DTP VIEWS

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Stress testing – thinking about the future –

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The English novelist and playwright John Galsworthy once said: “If you don’t think about the future, you cannot have one”. Thinking about the future, however, is not the same as trying to predict it – and if the last few years have taught us anything, it’s that it would be foolish to try to predict anything.

Giving serious thought to what things could happen, and planning for how you might respond, is of course a different matter. In fact, it’s entirely sensible. A ‘no deal’ Brexit, for example, may well never happen. But it would be madness not to prepare for it; to ‘stress test’ the impact it might have and to prepare appropriate mitigating strategies.

Stress testing and thinking about the future have become the new normal for registered providers of social housing in recent years. That can in part be traced back to the financial crisis of 2007/08. When the practice was brought in for banks to improve their resilience, it was perhaps inevitable others would soon be expected to follow suit.

When it became a regulatory requirement in 2015 the approach remained a bespoke one. The regulator took a relaxed approach and wisely resisted calls to provide more clarity on what it expected. Stress testing should reflect each RP’s individual circumstances – what was right for a large provider in the South East wasn’t necessarily right for a stock transfer association in the North.

The then chair of the HCA’s regulation committee even went as far as saying if providers were only carrying out stress testing to please the regulator they were “starting from the wrong place.” They should, in other words, be doing it for the benefit of their own business.

Recently, we have seen more specific guidance from the regulator, however, it still encourages a tailored approach. Where it has sought to encourage greater consistency, it is more to do with process: for example, there has been greater emphasis on the involvement of boards.

At DTP, our stress testing work with clients considers carefully their own unique circumstances and challenges. Even where factors may affect the whole sector – Brexit for example – it’s about looking at how it might impact on that particular organisation.

But there are a few universal principles which can be broadly applied to the process.

As a starting point, stress testing needs to deploy a deeper knowledge of your business and its potential challenges in the face of adversity. This means it has to be properly informed by the corporate plan (and its key objectives), the financial business plan, the risk register (which must be fully reflective of the real business risks) and the assets and liabilities register. It’s vital that these key documents and records are joined up – and that they project an up to date and coherent narrative about your business.

Then it’s about developing a series of practical tests which reflect all known internal and external risks. Brexit is of course high up the list right now – and, in practice, that means the likely economic impact of a no deal, from inflation and house prices to the cost of borrowing and the value of the pound. It is worth considering rising costs of materials (fall in Sterling) and labour (fewer European workers), and potential failure of (more) contractors (counterparty risks).

Stress testing is not just about identifying risks however – it’s also about putting together credible plans to address those risks, should the worst happen. Mitigations need to be relevant to your business, deployable and up to date. It’s also important to be aware how long specific actions will take to be deployed, so you can decide which should be prioritised.

Many RPs we talk to are finding it useful to combine all this information into a resilience statement document which is regularly updated and approved by the board.

Here, it’s essential to set out your golden rules and triggers – a list of adverse scenarios and what plans will be mobilised in the event of them occurring. These secnarios could include stopping development, cutting back on planned stock investment, bringing forward the refinancing of the loan portfolio, and cutting back on management costs (staff).

All of this sounds like a potential additional administrative burden for RPs. But it’s worth the effort in our view – and not just to please the regulator. Ultimately it will help you to be more resilient, and to prepare for adverse events should they occur.

Yes, predicting the future is impossible – but by taking stress testing seriously you will at least increase the likelihood of having one.