DTP VIEWS

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Taking the stress out of stress testing

– Andy Roskell, Managing Director, DTP

We have all been stress testing for a couple of years now, but it is now clear that two years in, the Social Housing Regulator is no longer prepared to give anyone the benefit of the doubt on these matters. In particular, the HCA has made it clear that it will look to ensure that there is a joined-up approach to the process of business planning, stress testing, developing and maintaining risk registers and developing and maintaining assets and liability registers.

While most associations conduct these activities with appropriate care and attention, and a fair degree of sophistication, the regulator wants it to be clear that these activities should not be done in isolation, or as if in a vacuum. All of these matters are clearly inter-linked and they should therefore be aligned and used to inform the definition of the stress tests and the mitigations which would be required to realign a ‘broken plan’.

Going forward, boards must ensure that they show that the risks in the risk register reflect the business activities of the association, and that these risks can be quantified and then properly reflected in coherent stress tests on the business plan. Internal and external risks to the association should be recognised in this process.

The same process must be adopted for the asset and liabilities register, which incidentally should also support the ‘mitigation’ element of this work, by providing adequate information for use in mitigation strategies. This enables a board with the support of the executive to deploy actions in the face of a projected issue, or a series of issues, which threaten to compromise a ‘Golden Rule’, more of which later.

In conducting the stress tests, which clearly reference sections or elements of the risk registers and the assets and liability register, it is vital that they really test the plan and thus enable the board to assess resilience. The tests should not just show single scenarios, rather they should also show the impact of multi-variate scenarios. The results of the tests provide clarity on the impact that events may have on key business critical measures.

These should include the impact on cash, loan security and loan covenants, all of which must be properly understood. Intra-group risk flows can present some added complexities to the process, but nonetheless these need to be identified, understood and carefully mapped where appropriate.

Having established the risks to be assessed and conducted the tests on the business plan, it is important to have developed practical and deliverable strategies which can be adopted in the face of adversity (a broken or projected broken business plan).

These will need to be significant enough to address the emerging issues, but tailored enough to be used in the right circumstances. For example, some mitigations may take a long time to realise (sales of assets, or securing new funding arrangements, for example), but if the problem is not an immediate one then this can be a reasonable course of action to take. If a problem appears to be more immediate, then a deployment will need to be more dynamic, in the short term, perhaps reverting to a medium term strategy to address an underlying problem. Either way, the point is that there needs to be a range of effective options.

Crucially, the HCA is looking for evidence that the board is in control of all this, and therefore effective board engagement during the process will be required so that it can (and be seen to) direct the testing process and be fully involved in the establishment of mitigations and the prioritisation of these.

Having an effective testing process and robust mitigation strategies is clearly a good thing in the context of the scrutiny being exercised by the regulator, but these will naturally lead to an obvious requirement for adequate monitoring of management information to ensure that real life activities and internal and external factors do not threaten to compromise the business. It is for this reason that it is important to define your ‘golden rules’.

What are these, you may well ask. Well, these are the ‘red lines’ you must not cross as a business. Typically, you will have a series of targets for operational and financial performance, all of which will be closely monitored by the executive and reported to the board. The ‘golden rules’ can be described as the business critical, ‘high priority’ performance measures which must be maintained and will include the availability of cash (liquidity) and headroom on loan covenants. Some will also include measures relating to income recovery and other measures associated with the development programme (programme slippage and targets for sales receipts being obvious example).

Agreeing what these ‘golden rules’ are is the responsibility of the executive, working with the board, but once these have been set, the focus inevitably moves to monitoring performance and as far as possible ensuring that early warnings can be developed to show where performance looks likely to be heading towards a possible breach of a ‘rule’, which could then lead to a requirement for some recovery action.

With this in mind, it is logical for (internal and external) data monitoring to be undertaken to ensure that relevant evidence is collected on a timely basis to measure current and projected performance against the ‘rules’, so that early warnings can be secured on these important factors. Each ‘rule’ will require a different source of evidence, but as long as relevant data is collected and reported, the executive and the board can look forward and see potential issues arising, and identify the best opportunities to address these (potentially therefore to deploy a mitigation/mitigations).

We are supporting a number of clients with these matters at the moment and we have helped some associations to provide assurance to the boards through the development of ‘resilience statements’. These relatively simple reports can be prepared as often as you like, but typically they will be presented at least twice a year. The assurance is derived from a timely update on risks that the business is exposed to, the tests that have been conducted and the latest series of mitigations that have been designed to be deployed in the face of adversity. The relative position and the projected position of the association’s performance against the ‘golden rules’ can be shown, with the headroom (comfort) being reported also. This regular reporting can provide the board with the oversight that it needs, as well as assurance that the business is containing and managing risks (known and unknown). The process also provides excellent opportunities for defined mitigations to be regularly reviewed and updated, as inevitably some of these will become obsolete and less effective as time moves on.

So, a lot to think about there, but all in a good cause and the efforts made in the delivery of all these actions should help executives and the board to sleep a little easier at night!