become more readily apparent with values and mission being revisited to re-establish the sense of purpose.

As an adviser to the sector we have seen a variety of responses to the economic, political and regulatory challenges facing associations. Efficiency and effectiveness remain high on the agenda and for many, it is appropriate to consider the operating model in its entirety going forward – either as an individual entity or in conjunction with others through shared services, partnership or merger.

The sector faces many challenges in the coming years, but these contrast with significant opportunities. In order to fully maximise the success from these the governance of the organisation will become critical especially as the role of the Homes and Communities Agency (HCA) changes and each association has much greater freedom in its decision making.

With all of these factors, governance is more important than ever and it therefore needs to be operating effectively, with transparency and be seen to be top of the organisation’s agenda.

“Few of us could have anticipated the extent and nature of the change that has impacted the sector in the last year.”
The majority (87%) of the top 60 housing associations follow the National Housing Federation’s code of governance (NHF Code), with the remainder (13%) adhering to the Financial Reporting Council’s UK Corporate Governance Code (UK Code), which is usually associated with listed companies.

As at 31 March 2015, 22% of the top 60 associations (nine NHF Code, four UK Code) do not comply fully with their respective codes, up from 10% the previous year. The significant increase in non-compliance with the NHF Code is largely a timing issue. The updating of the code in February 2015 did not necessarily allow associations enough time to demonstrate compliance with its new, more stringent requirements. These included new provisions about the role of the parent board in determining board composition in a group structure and an expansion of the board’s functions beyond procedure to include behavioural and cultural aspects.

Both the NHF and UK codes follow the ‘comply or explain’ principle. This means that if associations comply they need only state this in their annual report, but if they don’t comply they should explain both why not and their strategy to achieve compliance. Of the 22% that state they are not fully compliant, all give their reasoning and how they intend to become compliant, although the level of detail varies.

The choice of governance code should reflect where an organisation stands and what it wants to achieve. Adopting and complying with a code is not just a tick-box exercise, it is about embedding good practice.
Adopting the UK Corporate Governance Code

Tom Dacey, Group Chief Executive, Southern Housing Group

The housing association sector has been famously described as a ‘broad church’, with a wide variety of members ranging from small, often entirely voluntary, organisations to large multi-regional businesses that produce much of the new housing in the sector. Broad churches require broad rules, such as the NHF Code, a one size fits all approach to governance for the large and the small in the sector.

Housing associations are obliged to adopt a code of governance of their choosing; they are not confined to the NHF Code, although the vast majority do use it. Producing a code for such a wide spectrum of members is a very challenging ambition, and the understandable desire to achieve a level of consistency has led to aspects of the NHF Code appearing prescriptive.

For example, the NHF Code offers very clear guidance on the size of boards: “at least five members, and no more than 12”. The UK Corporate Governance Code (UK Code), is silent on the issue of board size. This judgement is left to the discretion of individual governing bodies, all of whose circumstances will vary greatly. There may be a very good reason why the board is unusually large – a short-term measure post merger, or succession planning, for instance.

Having observed the social housing regulator’s growing interest in members’ compliance with the NHF Code, the board of Southern Housing Group asked the executive to investigate and review alternative codes of governance that might be suitable for adoption.

Our starting point was the UK Code, which originated from the Cadbury Report, The Financial Implications of Corporate Governance. The UK Code is now the governance benchmark for all UK corporate entities. While not designed for the housing association sector, with only modest adaptation it is capable of serving our objectives well. On reviewing the UK Code we were struck by its simplicity, brevity and lack of prescription. Drafted with the commercial environment in mind, the code offers a relevant framework for the challenges facing modern day housing associations.

With the state retreating from subsidising our activities, if housing associations are to continue to deliver their mission, we must become increasingly commercial. To provide genuinely affordable housing for rent or low cost home ownership, housing associations need to generate their own cross subsidy through property sales. In this regard, the sector’s risk is similar to the market risks faced by house builders.

As we continue to develop and sweat our assets, the loan books of the sector will grow through taking on the challenge of providing more homes with less state support. Ratings agencies will increasingly view the sector as ‘businesses with social objectives’ and expect to see well-run organisations, measured against a common standard.

Southern Housing Group has adopted the UK Code because it promotes high quality governance and reporting. Its stated purpose is to “facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company”. As a long-term business we think the UK Code is a very good fit for our future ambitions.

“Drafted with the commercial environment in mind, the code offers a relevant framework for the challenges facing modern day housing associations.”
Risk management

With the current amount of change and uncertainty in the housing sector, it is little wonder that risk management is a hot topic. The level of change also means the sector is becoming less homogenous and more fragmented and, with this, associations’ risk profiles are becoming more diverse.

The big question is how to approach risk management when there is so much uncertainty: the answer is not in the output but in the process. Associations must have established processes in place to identify issues as, or ideally before, they happen and to interpret how they might impact the association. This may involve developing strong networks within the sector – with other associations, the NHF, the Homes and Communities Agency (HCA), valuers, solicitors and lenders – so that ideas relating to impacts and mitigations can be shared.

The board’s role in this is to challenge the processes in place and to make sure there is sufficient risk management experience within the executive. The executive, in turn, needs to make sure that risk management is filtered down to all levels of the organisation so that it becomes embedded in the culture and everyone takes responsibility. The board should challenge the risks and mitigations on the risk register on a regular basis – crucially, this challenge must involve asking questions about what is not presented, as well as about the risks and mitigations that are covered.

The board owns the risk and the risk appetite, so it is its responsibility to ensure that suitable risk management processes and considerations are in place. Because of this, there is an increasing trend towards bringing in experts to assist in risk setting, thereby giving the board additional assurance.

With increased change across the sector, much stemming from government, and the need to make big decisions which could shape the future of associations, boards must aim to be risk enabled, not risk averse. They have to get the level of risk appetite right for their organisation.

Disclosure of key risks

Information on the specific risks faced by each association provides insight into what they see as the key issues threatening their business. Given the similarity of their core services, it is unsurprising that the same key risks are present across associations. Of the top 60, 57 provide details of the key risks that they face. Of these, 81% include details of mitigations. The most frequently disclosed ‘top 10’ risks this year, and last, are shown in the diagram on page 7.
‘Welfare reform’ remains the leading risk, cited by 60% of associations, the same level as last year.

The second and third most common risks, ‘volatility in the housing market’ and ‘government policy’ have much more prominence this year, featuring in approximately half of the top 60 associations. ‘Access to finance’, while dropping a place, is now considered a risk by 40% of associations, up from 28%. Other significant climbers from last year are ‘development programmes’, ‘staff retention and development’ and ‘asset management and maintenance’. The greater emphasis on all these factors could be seen as recognition that, in times of uncertainty, it is important to consolidate and ensure that the business base model is well managed before considering further development.

While the top 10 risks are common across associations, our study reveals a wide range of others under consideration. The number of risks mentioned in the annual reports varies from 0 to 23, with the average being 8.4, up from 6.5 last year.

Associations should look closely at their risk management processes, to ensure all risks are identified at the relevant operational level and that there are appropriate risk escalation procedures: significant risks impacting the whole organisation should, therefore, be presented in the corporate risk register considered by the board. Operational business units should maintain their own risk registers, with the top risks being escalated to the corporate risk register. This enables the board to focus on the key risks, rather than being drawn into lower level issues.

As risk management processes become more developed and spread through the organisation, associations can move from being ‘risk naïve’ to being ‘risk enabled’.

“Associations should look closely at their risk management processes, to ensure all risks are identified at the relevant operational level and that there are appropriate risk escalation procedures.”
TOP TEN RISKS

<table>
<thead>
<tr>
<th>Risk</th>
<th>Current Position</th>
<th>Position last year</th>
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<tbody>
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<td>Welfare reform</td>
<td>60</td>
<td>1</td>
</tr>
<tr>
<td>Housing market volatility</td>
<td>52</td>
<td>4</td>
</tr>
<tr>
<td>Government policy</td>
<td>48</td>
<td>7</td>
</tr>
<tr>
<td>Availability of finance</td>
<td>40</td>
<td>3</td>
</tr>
<tr>
<td>Health and safety</td>
<td>40</td>
<td>10=</td>
</tr>
<tr>
<td>Development programmes</td>
<td>37</td>
<td>10=</td>
</tr>
<tr>
<td>Weakening of financial position</td>
<td>35</td>
<td>9</td>
</tr>
<tr>
<td>Economic climate</td>
<td>33</td>
<td>5</td>
</tr>
<tr>
<td>Regulation</td>
<td>28</td>
<td>7</td>
</tr>
<tr>
<td>Pension cost</td>
<td>25</td>
<td>6</td>
</tr>
<tr>
<td>Staff retention and development</td>
<td>25</td>
<td>18</td>
</tr>
<tr>
<td>Asset management/maintenance</td>
<td>25</td>
<td>20</td>
</tr>
</tbody>
</table>

HOUSING GOVERNANCE REVIEW 2016
“With increased change across the sector and the need to make big decisions which could shape the future of associations, boards must aim to be risk enabled, not risk averse.”

**RISK MATURITY MODEL (GT LUXEMBOURG)**

The effectiveness of a company’s risk management system, in identifying and managing its principal business risks, can be assessed against the five levels of risk maturity.

**Where are you on this scale?**

5. **Risk naive**  
No formal approach developed for risk management

4. **Risk aware**  
Scattered silo-based approach to risk management

4. **Risk defined**  
Strategies and policies in place and communicated. Risk appetite defined

4. **Risk managed**  
Enterprise-wide approach to risk management developed and communicated

5. **Risk enabled**  
Risk management and internal control fully embedded in the operations
Responding to a fast-changing environment

Ian Graham, Partner, Trowers & Hamlin LLP

To say that the period since last year’s election has been a time of change for the housing association sector would be an understatement. In 30 years advising associations I’ve not seen anything quite like it. Speaking to clients, one of the most common comments people make is how hard it is to keep on top of the detail. There is so much, and it is changing almost daily, as the two key bills (Welfare Reform and Work Bill and Housing and Planning Bill) make their way through parliament.

Faced with this, how are associations to respond? We are finding no shortage of willingness to continue to look for ways to deliver much needed social rented housing. An absence of significant government assistance means this is harder but, where the local market makes it possible, associations are engaging in more commercial activity through trading subsidiaries to generate cross subsidy. Such vehicles are not new but more associations are now considering establishing them. To do so requires careful analysis of, among other things, loan covenants which may prevent the incorporation and/or funding of such entities without consent.

Some associations are looking at new corporate structures, perhaps involving the incorporation of sister entities which can take forward social housing provision outside the HCA’s regulatory framework. This type of vehicle might be set up as a charity with rules identical to those of the parent association. That is likely to facilitate the transfer of assets from the parent to the sister and/or the provision of financial support. Again, loan covenants need to be reviewed before action is taken.

The government’s focus on home ownership will provide some opportunities for associations. Shared ownership is being given a significant boost and there are also starter homes to consider. The voluntary right to buy will eventually translate into more development activity as replacement homes are provided. An obvious point to make is that this emphasis on sales of various types exposes associations to more market risk. Avoiding over exposure will be key as will having a ‘plan B’ to fall back on if the market turns.

In other areas of associations’ businesses, the need to think about the future and how things may have to change is also evident. Employment terms and benefits, including pensions, is one such area. Others include key services, such as repairs and maintenance, where the whole range of possibilities from outsourcing to insourcing and everything in between are being reviewed.

What about asset management? With the requirement for section 172 consent from the HCA for property disposals going, associations will have greater freedom of manoeuvre. This may well mean an increase in sales by associations to each other or outside the sector. Assets may be moved to the sorts of sister organisation I refer to above. For some associations a focus on non-core assets, such as commercial property, is probably overdue. Can these be managed more efficiently to generate revenue? I have long thought it would make sense for associations to pool such property in a jointly owned vehicle so it can be managed at scale.

The next few months will begin to reveal how associations are going to adapt to the myriad changes they are facing. I have no doubt that the response will differ markedly, depending on the attitude of the relevant board to risk and the local market in which the association operates.

“Avoiding over exposure will be key as will having a ‘plan B’ to fall back on if the market turns.”
The board

As the board represents those charged with the governance of associations, it is essential that it has the right members, in terms of size and skills, and the information it needs to govern.

Size and make-up of board
Across the sector, more associations are moving to unitary boards. The average board size is 10.2 members (10.3 last year), with an average of 8.75 non-executive members (9.4 last year). This means that boards in 2016 are made up of 86% non-executives, a decrease on 2015 when there were 91%. In general, the only executive member on the board is the chief executive. Of the top 60 organisations, only 22% of boards are made up entirely of non-executive directors.

There is a range of board sizes, with the smallest having five members and the largest 13, meaning that nearly all are within the range specified by the NHF Code (5-12 members).

In terms of gender diversity, 34% of board members are female, in line with last year. Within this, 24% of board chairs are female, a slight decrease on last year’s 28%.
The board

### Pay

Due to the complexity of sector organisations – particularly, but not only, groups with various functions – board members need a wide range of skills. Alongside the traditional desire for skills in finance and for legal and industry experience there has been a recent increase in demand for capabilities such as change management and channel shift (changing the method of customer interaction) and for wider commercial experience. Thought is also needed on the mix of personalities on the board, to make sure individuals can work together effectively.

To attract people with the appropriate characteristics, many associations believe board members should be paid for their time. Of the top 60, 87% remunerate board members, up from 82% last year. Among the 52 associations in the top 60 that pay their non-executive board members, the average individual payment, excluding expenses, is £11,387, up from £10,869 last year. The average total payment for non-executives within each organisation is £95,865, up from £91,012 last year. The average chairman’s pay is £18,790, a 4% increase on last year’s £17,984. This rising level of pay may reflect the increasing level of risk and complexity in the sector.

While the board is clearly important in setting the tone for governance and holding the executive to account, it is the chief executive and the senior management team (or executive team) that have the responsibility for ensuring that good governance operates on a day-to-day basis. Chief executive pay is subject to media scrutiny but it is a reasonable expectation that higher levels of pay are required for professionals with the right skills to lead such highly regulated and complex organisations.

The average chief executive salary (excluding pension contributions) among the top 60 is £212,508, up 7% from £198,573 last year. The average total pay for executives increased by 6%. In the same period, the total turnover among the top 60 increased by 12%. Pay rises were therefore not in line with the increase in association size.

Associations are not obliged to have an independent remuneration committee, nor does the sector statement of recommended practice (SORP) require disclosure of the considerations and arrangements for setting pay. This is where a lesson could be learned from the charity sector. The Charity SORP 2015 requires the disclosure of “the arrangements for setting the pay and remuneration of the charity’s key management personnel and any benchmarks, parameters or criteria used in setting their pay”.

### Key messages

While a board’s size is less important than its range of skills, it needs to be large enough for the right level of oversight and challenge, but not so big that it becomes unwieldy.

**Key messages**

Associations need to pay their board members and executive the salaries to attract suitable levels of individuals, both in skills and stature. But to survive public and media scrutiny and, most importantly, inspire confidence they must explain the reasons for their remuneration policy and the decision making process behind it.

**“Due to the complexity of sector organisations – particularly, but not only, groups with various functions – board members need a wide range of skills.”**
The regulatory environment

Consideration of the regulatory environment is essential to a review of governance within the sector. Regulation exists primarily to safeguard residents and ensure the organisations they pay money to provide them with an appropriate level of service and long-term security by remaining viable businesses. The regulator is effectively charged with governance of the sector as a whole, with any changes in regulation affecting how boards regulate and govern their individual associations.

The regulatory environment in the housing sector has evolved. The rationale behind the recent changes is to:

- achieve a more strategic grasp and better evidenced understanding of short and long term risks;
- gain greater assurance about associations’ vulnerability to covenant breaches and the risk to social housing assets from other types of activity,
- and to better integrate viability and governance work to enable more rounded judgements and a greater understanding of how value for money is delivered.

These changes should be complemented by a greater transparency in the reporting of compliance with regulation. In the past, associations have tended to confirm compliance with a brief sentence. Going forward, the statement of compliance should be accompanied by a discussion of process and of how associations are ensuring compliance. This will give tenants and the regulator greater confidence in the standard of governance.

The new requirement to create a register of assets and liabilities and to carry out stress testing is a step forward in this regard. It not only enables associations to better understand the sum parts of their businesses and the risks faced but gives evidence and reassurance to tenants and the HCA that such understanding exists.

**Assets and liabilities register**
The Governance and Financial Viability Standard requires all housing associations to maintain “a thorough, accurate and up to date record of assets and liabilities and particularly those liabilities that may have recourse to social housing assets”.

**Stress testing**
The standard requires all housing associations to carry out “detailed and robust stress testing against identified risks and combinations of risks across a range of scenarios, and putting appropriate mitigation strategies in place”.

Regulation is often seen as a burden but the requirements for stress testing and assets and liabilities registers have generally gone down well in the sector, as they are genuinely about understanding the business and its risks. Understanding the possible impact of the recent unprecedented change informs the risk appetite and allows boards to make wiser decisions.

As Julian Ashby, chair of the HCA’s regulation committee, said:

> “These new requirements are what any well-run provider should need to be doing to manage risk and maximise its social outputs. If you are only doing it to please the regulator, then you are starting from the wrong place.”

1 Source: National Housing Federation – Asset and liability registers and stress testing: safeguarding your business

**Role of the board**
The board needs to understand the requirements and what they mean for its association and to task the executive with designing the register and the stress testing process. The board must then rigorously challenge the assumptions applied by the executive and, in the case of stress testing, push the model to breaking point.
The regulatory environment

In depth assessments
The in depth assessment (IDA) model includes reviews of strategy, structure, governance, financial resilience, risk profile, impact and mitigation. The first quarter of IDAs have now been completed and judgements issued.

IDAs have been generally well received, particularly among organisations that have had them, but they are resource-heavy and intense. This has caused some sector concern that they may be short-lived as, while they are very detailed and involve deep-dives into organisations, there is a lack of breadth across the sector and many organisations will not be assessed.

There is a sense that there will be more focus from the regulator in the future on quarterly returns and financial analysis, leading to a greater quantity of assessment, albeit at a less detailed level.

A lot of the feedback from the first round of IDAs, and pointers for future assessments, relates to the evidence of control and the ability to physically demonstrate the governance and decision making processes. While the essence of good governance relates to the practices and processes themselves, from the regulator’s perspective, evidence is required to prove these are happening.

Deregulation
As part of the Housing and Planning Bill, associations no longer require HCA consent for transactions, being required only to inform the agency of what they are doing. For example:

- Disposal consents are being removed. This covers selling and changing the ownership of stock and charging stock for security
- Consents are also no longer required for merger, change of status, restructure or wind-up
- The Disposals Proceeds Fund is to be abolished, giving associations more flexibility to manage funds
- The HCA will only be able to appoint managers to associations when legal requirements are breached
- There will be a new special administration process via the courts for insolvent associations

These moves give associations greater freedom, but place even more emphasis on good internal governance. There is an expectation that key decisions that change stock ownership or the status of organisations will be fully documented, with challenge from the board included in this documentation. These changes should also be factored into stress testing, to ensure that possible outcomes are fully considered and can be demonstrated to the HCA and other stakeholders.

The role of the board and the regulator
The board needs to consider the impact each of these changes will have on the decision making process and the required documentation.

If associations are no longer required to go through authorisation and consent procedures for the HCA, internal procedures should be assessed to ensure they are sufficiently robust.

With the safety net of the regulator as overseer and governor gone, boards need to ensure they develop all safeguards themselves.
IDAs: Focusing on the big ticket issues

Kelsey Walker, Assistant Director Regulatory Operations, HCA

A year ago, we were carrying out our two ‘pre-pilot’ in depth assessments (IDAs) at the regulator to test our theory and pull together some guidance for our staff. We took the high level principles and produced a ‘tool kit’ as a staff resource, putting emphasis on the senior IDA lead to make the right decisions about how to focus the work and manage the team resources. Now we are further down the road in carrying out IDAs we have recognised that, along with well-evidenced judgements, consistency is crucial to credibility; we achieve this through real time quality control and independent quality assurance methods. So, IDAs won’t look the same, but they should consistently focus on the big ticket issues and judgements should correlate across the board.

This means there is a premium on the professional skills of our staff, the ability to form constructive dialogue with boards and executive teams, and the continuous capture and sharing of learning from the IDAs carried out in the five regulatory operations teams.

So what have we learned?

Primarily, that IDAs happen in real time. Providers’ key risks, stress tests, strategies and priorities are evolving, often at pace, as is our focus on the specifics of each. What it means to govern effectively in this sector and operating environment is certainly changing and the bar gets higher as the risk exposures increase. We know there is no ideal time for a regulatory visit and there is always work in progress. Regulators and providers have got to be on top of their game and make as well-evidenced decisions as possible, which means accepting a generous dollop of (stress tested) uncertainty.

Two areas subject to new requirements in the Governance and Financial Viability Standard are also worth pulling out for comment and feedback: assets and liabilities registers and stress testing.

The questions we ask in an IDA cover pretty much the same assurance and evidence we expect the board will be seeking. So, on assets and liabilities, how has the board been assured that the register is accurate and complete and will continue to be so? Has advice been taken? Is the work owned by senior management? Has any testing been carried out on the data to give independent assurance? Are there significant liabilities which need to be included in stress testing? A report simply stating that the work has been done to complete the register won’t provide the right level of assurance, nor will a copy of the detailed register at a point in time.

There is a wide range of approaches to stress testing and it’s fair to say the tighter the headroom, the better the stress testing needs to be. However there is a huge business benefit in understanding the impact of decisions (or not taking decisions) on capacity when considering different courses of action or the potential for different outcomes. The regulator may concentrate on capacity, but the board should also focus on risk appetite in the context of what they can deliver to meet their (new?) objectives within their financial and organisational capacity. Boards which describe the organisation as ‘cautious’ in response to this question do not really explain the position to a third party and it suggests limited internal discussion. A good stress test we shared at an internal learning event recently set out each narrative scenario, the results (modelled), the mitigations, the results post-mitigation, the early warning triggers and how they are built into the performance monitoring reports. Great evidence!

“What it means to govern effectively in this sector and operating environment is certainly changing and the bar gets higher as the risk exposures increase.”
Looking at property assets in a new light

Richard Petty, Lead Director, Residential Advisory, Jones Lang LaSalle

Funders’ discomfort over the impact of rent cuts, and the way valuers propose to deal with them in accordance with the legislation, has not been helped by the current proposals to introduce a ‘special administration’ regime. Although wrapped up in the Housing and Planning Bill, along with deregulation measures, this is very much an HCA initiative rather than a political one. It is driven by the need, recognised post-Cosmopolitan, to provide for a more orderly process in the event of a serious default. The existing moratorium period is too short to allow the regulator to deal with the potential failure of increasingly complex registered providers’ (RPs’) businesses, with a greater range of financial stakeholders.

The aims of special administration are fourfold: to protect social housing assets; to protect tenants; to safeguard grant, and to protect creditors (principally lenders). But these four objectives are not necessarily compatible with each other; and the order in which they should be satisfied by the administrator needs to be clear.

At the time of writing, we are hoping that the emerging legislation will put funders, as fixed charge holders, firmly at the front of the queue with a corresponding legal duty on the administrator’s part to look after creditors’ best interests first. The secondary objective, subervient to the first but still desirable, would be to retain the stock in the regulated sector.

If this is carried through properly, the measures should both retain and encourage the flow of new lending into the sector; as well as allowing that lending to continue to be secured against valuations on the basis of market value subject to tenancy (MV-T). But, if lenders cannot see a clear path to the open market to realise their security, then values could be restricted to existing use value for social housing (EUV-SH). The fact that lenders of course have a fixed charge over their security gives them a significant lever of control over an administrator’s plans.

The other key area of possible change is as a consequence of deregulation. Essentially, the existing HCA consents regime is being swept away in its entirety, including section 133 of the Housing Act 1988. That will give RPs much greater freedom in terms of asset management, including (in principle) the ability to sell tenanted as well as vacant properties.

Depending how RPs respond to that freedom, it looks likely that the existing definition of EUV-SH may need to change. This assumes only the re-letting at social or affordable rents of all existing properties, in perpetuity. To the extent that RPs choose to do different things with properties they acquire, either from each other or from a mortgagee, then we could see both the definition change and values on the basis of EUV-SH rise – although this is for the market to determine and for valuers to respond to that behaviour, rather than for valuers to make that leap on their own. I hope that we will see RPs looking at their property assets in a new light, and using them to fulfil their social mission. Over to you!

“Essentially, the existing HCA consents regime is being swept away in its entirety, including section 133 of the Housing Act 1988. That will give RPs much greater freedom in terms of asset management, including (in principle) the ability to sell tenanted as well as vacant properties.”
Viability – mergers and the alternatives

There has been a strong and consistent history of mergers within the social housing sector, with spikes in number during times of political and economic change. As we are currently experiencing such a period, the number of mergers is expected to rise once again. However, the history of mergers is not one of unequivocal success. Many post-implementation reviews have shown that the anticipated benefits of mergers have not been achieved – often due to cultural mismatches or unclear objectives.

Boards are required to undertake “rigorous appraisal of all potential options for improving value for money including the potential benefits in alternative delivery models – measured against the organisation’s purpose and objectives”, as part of their compliance with HCA Value for Money Standard. This means that they are required to consider the benefits of merging with other organisations.

The additional pressures placed on associations, specifically by the rent reduction, mean that a number of associations will struggle to remain viable, and so merger will become a necessity. In the past, mergers of this nature have fallen apart due to cultural clashes, board personalities and differences in values and objectives.

The National Housing Federation has produced a Merger Code – Mergers, Group Structures and Partnerships: A voluntary code for housing associations. This aims to help associations establish good internal governance procedures that allow them to consider potential mergers in an appropriate way. If there is a clear decision making process in place, conclusions are likely to be reached objectively.

When it comes to mergers, good governance involves a clear understanding of the purpose, culture and strategy of both parties, and the ability for board members on both sides to be objective and to put the needs of tenants over those of the board, executives and staff.

The best way to determine the criteria for a merger may be to set out which potential aspects of a merger would be unacceptable and which would be absolutely essential. If such ‘non-negotiables’ are set out clearly, not only will inappropriate mergers not go ahead, but they can be ruled out quickly and efficiently.

While the establishment of merger criteria in advance may seem cumbersome and time consuming, it is a worthwhile exercise. The set-up only needs to be done once, although it should be reviewed periodically, and the association will save time whenever a merger approach is made. Doing the work in advance will enable the criteria to be established and merger decisions to be made without pressures of emotion and time.

“The additional pressures placed on associations mean that a number of associations will struggle to remain viable, and so merger will become a necessity.”
The alternatives
Of course, there are alternatives to merger, even for organisations with threatened viability. Remaining independent and establishing a reputation for delivering a specialised service to a particular group of tenants may be a viable option. Merging into a larger organisation will not necessarily lead to efficiencies and improved levels of service if the group lacks experience and expertise in the delivery of specialised services.

Large organisations with complex group structures should consider whether they would benefit from a simplified group structure. There are clear advantages to having a range of different subsidiaries within a group, such as tax related benefits. However, boards should consider if the benefits to be achieved from a complex structure could be matched or exceeded by greater efficiencies.

Alternative delivery models are available, with shared services being one possible route for smaller organisations. This approach allows associations to share back office functions, such as finance, procurement, IT and development, so reducing overhead expenditure and allowing more budget to go on front line services.

As part of the annual value for money review, we recommend that boards consider whether their current structure is generating greater value for money and efficiency savings than an alternative model and, where relevant, to report on merger savings and achievements in their value for money statements.

“When it comes to mergers, good governance involves a clear understanding of the purpose, culture and strategy of both parties, and the ability for board members to put the needs of tenants over those of the board, executives and staff.”
Mergers – The impact of a code

Margaret Allen, Senior consultant, Savills

Housing associations have received significant public funding to develop their asset bases, despite being independent bodies. Like it or not, the sector is in the public eye and how it responds to efficiency challenges as a whole is important.

Mergers have been seen as means by which organisations can achieve transformative change and efficiency gains but, in a scenario where business drivers combine social and financial return, mergers are less a meeting of minds and more a survival tactic.

Changing the structure of an organisation is significant. It can tear at the heart of purpose; a decision that is not just about financial return, but one that affects customers in the long term. It is a decision that cannot be taken lightly and one that must reflect the responsibility of the board to set a direction of travel that best serves the long-term interests of the organisation and its beneficiaries.

There are three stages to any change process: the decision, the execution and the delivery. At the close of 2015, working with Savills, the NHF published a ‘Voluntary Code for Partnerships, Acquisitions and Mergers’. The code focuses on the first of the three stages – the decision.

The existence of a code does not suggest that organisations are unable to make appropriate decisions, nor does it seek to encourage mergers or prescribe how to do them. The code is a high-level governance document that places boards centre stage in any initial considerations and puts an emphasis on transparency in the process.

The code lists 10 principles that a board should adopt in considering how best to serve the long-term objectives of its beneficiaries. Adoption of the code confirms that boards periodically review their purpose values in advance of decisions on how best to achieve them. It assures that boards are notified when opportunities/propositions emerge and that a proper and robust scrutiny of proposals is undertaken before a decision is reached.

The code places the responsibility and decision firmly in the hands of the board; expecting appropriate advice and skills are considered to facilitate the right decision. Transparency is expected through expectations on how decisions are notified and how an adoption of the code is made known. The code also works to a principle that personal considerations are put aside and do not hinder pursuit of an outcome that will best deliver financial security and good value for tenants.

So what might the sector gain from adoption of a code? Aside from assurance to others, adoption of understood rules of engagement should help avoid unnecessary costs and strengthen the governance of organisations.

Mergers and partnerships can be a great opportunity, not least for the customers of the new combined organisation. This is recognised in the commercial world and should have a similar standing in the housing association sector. The code is as much about good governance as practice on mergers, and where adopted will demonstrate how the sector can make sustainable decisions in a business environment alongside private and public sector entities alike.

“Aside from assurance to others, adoption of understood rules of engagement should help avoid unnecessary costs and strengthen the governance of organisations.”
Government policy changes – the governance challenge

With the many government policy changes in the past year, boards and executives have much to consider. As well as the internal pressures of determining where to direct their business and how to best deliver services to tenants, there are external threats to safeguard against. This perhaps represents the ultimate challenge for board members – to find the right balance between delivering enhanced and improved services for customers while ensuring survival in the face of external change.

The key challenges include the forced rent reduction, the Office of National Statistics’ (ONS’) reclassification and the introduction of right to buy. Below, we consider the governance challenges of each.

Rent reduction
When associations were presented with the 1% rent reduction in the July 2015 budget, they were faced with tough decisions about how to find cost reductions to match. Associations have taken a range of approaches, depending on their resources and the attitude and approach of those charged with governance. Those with larger resources have more options as they do not need to find savings immediately and have a wider range of expenditure to choose from when making cuts.

Some associations have made positive choices that, not only reduce pressure on themselves, but also improve the service to tenants. If they were not considering it already, many organisations have invested in digitalisation programmes and channel shift, to move their records and services online. While there is an immediate investment, in the long term there should be savings, mainly in terms of manpower, and an improved level of service for customers. In these instances, the rent reduction was seen as an opportunity to make change within the organisation that would be sustainable in the long term and keep the cost base low.

The choices made at the outset of the rent reduction can have an on-going and long-term impact on the organisation, so it is important to take account of an association’s long-term objectives. As well as the impact on costs, it is also necessary to consider the effect on the customer experience, the control environment and governance arrangements. For example, it may seem a good idea to reduce finance or procurement staff, but if this increases the risk of fraud it may lead to further problems.

Some of the cost-saving options our clients have discussed are included in the diagram below.

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<th>Finding the 1%</th>
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<tr>
<td>Cutting back office costs</td>
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<td>Investing for future savings</td>
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<td>Changing loan repayment arrangements</td>
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<td>Sacrificing development</td>
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Government policy changes – the governance challenge

Where loan payment arrangements cannot be changed because associations are already paying the minimum, and there is no development to curtail or stop altogether, organisations must cut costs. A shortage of available funds may mean that decisions need to be made quickly to find the easiest – rather than the most appropriate – savings. This often enables immediate savings, but these will tail off as the rental income continues to reduce. This is where good governance is essential – there is a need to consider the longer-term benefits of decisions rather than just the short term gains.

“The majority of associations are not developing at present and therefore cutting development was not an option. This meant that finding efficiencies was the only way forward.”

Gordon Perry, Chief executive, Accent

To make informed decisions when confronted by an enforced rent reduction, boards need complete and accurate management information, including financial data and customer feedback, from the executive. Only with the necessary information, projections and stress testing of scenarios can boards set the level of risk that they are willing to accept in their future strategy and make the necessary decisions. Whether by accident or design, the timing of the announcement on rent and the requirement to carry out stress testing went hand-in-hand, meaning that many associations had already run scenarios involving rent cuts by the time of the announcement.

The other aspects of rent reduction that caused major concern at the time of the announcement were the possible impact on property values and the knock-on effect on loans. In regard to property values, there was apprehension about the immediate impact of potential covenant breaches as security value decreased – a threat to the financial viability and going concern status of organisations. Where loans were concerned, there were fears that they would become harder to secure and rates would grow increasingly expensive: affecting the ability to spend on development and other future projects. The threat caused by reduced security valuations has been resolved, with lenders confirming this would not have an impact. However it was a significant issue for boards and showed the importance of considering decisions and changes on financing arrangements, and the value of good relations with lenders.

It is therefore important for boards to consider the wider implications of government policy changes and to ensure they are factored into risk discussions and stress testing.

ONS reclassification

The ONS reclassified housing associations as public sector bodies in October 2015, due to the level of control government exercises over associations. (Government had consent powers over asset disposals and the restructuring and winding up of housing associations, and the ability to appoint managers and officers.) The initial change in ONS classification is not itself expected to have a huge impact on associations: of more concern currently are the potential ramifications of the anticipated future declassification.

Boards should consider the potential changes – particularly if credit ratings seem likely to be revised – to allow them to take steps to put their associations on a good footing before declassification occurs.

The earlier discussion on deregulation, and the governance concerns associated with the reduced role of the HCA, comes to the fore when considering bringing housing associations out of the public sector.

Key questions

The threat to credit ratings and consequence statement of confidence by lenders is evidenced the importance of developing and maintaining transparent relationships with lenders.

The removal of consents gives more freedom, but extra responsibility.
Right to buy and the change in role

Right to buy is a polarising force in the social housing sector, hinging on the differential between sales price and build costs. If sales prices exceed costs to build new properties, then associations can in theory both increase their stock and increase profitability. Where costs exceed prices, associations are faced with either a reducing stock level or dwindling profitability, or both.

"The right to buy scheme can be either financially beneficial or financially crippling for associations depending on their location and the sale value of properties."

Gordon Perry – Chief Executive, Accent

In the south-east, where sale values are high, properties will sell for more than it will cost to build new properties. But away from the south-east, the build costs are similar but the sale prices are a lot less, so it might cost two or three times the sale value to build a new property.

The other issue regarding right to buy is around the government requirements for newly built properties. Home ownership is now seen as the most important thing by government, meaning that there is a requirement for new stock to be developed for shared ownership and outright sale, so the replacement stock is serving a different purpose.

This represents a change in outlook and strategy for many associations whose business was primarily based on the provision of low-cost rented housing.

Key questions

With the change in government focus, there are questions for associations to answer about the purpose of their organisation. Such as, does the move towards home ownership fit with the purpose and, where associations are registered charities, their charitable objectives? Do they need to consider diversifying their offering, accepting that part of the business will have to be the development and sale of housing property?

"The ultimate challenge for board members is to find the right balance between delivering enhanced and improved services while ensuring survival in the face of external change."
Rethinking valuations

Richard Petty, Lead Director, Residential Advisory, Jones Lang LaSalle

Last July’s Budget took registered providers (RPs) and their funders by surprise, by introducing rent cuts across the board for the first time, effected through primary legislation. This unexpected move threw valuations and business plans into turmoil, and prompted some fundamental thinking in the sector about what valuations mean.

So how will four years of 1% reductions in rents, starting in April 2016, affect asset values? Where a valuation on the basis of EUV-SH is not given for loan security purposes, the value is likely to fall by between around 20% and 40%. Where individual RPs or portfolios sit within that range will depend on the size and profile over time of their operating surplus. An RP with a comfortable surplus and controllable expenditure is likely to be at the lower end, whereas a recent stock transfer with high, committed expenditure in the near term will be at the upper end. RPs carrying their housing stock at value in their accounts will suffer material falls. Similarly, the values seen in stock rationalisation trades between RPs should be at lower prices – providing that the pricing is rational.

But, for loan security purposes, EUV-SH valuations should prove much more resilient because of the exemption given to mortgagees and their successors in title in section 22 of what will be the Welfare Reform and Work Act, also currently going through parliament. Nevertheless, once rents start to be cut in April, so the pressure on the surplus we value will become progressively greater. Over the four-year period, a sensible rule of thumb might be to expect EUV-SH values to be about 10% down.

That said, there are mitigating measures which RPs can take, particularly in reducing operating costs where possible, to protect the surplus on which EUV-SH value depends. Deregulation may also play a significant part, if RPs start managing their assets more actively in response. However, funders’ instructions may be adjusted to rule out such assumptions made by valuers.

Moreover, some funders have struggled to accept the arguments inherent in exploiting the opportunity to protect the EUV-SH value of their security given to them by section 22 of the act, and the implications of how they would realise their security if they were to take possession. In contrast, values on the basis of market value, subject to the existing tenancies (MV-T), should be unaffected by the rent cuts, whether for loan security or balance sheet purposes.

The difficulties funders are having adjusting to the new order are now compounded by the further challenges of the deregulation and ‘special administration’ measures set out in the Housing and Planning Bill.

This all means that it is a difficult time for valuers trying to form robust, reliable opinions of value in a market with, at best, only limited transactional evidence. It is important for all concerned with valuations that the assumptions behind opinions of value continue to bear as close a relationship as possible to the market, and are not artificially constrained.

“There are mitigating measures which RPs can take, particularly in reducing operating costs where possible, to protect the surplus on which EUV-SH value depends.”
Turning up the dial on governance

With the increased level of change in social housing, and the heightened degree of scrutiny the sector is facing, strong governance is more important than ever and all organisations will need to consider what improvements could be made. While one size does not fit all, the essential elements are universal.

The essential elements of good governance are:

1. Understanding purpose
2. Having the right size board with an appropriate mix of skills and personalities
3. Having suitable processes in place to make big decisions, such as about mergers
4. Understanding and considering upcoming changes, and factoring them into the business model
5. Showing evidence of good governance practice to the regulator
6. Being transparent, so that tenants and the public can have confidence in association processes
When making key decisions that will lead to changes in the association, boards should consider the following:

1. **Can the change be adapted?**
   - **NO** → REJECT
   - **YES** → **Will it lead to improved services for customers?**
     - **NO** → REJECT
     - **YES** → **Does it fit with culture?**
       - **NO** → REJECT
       - **YES** → **Will transition/implementation costs be prohibitive in short-term?**
         - **NO** → **Will there be adverse governance/control impacts?**
           - **NO** → REJECT
           - **YES** → **Will it adversely affect stress testing in combination with other factors**
             - **NO** → REJECT
             - **YES** → **Does the change fit with the current purpose?**
               - **NO** → REJECT
               - **YES** → **Will it lead to increased efficiency and value for money?**
                 - **NO** → **ACCEPT**
                 - **YES** → **REJECT**

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Steps to establishing good governance

When considering how to set themselves up, and whether they have the right governance model, boards should consider the steps below.

How do we document this internally?

How do we present this externally?
Dynamic organisations know they need to apply both reason and instinct to decision making. At Grant Thornton, this is how we advise our clients every day. We combine award-winning technical expertise with the intuition, insight and confidence gained from our extensive sector experience and a deeper understanding of our clients.

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Grant Thornton in the housing sector
We have a national team of housing specialists working with housing associations, local authorities and other housing providers on a wide range of assignments. We have a longstanding reputation in delivering effective, added value external and internal audit and assurance services to many housing organisations around the UK.

We also provide a full range of advisory services including taxation, business planning, due diligence, forensic investigations, cost reduction and value for money reviews, development of effective risk management strategies and the provision of training for Board members.

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Governance matters
Advising on governance

Corporate reputation

**When is it relevant** – Perceived value gap between corporate and investor stakeholders’

**Value add to client** – Independent investor and stakeholder relations advisory services to boards and executive teams

**Types of solutions enabled with management**

- Tailored Investor and stakeholder relations training for all levels
- Undertake full capital markets perception audit skewed towards investors but also to include analysts and press if needed
- Refine investment case and update investor toolkit materials as and where necessary
- Best practice Investor and stakeholder disclosure and reporting (websites/presentations/investor documents)
- Shareholder and debt holder register analysis with targeting, access and roadshow management – UK, Europe and globally

Governance diagnostics

**When is it relevant** – Organisations seek to understand whether existing governance reflects good practice

**Value add to client** – Detailed and insightful comparison to a database of peers enables gap analysis of As-Is structures and identification of solutions

**Types of solutions enabled with management**

- Benchmark reporting to market good practices
- Identification of areas for improvement (in annual report and/or issues with internal framework and approach) dependent on appetite and suggested solutions prioritised
- Development of implementation plans and change programmes
- Peer and sector comparison

Governance renewal

**When is it relevant** – A significant change event has occurred which means that the current governance framework is no longer fit for purpose

**Value add to client** – We facilitate the design and implementation of corporate frameworks which support value creation

**Types of solutions enabled with management**

- Strategic reviews, integration and organisational design
- Development of frameworks, policies and procedures
- Group Risk appetite identification and embedment
- Internal control reviews and redesign
- Internal audit effectiveness reviews
- Performance and incentivisation measures, restructuring and implementation

Strategic sustainable reporting

**When is it relevant** – Performance is focused on short term or unbalanced targets

**Value add to client** – Ensures that performance and reporting is aligned to sustainable, long term value creation

**Types of solutions enabled with management**

- Review of and advice on corporate reporting
- Integration of internal performance reporting with strategy
- Creation of sustainability and compliance reporting methodology
- Non-statutory reporting assurance

Leadership and culture

**When is it relevant** – Culture needs to be aligned to strategy in order to realise corporate purpose

**Value add to client** – Cultural change can be achieved more efficiently when values and behaviours are considered alongside strategy, systems and processes

**Types of solutions enabled with management**

- Cultural audit
- High potential assessment and development programmes
- Executive and board level coaching

Board evaluation

**When is it relevant** – assessment of board practices or restructuring of board governance

**Value add to client** – External assurance over board and/or structure, capability and function

**Types of solutions enabled with management**

- Board effectiveness reviews
- Committee effectiveness reviews
- Committee structure and terms of reference design
- MI quality and effectiveness assessments
# Contact us

For further information on any of the issues explored in this report, please contact:

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