Homes & Communities Agency

WITH THE BENEFIT OF HINDSIGHT

Learning from problem cases: volume 4

June 2015

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Disclaimer

This report was written by Campbell Tickell, using a standard of reasonable care and diligence. We have taken reasonable steps to protect the identities of the organisations concerned, and we urge readers to concentrate on the issues described rather than on speculation about historical events.

The views expressed are those of Campbell Tickell alone, and are not necessarily shared or endorsed either by the Homes and Communities Agency, nor by London and Quadrant Housing Trust.

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For board members, senior executives of housing associations and regulators, this is a riveting read. The seventeen case studies unpick how problems arise and form the basis for the lessons summarised in the excellent 'Learning' chapter.

But the great thing about these case studies is that they show real problems in the raw. They illustrate how they can arise and how they can be made worse (as well as how they are ultimately resolved). They prompt fundamental questions:

- Could that happen in our organisation?
- Would we have spotted the problems earlier – before they became so serious?
- What would I have handled differently?

Thinking about these and related questions should be a salutary experience. It is an opportunity to learn from other people's mistakes rather than your own – and this is generally a less painful way to learn.

These cases are drawn from the last eight years. But they are only a small selection of the serious cases that have arisen in this period. As the operating environment gets tougher we all need to raise our game. Absorbing the lessons in this publication is a great way to avoid appearing in subsequent volumes of this series.

Julian Ashby

Chair of the HCA Regulatory Committee

A welcome from the sponsors of this report

Dear reader,

With the Benefit of Hindsight

London and Quadrant is pleased to have sponsored this volume. None of us is so perfect that we have nothing to learn – and as a sector, we have certainly had to upskill over the past few years.

Indeed, social housing providers have undergone massive change since the regulator published the last volume of Learning From Problem Cases, back in 2010. The Tenant Services Authority itself has gone, and austerity and welfare reform have become household words.

All of us have done our best to weather the economic crisis in recent years. Indeed, many housing associations have used it as an opportunity to reinvent ourselves. We recognised that we needed to change.

For some of us, the experience has been liberating.

Taking responsibility for our own futures has involved finding ways to support ourselves while remaining loyal to our core social mission: providing homes for people in need.

As this report show us, some of us have got it wrong. The good thing, however, is that a report like this helps us all to understand what happened, so that we can do our utmost to avoid ever finding ourselves in a similar position.

Hindsight, as we know, has great benefits.

Yours

Turlogh O'Brien CBE, Hon FCIBSE, FRSA
Chairman of the L&Q Group Board

Introduction

This volume

We live in a volatile world. Banks, major companies, even sovereign nations, can crash and burn. The seismic aftershocks of the 2008 global financial crash rumble on, and a more dramatic reprise of those problems can't be ruled out.

The smaller circle of housing associations is not isolated from the outside world. Over past decades, each year has seen a number of failures, usually financial but sometimes with wider implications. So far, all that needed rescuing have been saved by larger and well-run organisations, with the human and financial capacity to act. One of the intentions of this report is to help maintain that important track record for the sector.

This book is the fourth in a series, chronicling the affairs of selected failures and near-misses. The first two were produced by the then regulator, the Housing Corporation. The third was funded and published by the Tenant Services Authority during its tenure as housing regulator. This latest volume was generously funded by London and Quadrant Housing Trust, which has played a major part in several prominent rescues. It was published and enabled by the new regulator, the Homes and Communities Agency.

The book is aimed primarily at the boards and executives of housing associations and other similar organisations, in the hope that it will enable them to learn from the mistakes and setbacks of others, and avoid encountering similar fates.

After this introduction and its summary points, we start with a more reflective chapter, looking at how such inherently stable organisations as housing associations can occasionally go so badly off track. The first case study chapter is an examination of Cosmopolitan – although covered in other reports, the book would not be complete without an assessment of its significance and impact. The main body of the case studies then follow, these all but one anonymised, and grouped under themes where appropriate.

We have aimed to tell each story in a neutral way, not casting unnecessary blame on individuals, nor imputing any untoward motives to those involved. The narratives are the responsibility of the authors, and we have not told them from the regulator's point of view, nor indeed from any set perspective. We should note that over the period we cover, the regulator changed from Housing Corporation to TSA to HCA – we refer throughout simply to 'the regulator' and the investment agency changed from Housing Corporation to HCA and, in London, to the Greater London Authority – we refer throughout to 'the investment agency'.

Campbell Tickell

In a nutshell …

For readers in a hurry to cut to the chase, we offer ten precepts to Boards, not necessarily in order of importance, which may be a useful checklist in considering how best to apply the lessons of our problem cases to their own situations:

(1) **Drive out unnecessary complexity:** The more complicated things become, the greater their chances of going wrong. Complex funding packages, activities, group structures, staffing arrangements, all carry and compound their own risks. Life is unavoidably complicated, but the virtue of deep simplicity, at least as an organising principle, lies behind most successful organisations.

(2) **Understand the risks that could be fatal**: sample engineering components are routinely tested to destruction before they can be used; every drug on the market has a lethal dose established. And so it should be with business plans and financial assumptions. Just how much strain would it take to spell the end for this organisation? How would we spot it coming, and what could we do to fend off disaster in a hurry? Stress testing is here to stay, and Boards may as well have some fun with gloom and doom scenario planning.

(3) **Always have a Plan B**: Most things will go wrong sooner or later, given half a chance. Following on from the 'what ifs?' of stress testing, it's important to have credible and oven-ready plans for the day the bond market collapses just ahead of an issue, a main contractor goes under, a new computer system just doesn't work, the property market takes a sudden nosedive, or a covenant is carelessly breached in the run-up to Christmas.

This thinking also applies, incidentally, to the organisations which may be involved in the rescue of their failing brethren, the question here usually being some variation on "How can we lay our hands on £5m of unencumbered liquid funds by Friday afternoon?"

(4) **Be ambitious, but keep perspective:** Low aspirations are disappointing – in the face of a housing crisis, of course every organisation should deploy its assets for maximum social result. But the 'bridge too far' scenario is all too common – the time when ego outstrips competence and capacity by a substantial margin. Without party-pooping, Boards need to be the inbuilt reality check for the vision and drive of the executive.

(5) **Focus on the skills and competence of Board members**: Because without a high-performing Board, no organisation can get by for very long. Good governance demands creativity and strategic vision, not to mention a robust 'grip' of the core business areas. With smaller boards, getting the right team in place is now mission critical, and demands a rigorous approach so to do.

(6) **Create the conditions for effective challenge:** A highly skilled Board is a good start, but not always enough. The right behaviours and a well-designed governance cycle also need to be in place. And behind that a Board culture which allows and enables dissent, challenge and debate. In many of our cases, a Board which had been readier to challenge may have been able to head off the crises long before they became catastrophes.

Arguably, if some of the Boards concerned had been prepared for the ultimate challenge and duty – dispensing with the services of executives who had become a liability at some earlier stage – the organisations would not have featured in this volume at all.

(7) **Engage positively with the regulators:** They may not always be 100% right, but they have the valuable perspective of experience, not to mention a range of statutory powers and responsibilities. Organisations that are open with regulators, seek to understand their concerns, and are prepared to regard them as partners for getting out of a pickle, are more likely to bounce back quickly from any setback.

(8) **Keep an iron grip on performance and compliance:** The strategy and vision may be fine, but without the firm hand of the Board on the key business drivers, they count for little. Of course Boards should not allow themselves to become operationally embroiled. But they do need to know that, in their name, the cash is there to pay the bills, rents are being collected, tenants are being well served, gas boilers are being serviced, and that all conditions of loans and grants are being met. And when things do go off track – as they must from time to time – that issues can be identified and dealt with swiftly and robustly.

In a complex modern business, there is a myriad of important compliance areas, and each one needs regular attention and oversight, within an overall integrated framework of business assurance.

(9) **Empower and value the Audit Committee:** There is a lot more to business assurance than the work of the Audit Committee. In terms of governance though, that committee is the immune system of the organisation, and should generally be the point of first alert for a possible failure of control. In some organisations, the audit work is seen as the unglamorous province of box-tickers and procedure enthusiasts, and such preconceptions must be dispelled. Like the Board, an Audit Committee needs a strategic view, the right skills among its members, and the autonomy and 'clout' to be taken seriously.

(10) **Never forget the tenants:** Last but far from least, tenants and other customers are not prominent in these volumes, and yet they of all stakeholders have the greatest interest. Their homes, their services and the identity of their landlord may be at stake; by the time things go wrong, there is often little opportunity for their voices to be heard. The core tenet of upholding the tenant interest often falls thus upon board members, regulators and advisors, whose duty is to the current and future generations of tenants, as well as to taxpayers and the wider sector.

Chapter 1: The learning

The roots of all evil

Across all the volumes of the series, it is striking (if only mildly reassuring) that corruption, criminality and malfeasance are rare occurrences in the case studies. The roots of problem cases among housing associations are more simply stated as an unholy trinity of:

- Weak governance leading to failures of non-executive oversight;
- Powerful ambition, from Board and executive, unmatched by ability, capacity or understanding of risks; and
- Incompetence and lack of attention to detail and compliance, the issues often compounded by excessive complexity.

And the greatest of these three is weak governance. By definition, and given that 'the buck stops with the Board', any problem case necessarily is a failure of governance. In today's tough business environment, Boards need skill, grip and effective team work if they are to exercise proper oversight of the executive and the operations of the organisation.

Critically, they also need robust systems of business assurance, so they can reasonably believe the information they receive to be true and well-founded. In all too many of our cases, Boards have been assured that all was well, when in fact it was not. Or they have simply not been given key pieces of information, nor indeed even asked for them.

Brutally unfair as this may sometimes seem, Boards can only blame themselves when this occurs – the 'rogue executive' explanation carries little weight in mitigation. Nonetheless, executives out of control do play some leading roles in this volume. There is a fine line between a charismatic and successful risk-taking leader, and someone who has become a dangerous liability. The personal myth of a leader's infallibility, reinforced by the sycophancy and optimism bias of others, can create the very conditions that lead to a crisis. Boards need always to remember that, very occasionally, it is their sad duty to consider initiating a change of executive leadership.

As well as personalities, money – the original root of all evil - is behind many of our problems. For instance, the issues at Cosmopolitan were unveiled by a straightforward liquidity crisis, as forward funding was simply not in place. In other cases, there were significant financial losses as a result of over-trading, or loss-making activities that had been intended to return a surplus. Actual or threatened breach of lenders' covenants is another recurring theme.

And finally, it does seem an iron rule of problem cases that once one thing goes wrong, others will follow. In some cases they are linked – a covenant breach for one lender can trigger cross-defaults across the whole loan portfolio. Once an organisation is subject to regulatory action, its loans may be repriced, creating a spiral of financial issues. These are often results of the spider's web complexity of financial and constitutional arrangements.

But in other cases, new issues will also emerge, apparently unconnected to the original presenting symptom. A Board which has lost its grip in one key area may well have been weak in its oversight of others as well, such as service delivery. The theme of 'grip' runs through this introductory chapter. Successful Boards need absolute clarity on their responsibilities as company directors, employers and landlords. And to sleep easy they need the robust audit and business assurance systems that give them the grip they need.

Know the risks …

The grip of each Board on risk is key. Again, and by very definition, each of our problem cases fell victim to risks that had not necessarily been envisaged, and for which effective mitigations were not in place.

The events of 2008 were a powerful reminder that the complexity of the modern world makes it impossible to isolate risk, whether because of the global nature of markets, institutions and investors, or the sheer speed with which events can unfold. It is surprising to remember that a chain of events starting with the far away insolvency of Lehman Brothers in 2008 eventually acted as catalysts for the solvency problems of Boron Homes, Bismuth Living and Polonium Group in this volume.

Organisations are often fallible in their responses to risk because they make assumptions about certain 'givens'. Before 2008 for example, the possibility that banks in Britain might run out of money featured low on most risk maps. For the known financial risks, such as a rise in interest rates, traditional processes and arrangements remain adequate tools. Internal audit programmes, or the oversight of an Audit Committee able to signal issues to the Board, or the sensitivity analysis of business plans, are still valid and important.

But even these conventional risk management frameworks were neglected in some of the cases in this volume (such as Thorium or Caesium), instead of being reviewed even more rigorously during times of rapid change. It is not so much that the processes were entirely absent as that the weight attached to them was insufficient and the context too narrow.

The global financial crisis also highlighted the limitations of the conventional risk tools. In the wake of that crisis, a review[1] of corporate governance (among banks and other financial institutions) was commissioned by the government, led by Sir David Walker. Walker draws out that the failures of the banking sector did not arise from 'backward-looking', conventional compliance and audit processes, '*but to defective information flow, defective analytical tools and inability to bring insightful judgement in the interpretation of information and the impact of market events on the business model*'.[2]

Past experience was a poor navigation tool when what was required was oversight of risk in 'real-time'. Traditional assurance processes needed to be accompanied by a Board dedicating its attention to '*current and forward-looking aspects of risk exposure, which may require a complex assessment of the entity's vulnerability to hitherto unknown or unidentified risks*'.[3]

A particular theme of the case studies is that of complexity compounding risk. Complicated finance deals and lease-backs, the labyrinthine documentation of the Private Finance Initiative, cross-default provisions and group structures with too many dotted lines – all have played a part in compounding problems, and hampering the ability of an organisation to respond swiftly to problems that have arisen.

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[1] *Review of corporate governance in UK banks and other financial industry entities*, Sir David Walker, 2009 (hereafter Walker).

[2] Walker, Chapter 6, p. 93.

[3] Ibid., p. 94.

Keep that iron 'grip' …

In a more complex operating environment, Boards need to exhibit a stronger understanding of dependencies and contingencies. If property sales don't materialise or funding is suddenly not available to finance a development pipeline, there needs to be a credible Plan B capable of swift implementation. A Plan C may be useful too, just in case.

Among the perfect storms in this volume are those that combine ambitious development programmes with unusual or complex or unsecured funding arrangements (such as Cosmopolitan and Boron's Project Thallium). Cosmopolitan was depending on arrangement of a complex finance leaseback and on regulatory approval to charge assets to fund an ambitious development programme. Costs were incurred on the development programme before the funding or the consents had been secured. Thorium Housing had a large regeneration programme but was dependent on huge efficiency savings and asset sales to achieve covenant compliance.

These interdependencies create a momentum; one risk crystallising potentially quickly precipitates others. The speed with which organisations such as Cosmopolitan Housing Group or Boron Homes find it almost impossible to regain 'grip' can seem breathless, as events run beyond control.

It is at moments of crisis that some of the real work seems to get done: the more frequent monitoring of cash-flow; the modelling of scenarios (such as re-pricing); the acquisition of specialist advice; the recovery and Plan B action plans. One way of exercising grip and prudence, therefore, may be for a Board - before it embarks on major new initiatives -to import as routine some of the practices that organisations suddenly undertake when things go seriously wrong.

There are case studies in this volume in which Boards have approved complex agreements, under which perceived matters of detail assume real substance at a later date, with negative consequences. These are nearly always related to ways of raising new debt or generating new income, whether leaseback schemes, mark-to-market swaps, exposures on PFI contracts or special purpose vehicles.

This underlines the need for all of the Board to understand – really understand - the short and longer term risks associated with new funding strategies or business ventures, a point underlined in the regulator's regular Sector Risk papers. While contracts are full of tiresome small print, this does not excuse Boards from understanding their obligations. Recognising the limits of their knowledge may be an important step in securing independent advice and support.

Boards need to make sure that they are considering information in the round – this may mean more 'hands-on' involvement in directing and checking the briefs given to legal, HR or governance advisors. Appropriate advice needs to be available before a decision is being made – the tale of Nickel (in which legal advice is sought only after the Board has made its decisions) seems to suggest that advice may sometimes be sought retrospectively to 'cover' the Board rather than to inform and guide it.

Some risks are internally generated within organisations. The parent of a group must have effective control over the subsidiaries – see the Carbon case study for a cautionary tale. Groups also create a two-way relationship in which subsidiaries must see it as part of their obligation to raise emerging issues to Group Board level. This is particularly important given the potentially contagious nature of risk for an entire Group (whether reputationally, financially or in terms of regulation). In any case, the ultimate authority of the Group Board needs to be real, and respected. In the case of Argon, a subsidiary appeared able to over-ride the decisions of the rest of the Group, and this situation must be avoided.

Stress test the plan …

Central to understanding risk is a real appreciation of exactly how things could go wrong, under changed scenarios. The focus on stress testing now being promoted by the housing regulator, but also more widely used in the banking sector, recognises that ability to withstand 'pessimistic but plausible'[4] events – such as the collapse in property sales that hit the organisations above so dramatically – must involve a deeper understanding of how adverse events could happen and how this should affect thinking about risk appetite and exposure.

Given that housing growth strategies rely strongly on two markets that are vulnerable to global influences, namely finance and property, the case for asking 'but what if..?' becomes stronger. In 2012 a panel established by the Financial Reporting Council to review lessons from the financial crisis in relation to such issues as liquidity saw in stress testing '*a powerful tool to lean against the natural optimism of management in thinking about the future success of the business*'.[5]

Unchallenged, the enthusiasm that is often desirable to foster among executive teams can spill over into poorly reasoned and evidenced ambitions. A number of case studies in this volume exemplify such intoxicated growth aspirations, with plans sometimes predicated on the perfect convergence of events rather than consideration of the adverse. As mentioned above, optimism bias can be a powerful driver of unwelcome events.

As the uncertainties of the operating environment have increased, the need for Boards to engage proactively in this forward focus has strengthened. Horizon scanning, staying informed about the wider world, scenario planning, financial modelling, stress testing and reverse testing need to be part of the governance package.

Keep up the challenge …

The quality of challenge a Board can offer is fundamental to the value it can bring. How well this works depends hugely on the nature of the relationship between the Board and executive and of course on the competence of both. In this volume are examples of: poor functional relationships between Boards and executive staff (see Argon Group); and a lack of understanding of the difference in roles between each (see Thorium).

There are also good examples of effective collaboration between Boards and executive teams, often after some Board and/or executive renewal has taken place. This highlights the dangers of complacency, acceptance of the way things have always been done, cosy relationships or poor ones, and longevity in a role. Walker's review of banks and other financial institutions is alive to how these dangers affect the quality of conversations in the board room environment:

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[4] *The Sharman Inquiry. Going Concern and Liquidity Risks: Lessons for Companies and Auditors. Final Report and Recommendations of the Panel of Inquiry*, June 2012 – this report has a useful definition of stress testing as enabling 'the directors to assess the effect of a combination of pessimistic but plausible estimates or assumptions on the company's solvency and liquidity' and reverse stress-tests as seeking 'to identify and consider scenarios that would lead to a firm's business model failing', p.4.

[5] Stress testing emerged as a key recommendation from the various reflections on the financial crisis, in particular the work of the UK Sharman Panel of Inquiry which looked at lessons from the crisis and from a recessionary environment in relation to liquidity and going concern risks. Ibid.

> '*Even a strong and established CEO may have a degree of concern, if not resentment, that challenge from the NEDs is unproductively time-consuming, adding little or no value, and might intrude on or constrain the ability of the executive team to implement the agreed strategy. Equally, however, the greater the entrenchment of the CEO, perhaps partly on the basis of excellent past performance and longevity in the role, the greater is likely to be the risk of CEO hubris or arrogance and, in consequence, the greater the importance (and, quite likely, difficulty) of NED challenge*.'[6]

This volume contains evidence of key individuals (executives and non-executives) sometimes needing to leave to allow real cultural change to take place. There was significant senior change at Boron, Polonium, Nitrogen, Argon, Thorium and others, which then created the conditions for resolution. Although the 'nine year rule' adopted by many housing association board members in their code of governance has proved controversial, and is admittedly a blunt instrument, the evidence of this volume supports its use.

The inability of Board members to provide effective challenge in failing or struggling organisations is a persistent theme across sectors,[7] and it appears – for instance in relation to the troubles of the Co-operative Group. Lord Myners, tasked with reporting on the episode, sees Board composition hampered by a process which elects 'representatives':

> '*without the necessary qualifications and experience to provide effective board leadership and to monitor, challenge and provide direction to management. This has massively raised the cost of decision-making and diminished genuine accountability throughout the Group's governance hierarchy. – The result has been an inability to hold the Executive to account or to provide the guidance, motivation and counsel that any management team competing in this demanding competitive environment might reasonably deserve and expect*.'[8]

Increasingly across sectors, we are seeing a higher bar for the standard of skills and competencies required of non-executives. This may suggest a number of things: that our understanding of the relationship between governance and organisational performance is evolving; that the operating environment is changing and with it the nature of governance; that the nature of the modern world – the plethora of data and information,[9] the speed with which opinions can be sought and conveyed in real time – makes different demands of those reflecting on all of these inputs to create strategy.

It is clear that a shift is happening in the social housing sector. Being a benign and supportive presence on a Board was once seen as enough for an effective contribution for its members. We are now seeing – if not universally - a more ruthless focus on skills, capabilities and the depth of knowledge in much Board member selection.

Walker also draws out the particular roles of the Chief Executive Officer and of the Chair in creating a climate and culture in which challenge 'as distinct from a conventional relatively box-ticking focus on process', is part of how proposals are discussed, that it is to be expected and

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[6] Walker, p. 53.

[7] E.g. The inability or insufficient strength of character to participate', and engage proactively in Board deliberation undermines in Walker's eyes someone's suitability as a continuing Board member (Walker, p. 54).

[8] Myners, p. 17.

[9] Hospital trusts have at their disposal large and rich data sets; however, the Keogh review '*found a deficit in the high level skills and sophisticated capabilities necessary at board level to draw insight from the available data and then use it to drive continuous improvement'* (Keogh, p.8).

encouraged and conducted in such a way that it proves beneficial. Challenge should not be received as provocation, disruption or disloyalty.

> '[…] *clear responsibility should be laid, and be understood to be laid, on the chairman to promote an atmosphere in which different views, within the ambit of convergent views on core long-run objectives, are seen as constructive and encouraged. This will be particularly relevant in relation to new strategic initiatives…*'

Focus on governance …

Effective challenge is desirable, but Boards cannot act if senior staff do not make them aware of emerging issues, as was the case at Bismuth Living. It is probably also the case that Boards are more vulnerable to being misled (see Boron or Ujima) or ignored (Bismuth) when they are insufficiently proactive. Boards need to be more than passive respondents to executive agendas, however well-intentioned. To make this happen will require Boards to make time for reflection, informal discussion, early engagement with their executive teams and active connection with other organisations, networks or sources of good practice.

The culture of governance is fundamental to providing a Board environment in which there is challenge, learning, and a willingness by staff to escalate problems at the earliest opportunity. The inability to offer effective challenge, the tendency to just take at face value what one is told, is a thread running throughout the volume.

Unsurprisingly, it is also an issue that reaches across to governance problems in other sectors, for example in the hospital and banking reviews aforementioned, Keogh found that some of the issues highlighted in the reviews were not on the Board's agendas at all[10] because they were not probing in the right areas or gathering independent assurance. Walker found that an essential step in Board discussion – 'a disciplined process of challenge'[11] – had in effect been missing in many Board situations.

Never forget the housekeeping …

Excellent governance is not all about being strategic. Of course Boards need to avoid operational entanglement, but they need too a real 'grip' on a wide range of compliance issues. Gas servicing, data protection, value for money, employment matters and rent setting are just five areas where various organisations have – some even since the cases in this volume – experienced fairly public setbacks. Compliance with lenders' covenants is mission critical for any organisation that has borrowed money. The need for an energised Audit Committee as part of a wider business assurance trail is very apparent.

Good housekeeping around governance documentation is important – it provides an audit trail and helps to retain corporate memory. Effective housekeeping can help, for example, for a proper piece of due diligence to take place. Chester and District Housing Trust might have had second thoughts about joining the Cosmopolitan Group had the exact nature of the student leaseback arrangements been properly understood; or for a quick process of Plan B to be executed – again Cosmopolitan's rescue was hampered by poor record-keeping.

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[10] Keogh, p. 27.
[11] Walker, p. 12.

There needs to be basic discipline and formality to how a Board conducts its business. The findings of the Myners report into the Co-operative Group highlights how Board time can be wasted and diverted in matters of secondary concern, with little in terms of decisions and next steps, and overly long meetings. Some kind of ethics also need to underpin a Board's competence – respect for confidentiality, cabinet responsibility, courtesy and so on. Again, the report into the Co-operative Group provides many examples of the converse, such as a culture of leaks, a failure to raise potential conflicts of interest, and personal rebukes to Board members or executive staff.

The housekeeping of employment matters has been highlighted by recent episodes, three covered in this volume. Some Boards need to take their role as an employer more seriously than they have to date. Although large sums and much reputational risk are involved, we give three examples of Boards not applying this formal mind-set to executive retirements – Erbium, Nickel and Antimony. In this and other areas, sub-committees should not have the power to commit the organisation to significant future expenditure without the Board's full involvement and approval. For instance, a sub-committee at Nickel had agreed general severance terms for the CE's contract without reference to the Board.

There is evidence of Boards not asking the right questions, for example in relation to seeing the entirety of remuneration for any pay and bonus packages for executive staff. In the three cited cases, Boards considered information at short notice or with missing documentation or with insufficiently comprehensive advice. Merger situations appear particularly vulnerable to this disregard for responsible stewardship – for example, Erbium's Chief Executive was to leave as the consequence of a merger, and a proposed merger for Antimony led indirectly to the Chief Executive choosing to retire.

When it does go wrong … jump the right way …

A common feature of problem cases is the propensity of some Boards to jump the wrong way when things do go wrong. Spending time arguing or resisting regulatory perceptions and judgements is more than likely to make things worse. In the case of Neon, for example, there was a history of challenging the agencies with which it was dealing, and in the case of Thorium the Board would not at first accept the various shortcomings highlighted by the regulator and by consultants. We do not suggest that the regulator is always right about everything, but the cases in this book suggest that more often than not, their concerns are valid.

The Board or organisation in denial tends to be a classic symptom of a deeper malaise, whether poor attention to performance, or simple lack of awareness of what 'good' looks like. By way of example, the Keogh Mortality Review of 14 failing NHS Trusts (a small volume on problem cases from another sector)[12] judged that the trusts which benefited most from the review process were those that chose to engage with it positively, while a small number 'spent disproportionate time challenging the findings of the review team' and some even briefed their staff on what to say.[13]

Furthermore, failing to appreciate the regulator's role or respond to regulatory instructions (for whatever reasons) is likely to exacerbate matters further: Antimony seemed unaware of its need

[12] On 6 February 2013, the Prime Minister announced that Professor Sir Bruce Keogh, NHS Medical Director for England, was to review the quality of care and treatment provided by the 14 NHS trusts and NHS foundation trusts that were persistent outliers on mortality indicators.

[13] *Review into the quality and care of treatment provided by 14 hospital trusts in England: overview report*, Professor Sir Bruce Keogh KBE, 16 July 2013 (hereafter Keogh), p. 31.

to inform the regulator of the CE's departure; Ujima supplied Board papers sporadically or not at all at the regulator's request; Polonium Housing Group was slow to respond to regulatory requests and to address governance issues; Nitrogen was unresponsive to regulatory requests. This kind of foot-dragging or lack of transparency starts to create a new strategic risk in terms of further action by the regulator. The inability to get things done, act transparently or show due regard for the need to act promptly, compounds the regulator's concern.

Concomitantly, positive and proactive engagement with the regulator – in effect assuring the regulator about the route and intent to get to the desired outcomes – is an important step in managing down risks through a material event and not triggering a loan covenant breach.

And jump fast …

Agility to act when things go wrong is impeded by the manner in which growth has been planned and managed. There is evidence in this volume of organisational capacity – skills and tools – failing to keep step with ever more dramatic spurts of growth, as was the case at Thorium Housing. Failing to resource and support growth in a managed way can only be a failure of governance: it is the Board's role to ensure a prudent path to fulfilling its ambitions.

The velocity with which events move accentuates the need to respond quickly at the first signs of trouble – Bismuth had three emergency meetings in the space of two weeks when it was affected by volatility in long-term swap rates owing to the credit crunch, with two banks calling for up to nearly £30m of collateral.

Regulators are also likely to look for signs of a Board appreciating the depth of the water that it is in – moving quickly, getting appropriate advice, ring-fencing the risk, and so on. These are read as signs of a Board in control, and again Bismuth provides a good example of a Board keeping the bit between its teeth and not simply delegating the work elsewhere.

In conclusion

As with the three previous volumes, it all comes down to governance. The world of housing associations has changed substantially even since Volume 3, almost beyond recognition since Volume 1. The risks are greater, the safety nets less comprehensive. The more recent problems described are different from the past in many ways, but the underlying logic of good governance remains the same. We can be certain that today's well-governed housing association will not feature in Volume 5.

Chapter 2: Cosmopolitan's defining impact

The 2012/2013 episode of Cosmopolitan Housing will be familiar to many readers, and a recently published review of events[14] by consultancy Altair gives a full account of what happened. Most importantly, it came within a whisker of insolvency, which would have been potentially catastrophic for its tenants, and would have affected the credit rating of the entire housing association sector. Ultimately, Cosmopolitan was rescued by Sanctuary Group, but the episode was an alarming 'near miss' for all concerned.

As 'problem cases' go, it was thus the most important of recent years, and has had a major effect of the thinking of both the regulator and lenders to the sector. In addition, it acted as a wake-up call to many Boards as they planned new ventures, sought to re-energise governance, and manage their risks sensibly.

The basic facts

The basic facts are simply stated. Cosmopolitan Housing Association was a developing association operating in the Merseyside area, with some 3,400 homes. Within its group, there was an unregistered subsidiary, Cosmopolitan Student Homes, with 3,500 bed-spaces. In 2011, as the long-standing Chief Executive retired, the Group was joined by Chester and District Housing Trust ('CDHT'). The Chief Executive of CDHT assumed responsibility for the whole expanded group at that time. CDHT was a transfer association with 7,000 homes. It had experienced early regulatory problems after transfer in 2000, but at time of merger was well-regarded and high-performing.

The thinking behind the merger was to achieve economies of scale, and for CDHT to benefit from Cosmopolitan's expertise in more complex development and financing activities. The business case for merger made a strong offer to create substantial efficiency savings, and also highlighted that Cosmopolitan would be able to learn from CDHT's work with tenants and communities. Due diligence was conducted by both sides, but there was no detailed review of the contractual documentation around certain of Cosmopolitan's leaseback deals signed in 2003 for development of student housing.

The new combined Group was given a substantial allocation for new development from the HCA, and was in discussion with the insurance company Aviva about its forward funding needs. The regulator was (rightly) concerned about the complexity of the Aviva deal, and raised various issues with Cosmopolitan, including those relating to the need for forward funding to be in place. But before these could be resolved, Cosmopolitan began to experience cash flow and liquidity issues from March 2012.

In effect, it became clear that there had been no 'Plan B' for funding the development programme, were the Aviva deal not to go ahead. At the same time, there were substantial quarterly payments to be made on the student leaseback schemes.

[14] http://www.altairltd.co.uk/cosmopolitanreport.pdf

Remedial actions get under way

An interim finance director was appointed, and three experienced housing professionals joined the Board of Cosmopolitan Housing Group. Various actions were initiated:

- Cash flow was monitored daily;
- Operational savings and efficiencies were implemented;
- Various intragroup property transfers from Cosmopolitan to CDHT were made, with much-needed cash passing in the other direction;
- Riverside Housing Group, a large locally based organisation, was approached and agreed to act as funder of last resort with up to £2m as a line of credit;
- Existing lenders were approached to extend existing facilities and overdrafts; and
- The leaseback documentation was located and thoroughly reviewed.

Further concerns emerge

Over time, the review of documentation revealed more matters of serious concern, including:

- The business plan and assumptions for the student housing were not realistic, and the portfolio would generate increasing losses into the future, not least because of the onerous terms of the student leases;
- Maintenance, asset management and service delivery to tenants within Cosmopolitan (although not CDHT) were weak, potentially undermining asset values;
- Record keeping and document retention generally was poor;
- The accounting treatment of the leaseback schemes was wrong, and the leases should have been classed as being on balance sheet, rather than off; this meant that the organisation would breach covenants, and would not be able to sign off its accounts;
- There were various other risks to Cosmopolitan's covenant compliance going forward;
- The business partners on the student schemes were identified as being highly commercial in their approach, and (as was their right) reluctant to renegotiate the terms of the leases;
- The evidence trail of Board scrutiny and oversight of decisions made revealed a lack of challenge, and skill sets that did not match the association's risk profile;
- Cash flow would continue to be an issue for the foreseeable future, despite the actions taken; and
- The student leases had been guaranteed by Cosmopolitan Housing Association, which owned the social housing assets within the group, thus placing social housing assets directly at risk.

The decision to seek merger

In September 2012, Cosmopolitan accepted that it no longer had an independent future, and after a summary selection process decided to join the Riverside Group. The organisation was now clearly in a crisis, and there were regular meetings with the regulator and advisors. Board members became concerned about their personal positions, and the advice of an insolvency practitioner was obtained. A key concern for the Board was whether it would be able to sign off the annual accounts as a going concern, and the extent to which the existence of a potential rescuer could be taken into account.

The regulator began detailed contingency planning for insolvency, and looked at the use of its statutory moratorium powers. Riverside began its due diligence process, and meanwhile, Sanctuary Group was being kept informed, so that they could – if necessary – step in as 'Plan B'.

Darkening skies

Riverside's work revealed that the liabilities could – in a worst case scenario – add up to tens of millions, if crystallised by buying out the onerous student lease terms and the guarantees. At the same time, the regulator's planning revealed that its statutory moratorium powers had some limitations. There was thus at least the possibility of tenanted social housing being taken into the possession of lenders after an insolvency event. It was also considered probable that, in the event of such developments, all housing associations across the UK could face more expensive future borrowing, and even a re-price of their existing loans.

The ongoing negotiations with the leaseholders and their lenders were proving protracted and complex, and there was a considerable number of interested parties. Late in 2012, Riverside decided that it would not be prudent for it to proceed, and in January 2013, there was an orderly handover whereby Sanctuary became Cosmopolitan's rescuer of choice.

Saved by the bell

Sanctuary was prepared to move quickly, and to manage out the longer term issues with the student leases, and the rescue was able to move ahead at some pace.

As a part of the rescue, the Chester local authority was required to give up its 'golden share' in CDHT, and was persuaded so to do. This was key to the rescue, as the economics of the transaction from Sanctuary's side depended on the ability for it to utilise the value within all parts of the Cosmopolitan Group as necessary going forward. It is fair to say that without the value inherent in CDHT, the rescue would have been much less feasible for Sanctuary to consider. The rescue took place at the end of March 2013, to the considerable relief of all concerned.

The particular lessons of Cosmopolitan

The key factors in creating this episode can be summarised as:

- Poor governance and risk management; in particular, weak board skills and oversight of risky non-social housing activity; this was compounded by the existence of a relatively complex group structure for a small organisation;
- An over ambitious development and growth programme relative to the human and financial capacity of the association;
- Onerous and over-complex leasing and finance deals for the non-social (student) housing, compounded by weak underlying business planning and cashflows;
- The existence of financial guarantees directly putting at risk social housing assets;
- The lack of considered planning for liquidity and cash-flow, and in particular the reliance on one potential funding deal, without any Plan B; and
- Weak record keeping and document retention, which slowed down potential remedial and rescue activity.

The role of the HCA and previous regulators for Cosmopolitan is examined in some detail in the report referred to above. The HCA emerges from the episode with reasonable credit, recognising that the rescue did happen, and that the potential 'train crash' was avoided. The report makes certain recommendations to the HCA and to housing associations.

The HCA has accepted the relevant recommendations, and they have been influential in the 2014 consultation on changes to the Regulatory Standards, now implemented. These are summarised as the need for:

- Boards (and also the regulator) to have the skills and access to advice they need to discharge their responsibilities;
- The regulator to update its plans for dealing with future insolvency and moratorium situations;
- Changes to the relevant legislation and regulations to update the regulator's powers, both in respect of insolvency and to allow the more flexible use of other powers;
- Housing associations to have accurate registers of their assets and liabilities;
- Enhanced and intelligent approaches to risk management, again by both regulator and associations;
- A more rigorous approach to compliance and business assurance by the Boards of associations;
- A more rigorous approach to mergers and due diligence by both Boards and regulator; and
- Better planning for potential crises and cash flow difficulties by the Boards of associations.

In conclusion

The Cosmopolitan episode was a close call for the association, its tenants, the regulator and the wider sector. In the event, the difficulties were resolved with a rescue, as other similar cases have been before. Lessons have been learned, and are being applied. But another time, events may unfold in a less positive manner. Each Board needs to consider the lessons of this and other problem cases, and avoid ever becoming 'the next Cosmopolitan'.

Chapter3: Boron Homes, Bismuth Living and Polonium Group - the global financial crisis and its effects

The global financial crisis started in autumn 2008. As will be remembered, the credit crunch caused various difficulties for housing associations. The problems potentially affected both cash flows and balance sheets, and these rightly gave rise to concerns for the regulator. Key problems include:-

- The collapse of the market for homes for sale, outright and intermediate, leading to cash flow and solvency concerns;
- Collapse in the value and saleability of sites held for development;
- Significantly reduced values leading to the need for impairment in accounts;
- An unprecedented reduction in long term interest rates, leading to substantial cash or collateral calls in relation to financial derivatives;
- Constraints on the availability and cost of new lending; and
- Potential for breach of loan covenants.

Three cases demonstrate this range of problems and how rapidly a situation can escalate. In two examples, events moved so fast that the associations concerned cannot be seen as having any real control of the situation. It is more the case that events were controlling them. In none of our cases are the events, or the combination of events, foreseen. None of the associations concerned had risk management systems which had identified the particular combination of risks which materialised as potential 'black swan' events even to threaten the very existence of the organisation. None had suitable contingency plans.

In one case, the credit crunch is just an additional factor precipitating issues which already exist. In another, two more minor credit crunch problems combine with an unrelated governance issue to give the regulator a more general concern. In the third, a very specific credit crunch problem quickly becomes potentially life threatening and is almost as quickly resolved – but the aftermath, not least the damaged relationship with the regulator, leaves the association in a weaker position for some time.

Boron Homes

Boron Homes is a group with an extensive development programme including a number of joint ventures.

Timeline

Year 1	
Month 1	Boron submits a capacity model to the regulator, which considers that the cash flow position is unstable. The regulator's initial investigation identifies ➢ A solvency risk due to delaying payments to creditors ➢ Inadequate planning for loan security requirements ➢ The risk of breaches of loan covenants ➢ A weak viability rating going forward ➢ Unreliable reporting and financial management

	➢ Several joint ventures have net outgoings in the short to medium term ➢ Reliance on property sales to meet interest payments and part fund the development programme Boron has substantial commitments which require additional funding, and it is apparent that raising the funding is problematic. In addition there are concerns regarding a very large development project (Project Thallium), with the likelihood of substantial impairment. The regulator requests weekly cash flow information. The position from week to week is volatile, with several large draw-downs required. All drawings are dependent on security being in place, and there is a risk this will not be done in time. External consultants are asked to review the robustness of the cash flows. The regulator facilitates arrangements with two other housing associations to provide stand-by loan facilities on commercial terms which alleviates the short term liquidity issues.
Month 3	The cash flow position is improving because of better forecasting and management, better development forecasting and improved processes for arranging security. However ➢ Additional lending is not yet in place ➢ Cash is tied up in Project Thallium, and additional government grant funding is critical ➢ Forecasts in relation to the joint ventures indicate significant and mounting losses ➢ Property sales are very weak; some sites look like realising far less than their projected returns, with receipts at c. 10% of the predicted sums Phase 1 of the review of the cash flows does not highlight any significant new issues. An audit of Project Thallium is in progress, and a governance review is also in progress.
Month 4	Additional grant funding is agreed to ease the position, although funding for Project Thallium remains under negotiation. Phase 2 of the cash flow review is critical of cash flow management and financial management information. It highlights a lack of direction in the finance team and a weak control environment. A development review highlights similar concerns about controls and forecasting, but also notes an improving situation and no fundamental weaknesses.
Month 6	New facilities have been arranged and are ready to draw. This ensures that at the year end, there is a stable cash position with adequate headroom. However because of the other financial uncertainties the overall viability position will not be clear until the accounts are finalised. The governance review confirms a number of failings at board and executive levels. Boron agrees to some changes but the regulator is not content with Boron's response and asks for a more robust action plan. The regulator is holding fortnightly high level meetings with Boron.
Month 7	The investment agency agrees further grant allocations for other schemes.

Month 9	Additional funding for Project Thallium is still not agreed and this is material to the potential impairment in the accounts. The level of impairment is such that covenants might be breached. The retirement of the Chief Executive is announced. The internal audit report on Project Thallium is completed and raises concerns about procurement, and a further investigation is begun.
Month 11	The position for the year end accounts is acceptable. A new Chief Executive is appointed. Steps are taken to strengthen the Board.
Year 2	
Month 1	It becomes apparent that Boron is in breach of its constitution, having exceeded its borrowing limit by some 30%. A rule change is agreed as a matter of urgency by the financial services regulator. Lenders are supportive and do not seek to call a default. The regulator asks Boron for an explanation as to how it arose. The investigation into Project Thallium indicates that procurement may have been in breach of EU legislation. Boron agrees to adopt procurement arrangements for completion of the project that are OJEU compliant.
Month 3	It is established that there was a breach of EU procurement rules, and this is corrected by going out to tender in compliance with the regulations. Boron also discovers it has breached its borrowing limit in one of its subsidiaries. A further rule change is required. The audit management letter is issued and highlights internal control weaknesses. The regulator takes the view that these further issues point to continuing governance failures. Boron's governance and finance ratings are both downgraded. Despite this, the regulator considers the strengthened board and executive has the capacity and willingness to address the issues.
Month 5	A new business strategy is agreed which includes simplifying its group structure, and it receives in-principle agreement from its funders. Boron revises its asset management strategy and addresses service delivery improvements. The financial position remains stable and satisfactory, and Boron makes good progress on addressing the issues in the management letter. A review of projects similar to Project Thallium reveals no further irregularities. The regulator concludes Boron has made sufficient progress to enable them to reduce the level of regulatory intervention and remove Boron from the 'intensive' category.

Analysis

A large and aggressive development programme, together with a complacent approach to financial management and risk management, combined here to create a situation where Boron came close to insolvency. The regulator picked it up quickly and was strenuous in its efforts to ensure a satisfactory resolution.

Boron's development programme had complex arrangements for its delivery, including through a number of joint ventures. The various reviews highlighted that its systems for financial forecasting, management and reporting were not sufficiently robust to manage a programme of such size and complexity. The credit crunch exacerbated the situation for Boron; difficulties selling homes, impairment, and difficulties raising funding contributed to serious short term cash problems and medium term balance sheet concerns.

After the initial problems had been identified, events snowballed very quickly. In the early stages, there is a sense of things being almost out of control. Boron's management team was fire-fighting for some months and was under huge pressure to keep the organisation's head above water.

The regulator was key to saving the situation. It acted swiftly and decisively to facilitate credit arrangements with other associations. In the event these were not needed, but the regulator should take credit for having arranged a fall-back position vital to limiting the immediate solvency concerns. Indeed under a slightly different scenario, these measures could have prevented an insolvency with potentially huge ramifications for the whole sector.

The further grant allocations were also important in recovering the wider financial position. The lenders themselves also contributed positively by their forbearance in not calling default (when they appeared to have the opportunity to do so) as a response to the constitutional issues.

By the end of Year 1 the regulator's primary focus shifted from the financial position to the control over the development programme and need for a governance improvement strategy. The regulator rightly concluded that the operational and financial failures were symptomatic of governance failures. The governance review indicated that board was misled about loans, security and IT problems. Despite this, the Board is held accountable for its failure to manage the risk of the development programme, and to failure to exercise financial stewardship. The organisation was development led, the approach was over-optimistic and the Board did not maintain adequate control. The strengthening of the Board and executive team was key to the regulator regaining its confidence in Boron.

Polonium Housing Group

Polonium is a group of associations, with one small stock transfer subsidiary. The Group also provides special needs housing.

Timeline

Year 1	
Month 1	During an annual process of considering the organisation's financial viability, the regulator is alerted to financial issues which cause regulatory concern. The group is heavily dependent on sales of low cost home ownership schemes from its development programme. It is exposed to margin calls on stand-alone swap deals, and has recently had to meet a substantial cash call. The regulator begins a period of intensive regulatory engagement, requesting regular weekly cash flow information, monthly management accounts, updates on sales performance and board reporting. A number of independent reviews are commissioned, including asset management and the Decent Homes Standard position, and treasury management.
Month 2	The sales position remains problematic but the financial implications are manageable in the short to medium term. Polonium begins negotiations with the investment

	agency to change tenure on some of its sales programme, to reduce risk.
Month 3	Some additional grant funding and tenure changes to some sales schemes are agreed. Despite this, the regulator downgrades Polonium's viability, whilst noting there are no immediate liquidity concerns. Its records show the downgrading is in part due to difficulties in obtaining information promptly from Polonium. The asset management review criticises lack of information about stock condition and some concerns about oversight of the DHS programme. The other reviews are yet to be completed. The regulator meets with the new Chair at Polonium and expresses concerns that matters are not being resolved quickly enough.
Month 4	Polonium revises its projections to take account of the decisions on grant funding and tenure changes. Polonium submits a business case for taking transfer of two special needs schemes from other providers. Despite its other concerns, the regulator recognises Polonium's strengths in this area and agrees to the transfer.
Month 8	Polonium submits an updated business plan and capacity model. The regulator upgrades Polonium's viability. Progress is made on the asset management review outcomes. The treasury review is complete, and an action plan is developed and is in implementation. The regulator concludes that there is sufficient all round progress to remove Polonium from intensive regulatory engagement.

Analysis

Once again the credit crunch and resultant property market collapse threw up financial challenges which had not been foreseen. In this case the potential implications were not so serious as at Boron, but they nevertheless reflected a similar lack of effectiveness of the organisation's systems for risk assessment and management.

Although the total case study covers only just under a year, there is a sense – articulated by the regulator - that Polonium did not act swiftly.

The regulator rightly took the view that Polonium had an appropriate range of skills and experience on the Board and did not need statutory appointees. Following the appointment of a new Chair and progress on all the issues, the regulator reduced its level of regulatory activity and removed Polonium from the intensive category.

The case was resolved quickly once Polonium got a grip on the issues, and it was helped by the investment agency's decisions about allocations and change of tenure. Despite the increased regulatory scrutiny on these specific issues, the regulator retained its confidence in Polonium in other respects, and allowed transfers of special needs schemes from other organisations to proceed during this period.

While the focus in this case was on financial viability there were also governance issues emerging in the small stock transfer subsidiary. It seems quite possible that neither problem on its own would have resulted in the increased regulatory activity. This is an interesting point for both the regulator and the regulated to ponder – for the former, when is it appropriate to consider together two completely disparate problems and then increase regulatory activity, and for the latter, be aware that the sum of smaller problems may add up to a whole which is of much greater significance in the eyes of the regulator.

Bismuth Living

Bismuth is a large group of associations. The association is financially highly sophisticated and its staff and board are knowledgeable, with strong finance and treasury skills. At the start of the case study Bismuth is committed to complex financial instruments ('swaps' or 'hedging instruments') relating to £450m of borrowings, by which Bismuth agrees to pay a fixed rate in return for receiving an adjustable or floating rate from another party.

These financial instruments have only two counterparties, both banks. Bank A has a weekly mark to market, Bank B's is monthly. Mark to market (MTM) is the point specified in the swap agreement when the price of re-establishing the fix at prevailing market rates is calculated, and can be either positive or negative. In the case of a stand alone swap the bank is able to call for collateral to cover its exposure should its position be negative.

In the first couple of months of the credit crunch long term swap rates were unusually volatile, with a generally falling trend. Initially Bismuth considers the situation manageable, as negative calls are matched by positive. However negative calls increase, the finance team starts to get concerned and begins daily monitoring of rates. It also opens up discussions with Bank B to attempt to mitigate its potential liability.

Timeline

Day 1	Before being able to conclude these discussions, rates take a significant downturn. Bismuth is called upon to place £16.6m of collateral with Bank B. The call is due on day 5. The Treasury Director advises the Group CE who in turn advises the Chair. The regulator is notified the next day by telephone in the first instance.
Day 5	Bismuth satisfies the call from Bank B. Bank A makes a call of £13.2m, payable the following day. Bismuth is not able to raise this in the time available; it is working on ensuring that it can provide the necessary security but this is not going to be in place sufficiently quickly. Bismuth tells Bank A's team that it needs to hold urgent discussions with them. The bank considers that in its opinion Bismuth is in default. The regulator, understandably concerned, demands an urgent meeting with Bismuth.
Day 8	A temporary waiver is agreed with Bank A, until day 13.
Day 9	Bismuth holds an emergency board meeting to discuss the crisis and to agree a strategy for dealing with the banks and with the regulator. Bank A agrees to allow an undrawn facility to be used as collateral provided it is repaid within 7 days. The Board concludes that the priority is for the team of the executive to meet the two banks concerned as quickly as possible with a view to restructuring Bismuth's hedging portfolio.

Day 13	A further emergency board meeting is held. Bank B has agreed that although calls will continue to be made monthly, Bismuth will be given 3 months to satisfy the calls. This gives Bismuth time to complete its work in relation to securities, and breathing space to negotiate a long term solution. Bank A is considering embedding Bismuth's swaps within existing loan facilities even though the value of the swaps exceeded Bismuth's current loan book with Bank A. This will require Credit Committee approval and the Committee is meeting at this moment to consider this. The bank's proposal, which would involve rolling up the existing unsecured facility and which could involve the crystallisation of a significant loss, might create accounting and financial covenant issues for Bismuth. In addition, Bismuth's cost of funds could rise significantly. Bank A has, however, agreed not to make further calls pending resolution of the negotiations. The Board is pleased to have a breathing space, and agrees that it will continue to meet in emergency session as and when required rather than delegating to a committee. Meanwhile another financial issue, signing off a complex financial deal, has become urgent, and must be concluded by day 24. There are reputational risks and abortive costs if the deal is not signed off, but the Board takes the view that there is greater risk to the organisation and to them individually as board members if they proceed whilst Bismuth's position remains uncertain. The Board agrees that until the outcome of current events is known, it cannot agree to the financial close of the contract.

Day 21	A third emergency board meeting is held. More discussions have been made with Bank A, which has written outlining its terms. These are more onerous than those previously discussed, but it is apparent this is a 'take it or leave it' offer. Bismuth's negotiating position is weak. The Board notes that the risk of not accepting the offer is to return to the 'mark to market' situation, which all agree is untenable. These terms effectively extinguish the risk on MTM. The Board gives authority to accept the terms. Negotiations with Bank B are continuing. Providing security is proving challenging because of the other funding under negotiation – more assets are coming on line but additional external resource is needed to work on charging. Agreement with Bank B is close, but heads of terms are not yet issued. The Board looks again at the financial deal which is now urgent. The Board agrees to close the deal subject to: ➢ The arrangements with Bank A being signed ➢ Heads of terms being issued by Bank B which are not unduly onerous ➢ Specialist advice is taken on cash flow The Board agrees that the Executive should revisit the Group's disaster scenario planning and strategic risk map, and conduct a form of stress testing, thinking the unthinkable.
Day 23	The deal with Bank A is completed. It will cost Bismuth an additional £2.6m each year. Bank B is proposing to increase Bismuth's unsecured facility which means that future calls can be met without recourse to Bismuth's own funds. The cash flow advisors give assurance about the model and the inputs. Bismuth advises the regulator of the updated position.
Day 24	Bank B confirms the agreement and expresses its willingness to review the structure of the long term swap arrangements. The crisis is at an end.

Analysis

The scale of the downturn in long term swap rates presented a major threat to Bismuth's short term cash position. Bismuth's exposure was exacerbated by the size of its stand alone swaps and the fact it was spread across just two counterparties, with one of those able to call for weekly MTMs.

The crisis faced by the Board when it held its first emergency meeting was made worse because neither the Group Chief Executive nor the Board had been alerted to the deteriorating position earlier. Various opportunities for this had arisen, but had not been taken. While earlier awareness of the looming crisis is unlikely to have avoided the remedial action Bismuth was forced to take, it could have allowed a more balanced and measured set of negotiations with the two banks, for the security charging work to be accelerated earlier and for the regulator to be properly briefed. There was no time in this scenario for regulatory action to be taken, but this reputational damage could have been avoided.

Once apprised of the seriousness of its position the Group Board acted with determination and decisiveness. In the space of two weeks, which included three emergency meetings, the Board developed and agreed a revised deal with both banks which mitigated Bismuth's exposure to future collateral calls. The deal with Bank A came at some cost which, in the weak position Bismuth found itself, was the price to be paid for sustaining it as an independent organisation.

The Board showed a good understanding of the best interests of the organisation, and of members' own individual positions in relation to potential trading whilst insolvent. Despite the regulator's obvious concerns, it is clear there was some recognition of how the Board handled the situation.

What has the global financial crisis taught us?

Each of the case studies has its own lessons, but one key lesson underpins them all. None of the associations foresaw what would happen. A second important lesson is that Boards need to have a thorough understanding of the complex risks that they are taking on, with some members at least who have direct experience of similar matters elsewhere.

Of course it could be said that no-one foresaw the global financial crisis, or had dealt with anything similar. But whilst the exact nature of the risk may not be foreseen, nevertheless risk management systems must identify worst case scenarios, attempt to ensure that whatever happens there is no fundamental threat to the continued existence of the organisation, and that contingency plans are in place.

Once things start to go wrong they can unravel very quickly indeed. Good risk management requires both management teams and boards to think the unthinkable, and equally to know how to respond when something unexpected occurs.

Chapter 4: Nitrogen Housing and the PFI

Background

Nitrogen is a large association, which at the start of this case study has the strongest governance rating available and a slightly downgraded viability rating, because of the unprofitability of one of its key business streams and weakness in controls.

Nitrogen had a large Private Finance Initiative ('PFI') scheme for refurbishment of council owned housing stock. The project inception was more than 6 years prior to the events recounted here. The council concerned had entered a 30 year contract with a Special Purpose Vehicle (SPV) which was an unregistered subsidiary of Nitrogen. The refurbishment works were carried out by one main contractor which employed a number of sub contractors, and the council made substantial monthly payments to Nitrogen.

After the works were completed, it was discovered that they had not been done to the specified contractual standard. The capital cost of rectification was well over £10m. The contractor was by then in severe financial difficulties. A dispute arose between Nitrogen and the council, and the council made substantial contractual deductions from the monthly payments, and sought to compel the SPV to make good the sub-standard work at its own expense.

Timeline

Year 1	
Month 1	The regulator holds an internal assessment meeting and notes the following points: ➢ The council could terminate Nitrogen's contract, leaving them without monthly income to offset the capital costs ➢ Nitrogen's exposure is established through the contract, and any shortfall in the SPV will ultimately come back to Nitrogen and be dealt with via Nitrogen's I&E account ➢ it is unclear if the capital cost liability will affect covenants, year end accounts or cash flow The regulator thinks that Nitrogen has been slow to notify it, although it recognises Nitrogen has already put in place a number of reviews and investigations. The two key questions are how Nitrogen has found itself in this position and what financial capacity it has to meet the costs of rectification and absorb the reduced monthly unitary payments. It asks Nitrogen for more information.

Month 2	Although cash facilities appear adequate there is some uncertainty as to the robustness of this analysis. Cash flows are being reviewed. Nitrogen embarks on a programme of property sales to minimise the risk of covenant breach. A private placement planned for later in the year cannot go ahead because of the PFI position, and Nitrogen starts negotiations to extend an existing facility. Nitrogen takes legal advice, and also financial advice to model the impact of the costs of default on the PFI funding model. Nitrogen believes there may be a legal case against other parties involved in the PFI, and actions against them are pending. Nitrogen also investigates whether any performance bonds in place would mitigate their losses but this proves unsuccessful.
Month 3	The council notes the "direction of travel (being) towards a solution for tenants which will not result in contract termination". The regulator considers the covenant position to be unclear, and asks Nitrogen for external confirmation of the covenant compliance position and the degree of tolerance.
Month 4	The regulator writes to Nitrogen again asking for urgent clarification on the outstanding points. Nitrogen appoints consultants to review what went wrong.
Month 5	The sales programme continues and looks on track to raise enough for the estimated capital cost of rectifications works, but will not improve the covenant position. Despite this, Nitrogen's external auditors are able to confirm Nitrogen will not breach interest cover covenants. Progress on alternative loan facilities is limited. The regulator is concerned that agreement with the council has still not been reached, and considers Nitrogen has been slow in setting out its plans and managing the associated risks. It advises Nitrogen it is considering downgrading the RJ.
Month 6	Nitrogen considers the various options available to it if it is unable to reach agreement with the council at a meeting due imminently. However, if agreement is not reached by the time Nitrogen's accounts are due to be filed, then Nitrogen will be forced to choose between either filing its accounts on time but possibly with a going concern qualification in the audit report, or filing its accounts late. Either option would almost certainly amount to a breach of funders' covenants which could result in re-pricing of existing lending agreements. If the council terminated the contract, that would have a similar outcome. The regulator stresses to the Chair and members of the Executive the seriousness of the concerns it would have if Nitrogen's problems led to the loss of social housing from the sector.
Month 7	Discussions with the council continue. Liquidity is not an immediate concern but discussions with lenders on additional funding remain on hold pending agreement with the council. Nitrogen considers there is no risk of impairment, since the return still exceeds its cost of capital. The consultant's report is delayed because of the volume and complexity of the documentation needing review.

Month 8	Nitrogen believes a resolution is now looking more likely but uncertainty remains as agreement still needs to be reached on the works programme. The risk remains that agreement will not be reached and the contract will be terminated. Negotiations continue. The cost to Nitrogen of termination of the contract is estimated at £52m. Nitrogen continues to develop contingency and mitigation plans: ➢ Funders are aware of the situation and are to date supportive ➢ Liquidity is assured for at least another 12 months ➢ It has modelled the potential impact of debt re-pricing and has the financial capacity to absorb this to a significant extent ➢ Its auditors are comfortable with its accounting treatment of the PFI ➢ It will not be progressing with its development programme until matters are resolved ➢ In the event of a default of its loans, Nitrogen would be sufficiently financially weakened to necessitate partnership discussions
Month 9	Negotiations with the council continue. Agreement regarding the works is reached, but two other areas remain unresolved. Both parties are working towards a Deed of Variation, but there is still no guarantee that this will be completed, or that it will be completed quickly enough for Nitrogen's accounting requirements. The consultants' report into 'what went wrong' concludes: ➢ Nitrogen made misjudgements in tactics in responding to the disputes and adjudications with the council. From the start right up until the breakdown of relations, the relationship with the council was not effectively managed ➢ There was a blurring of the separation of the governance of Nitrogen and the SPV. From inception all the non-executive board members of the SPV were also on Nitrogen's Board ➢ There was no separation of risks between Nitrogen and the SPV ➢ There were weaknesses by the executive in terms of management of the project risks ➢ Reporting lines within Nitrogen were fragmented from the start. There was no overall project director until after things broke down ➢ The terms of the PFI output specification and deduction mechanisms were vague and onerous to Nitrogen ➢ Too much reliance was placed on consultants and advisers in the stages up until formal entry into the contract The report notes that the current Board and Chair were not responsible for the majority of the origins of the problems with the project. A number of senior executive appointments have also changed in that time.

Month 10	Nitrogen now has a letter of intent from the council, and it looks as if the final approvals for the contract variation will go smoothly. The biggest risk to Nitrogen now is that it will be unable to deliver under the revised contract, which has tight financial and performance parameters. Failure might result in calling in of loans. The regulator requires Nitrogen to prepare what has subsequently become known as a 'living will' against this worst case scenario.
Month 11	The regulator considers a revised regulatory judgement. It concludes that, by current standards, Nitrogen does not have effective mechanisms in place, but that by the standards of the time when the project was entered into, it did. Nitrogen did take professional advice on the structure of the deal taking into account the relevant expectation of the regulatory Good Practice Notes of that era. Nitrogen's recent steps to manage and mitigate the risks of failure provide assurance that its ability to meet standards in the future is not sufficiently prejudiced by the unregulated activities. The regulator concludes that without this risk mitigation the technical non-compliance would have been more serious. In the event a new judgement is issued which puts both governance and finance a notch below full health.
Year 2	
Month 1	The Deed of Variation is signed, removing the threat of contract termination at least for the present. A new revolving credit facility is signed off. The accounts are signed off, unqualified. The accounts show a loss on the PFI contract of £12.3m and an overall loss for the year of £3.3m. The Chief Executive of Nitrogen leaves by mutual agreement. An interim is appointed. The risk profile of Nitrogen is such that it remains under enhanced regulation.

Analysis

After 12 months of intensive negotiations and financial fire fighting, a variation to the contract was agreed. The crisis was averted for the time being but Nitrogen remained under threat. Nitrogen lost its Chief Executive, and also lost the confidence of the regulator.

What went wrong was investigated by consultants and is described in Month 9 above. Underlying those causes is the sheer complexity of the project – not just the works, the legal and financial aspects and the governance arrangements, but also the risk management and control, and the project and relationship management needed to keep it on track. PFI was a novel arrangement and not one which Nitrogen had experience in managing. The consultants' report suggests that the Board and executive were not fully on top of it right from the start, and changes in personnel at both executive and non-executive level and resultant loss of knowledge would have made it harder to manage it effectively further down the line.

Events and Nitrogen's responses to them make evident that it had not appreciated and planned for the risks inherent in the contract and the governance arrangements which accompanied it. Both the regulator and the consultants note that at an early stage the risks were viewed by Nitrogen as being no greater than its core business. This was such an under-assessment that it suggests the association's entire approach to risk appraisal and risk management was flawed.

It took Nitrogen a while to realise the gravity of the situation. However once it had done so, it was very active trying to resolve the situation with the council and to put in place financial contingency plans. During the months it took to negotiate the revised contract terms, Nitrogen's future and independence were at considerable risk. If the agreement had not been concluded and the contract terminated, then Nitrogen would almost certainly have ended up seeking a merger partner. There was also risk to publicly funded assets within Nitrogen, because of the magnitude of the cost of failing to secure the contract variation.

Conclusions

Events here demonstrate why the regulator places such importance on the need to protect social housing from any threat that may come from unregistered subsidiaries and/or diversified activity.

Chapter 5: Argon Group and the perils of complexity

Argon is a group structure formed by the merger of two existing groups. One of the former parent companies Radon, and its main subsidiary Xenon, are in intensive regulatory engagement even before the merger, because of poor service delivery.

Timeline

Year 1	
Month 1	An Audit Commission inspection gives Xenon Housing "poor service, uncertain prospects for improving". The then parent, Radon commissions consultants to review the exercise of control and what has led to the problems. The review concludes that the subsidiaries are running the group rather than the group controlling the subsidiaries. Radon and Xenon are placed in intensive regulatory engagement. The group develops two action plans, one to address performance and one to address governance issues.
Month 9	A review by the regulator indicates that the governance actions are in hand, and some progress is being made on the performance issues. The regulator decides to lift Radon's intensive regulatory engagement status so as to allow a merger with another Group to take place. Part of the regulator's strategy in so doing is to enable a newly created merger group, Argon, to address the known performance issues within Xenon.
Month 11	A new non-stock holding group parent Argon comes into existence. Both former parent companies and all former subsidiaries retain their legal identities.
Year 2	
Month 4	Argon's management team is concerned about service improvements which are not bedding in. A decision is taken to postpone the imminent mock inspection to give more time to address the performance concerns. Argon asks the regulator to defer its planned review until after the mock inspection and the regulator agrees.
Month 9	A mock inspection of Xenon indicates another poor outcome is likely. Argon notifies the regulator. Argon uses its 'step-in' powers to appoint two group board members to Xenon's board, one of whom takes on the role of Chair. It also employs an external company to facilitate operational change. Xenon's Chief Executive resigns.
Month 11	The regulator holds an internal case review. It does not consider Argon's actions go far enough. It has serious concerns about the failure of the group parent to manage and control the subsidiary effectively, to implement change post-merger, and to deliver on the service delivery expectations that were envisaged when the regulator approved the merger. The regulator debates internally on the proportionality of applying intensive regulatory engagement status to all members of the group, and whether funding restrictions should be placed across the group. It eventually concludes that the parent Argon should be held accountable for the failure of the subsidiary, and that funding restrictions should be placed across the group. As a result:

	➢ Argon is placed in intensive regulatory engagement ➢ Three statutory appointments are made to Argon's Board ➢ Argon loses its 'lead partner' status ➢ All existing schemes of all subsidiaries which are not yet on site are transferred to other providers The forthcoming Audit Commission inspection is postponed.
Month 12	The statutory appointments are made and take up their roles.
Year 3	
Month 3	Everything appears to be going well; the appointees are making a positive contribution, and feedback from and about them is good. A detailed action plan is in place for the operational issues and working groups are set up.
Month 5	Tensions are developing between the Chair and the appointees, and the Chair and the Chief Executive. Following a very difficult and challenging board meeting, the Board agrees to accept the Chief Executive's resignation. A sub-committee is set up to consider interim arrangements.
Month 7	Argon is encountering difficulties in sourcing a suitable interim. The appointees go over the Chair's head to prepare an initial paper on strategic review.
Month 8	An interim Chief Executive is appointed, who in turn appoints consultants to undertake the strategic review. The brief is agreed with the regulator.
Month 10	The consultant's report back, with four possible strategic options. The option which is agreed involves: ➢ Collapse of most of the group into one company ➢ A new streamlined governance structure and executive leadership structure ➢ Revised accountability arrangements While this is agreed in principle there are potential obstacles, not least the need for agreement of all the subsidiary boards and shareholding members. The Chair and Vice Chair agree they will resign as part of the change process. Feedback from a review by external consultants indicates that service improvements are going well.
Year 4	
Month 1	The subsidiary boards accept the strategy for collapse of the group. A new Chair is appointed and takes up the post.
Month 5	The deferred Audit Commission inspection takes place and gives Xenon one star with promising prospects. Four new board members are appointed to Argon. A new Group Chief Executive is appointed.

Months 6 & 7	The shareholder meetings take place to vote on the rule changes; after considerable resistance and persuasion, all changes are approved. The appointees stand down.
Month 7	Argon is removed from intensive regulatory engagement, and consent is given to the constitutional changes.

Analysis

The Board of Xenon gave insufficient attention to service delivery and performance, leading to a poor inspection outcome. Once service delivery problems were identified, neither the boards nor the executive gave enough focus to ensuring these were addressed. This was the case both before and after the merger.

The original consultants' pre-merger report on governance – that the subsidiaries were controlling the group rather than the parent - proved to be correct. Although Radon and Xenon seemed to be implementing the resultant action plan, with hindsight they failed to give it sufficient weight and to act sufficiently robustly on its findings. After the merger and creation of Argon, the original analysis was if anything even more pertinent, but by this time the group's attention was turned elsewhere. The review was side-lined, and then forgotten altogether. No-one was accountable for seeing through the recommendations.

Radon's original structure was unwieldy and dysfunctional. Unfortunately, the governance issues identified in Radon were actually magnified as a result of the creation of an even larger group. The new Argon group was so labyrinthine that it affected the ability of both executives and non-executives to manage or govern effectively.

Immediately following the merger, regulation and contact with Argon was light, despite the fact that Xenon remained in intensive regulatory engagement. The regulator wanted to give Argon and Xenon time for the improvements to bed in and be reflected in the performance statistics. Its rationale was that it had no reason to think things were going wrong. However it had no clear evidence that things were going right either, and the unexpected postponement of the mock inspection was perhaps an indicator that things were not what they should be.

The role of appointees was very important in getting the case resolved. In the middle of the third year their actions, both inside and outside board meetings, were a catalyst to move things on to the next stage.

The interim Chief Executive was also critical to the resolution of the problems. He worked effectively with the consultants and the regulator, and was successful in selling the concept of the group collapse to the shareholders. Because the appointment was interim, it allowed him to focus on these particular issues. Had a permanent replacement been made at an earlier stage, the person appointed would have had the full Chief Executive remit with all its distractions, and potentially had less focus on the essential actions needed to bring the governance issues and supervision situation to a conclusion.

Conclusions

Xenon was in intensive regulatory engagement for approaching four years as a result of performance failings. This cannot be an acceptable way to deliver services to tenants, and the failings should have been addressed much more quickly. However it was a classic case of the problem (poor performance) being a symptom rather than the cause. The underlying issue was one of poor governance oversight and attention, and by adding further layers of governance complexity and distance, the merger exacerbated instead of addressed the problem.

Mergers, particularly those as large and complex and this, do present challenges for executives and non-executives alike. In these circumstances where one of the component parts of the merger already had known about serious problems, it might have been of benefit to have considered more carefully exactly how and by whom the issues would be progressed post-merger. Experience suggests that immediately post-merger attention is drawn away to all sorts of new and unexpected challenges, and that pre-existing problems can easily get overlooked.

The regulator was perhaps too easily persuaded that improvements were in hand, and should have followed up more robustly. Once the continuing problems were inescapably obvious, the regulator gave considerable thought to the proportionality of its response. Although the withdrawal of funding may have seemed harsh given that the other subsidiaries were not exhibiting any of the same problems, it was necessary to ensure that the parent did take rapid and appropriate action to deal with the underlying and longstanding problem.

This case reached a successful and logical conclusion. The regulator should probably have acted more firmly to follow up performance issues during the period immediately following the merger, which might have prevented the need for intensive regulatory engagement. However, investigating the performance issues served to highlight the underlying governance and structural problems which would have had to be addressed in any event.

Chapter 6: Thorium Housing - ambition & complexity

Background

Thorium is a group which has a number of subsidiaries, both registered and unregistered. At the start of this case study the group was facing significant cash generation challenges, and had embarked on a large scale and fast paced programme of re-structuring and re-organisation to deliver it. This included an asset rationalisation strategy which would mean relocation of its head offices, withdrawal from almost half of the local authority areas in which it worked, and a governance rationalisation including merger of two subsidiaries into the main association.

Timeline

Year 1	
Month 1	The regulator initially picks up the issues from a rents review – Thorium is planning to seek a rent waiver on one of the subsidiaries, Cerium. Cerium is a stock transfer with a substantial regeneration programme, which in the current economic environment is not viable, and the regeneration is unlikely to go ahead without the rent waiver. The local authority is not happy with Thorium's performance. The regulator is concerned that Thorium's programme of reform is over-ambitious and that there is too little contingency available in the business plan. The plan has already built in very large efficiency savings and relies on asset sales to achieve covenant compliance. The regulator is also concerned that Thorium has brought in an interim finance director a few weeks previously, without notifying the regulator. Thorium's new auditors have issued an Audit Management Letter (AML) raising controls issues, and lenders are expressing concern to the regulator about this and the way which Thorium have communicated with them about it. All in all, the regulator is concerned at the group's ability to cope with this period of rapid change and the needs of the various stakeholders involved, whilst having no immediate viability concerns. The regulator considers it needs much more assurance, and makes Thorium an intensive regulatory engagement case. A letter is sent to the Chair expressing its concerns.
Month 2	Thorium's board discusses its strategy. It wants to maintain an independent future but recognises the challenges facing it. It also confirms it wishes to continue with the regeneration project at Cerium but that in supporting Cerium it must protect the interests of Thorium. Discussions are in hand with the local authority and Thorium decides not to proceed with the rent waiver application. The Board asks the executive to draw up plans for a further £10m of cost savings. Thorium agrees to the regulator's request for a governance review. Thorium announces the departure of both the Chief Executive and Finance Director. An interim Chief Executive joins the existing interim FD.
Month 3	The regulator reviews viability and the grading remains as it was previously.

<table>
<tr><td></td><td>Thorium's discussions with the local authority continue, the master plan is revised and agreement is reached in principle on a new way forward, but the detail remains to be sorted out.

The regulator agrees to the merger of the two subsidiaries into the main association.</td></tr>
<tr><td>Month 4</td><td>Thorium revises its business plan which is now based on more realistic assumptions and is clear about what each business stream needs to achieve. Thorium's board sets up a series of away-days to take place during Month 5 at which it will consider the governance review, and options for the long-term strategic direction of the business. The regulator is reassured that the Board is now properly addressing the difficult decisions it faces.</td></tr>
<tr><td>Month 5</td><td>The governance review concluded that Thorium's governance arrangements were complex and unwieldy. Specific concerns include:
➢ Confusion over the roles of executives and non-executives
➢ Non-compliance with the parent's code of governance
➢ Some key issues are not given proper consideration by the Board because of poor reporting or crowded agendas
➢ Poor control of subsidiaries
➢ The Board's consideration of reports on risk was poor
The Board takes the view that the review looked at a snapshot in time, and that it does not accept all the findings. Nevertheless it agrees to some of the recommendations, including:
➢ Reductions in the size of the Board
➢ Changes to the committee structure
➢ A programme for board renewal
➢ Maximum terms of office</td></tr>
<tr><td>Month 6</td><td>The Board agrees that six members will stand down at the next AGM and starts to recruit replacements. This does not include the Chair despite them having reached the time limit.

Recruitment for a permanent Chief Executive begins.</td></tr>
<tr><td>Month 7</td><td>Work continues on asset sales and cost savings. Further office rationalisation and reductions in staff numbers are required.

Thorium agrees a level of support to Cerium to help kick start the regeneration scheme, and is also exploring the potential of alternative sources of funding for the regeneration including the possibility of additional investment by other registered providers.</td></tr>
<tr><td>Month 8</td><td>The regulator remains concerned at the Thorium Board's lack of acceptance of all aspects of the governance review. Thorium's action plan in relation to internal controls is considered to be too little, too slowly. The regulator sends a strongly worded letter to Thorium, again urging reconsideration of the Chair's position.</td></tr>
</table>

Month 9	Thorium completes revised business plans for the whole group and submits them to the regulator.
Month 10	A new Chief Executive is appointed and will start shortly. A problem comes to light with a recent major procurement with a potential cost of £13m to Thorium. This highlights further internal control issues. The regulator notes that procurement and contract management have been identified as problematic in several previous risk reviews and internal audits. It takes the view that this demonstrates systemic failure to deal with known risks and exposures quickly and effectively, and seek additional assurance from Thorium's board. Thorium instigates an inquiry into what happened. The Chair announces their intention to step down and recruitment for a replacement begins.
Month 11	The new Chief Executive takes up their post.
Year 2	
Month 2	The regulator downgrades Thorium's governance on the basis of: ➢ Poor risk management ➢ Serious weaknesses in financial planning ➢ Lack of control & support of Cerium ➢ Inadequate internal controls
Month 3	Thorium settles its claim against its supplier involved in the procurement issue. The terms remove a potentially significant financial loss, and restore Thorium's control over the contract.
Month 4	Thorium is implementing the revised business plan for the group, and also the new master plan for the Cerium regeneration project. Thorium agrees to on-lend to Cerium to sustain the project, and finalises further funding from lenders.
Month 6	The report into the procurement shows there had been significant historical control failures. The management response to the report demonstrates that Thorium has already put some better control mechanisms in place and has developed a robust action plan to resolve those issues that remain outstanding. The regulator is content with this as an initial response.
Months 7-9	The procurement function is reviewed and restructured, and a number of key contracts are re-negotiated. Internal audit is outsourced. The risk management process is overhauled.

Month 9	The last remaining board members stand down, so with the exception of Cerium's chair, there has been complete turnover of board members. A new post of Head of Governance is created. The committee structure is further revised and with it, new terms of reference developed. The new FD and team have thoroughly revised the budgeting process, and new financial policies and controls are being rolled out. The financial position and performance are much improved. There is headroom on covenants, and the business plan is no longer dependent on achieving efficiencies.
Month 10	The regulator holds an internal case review. It considers that Thorium has addressed the presenting issues, and that other problems which have arisen since have been effectively dealt with. Enough has been done to upgrade governance. Time is now needed to bed down the new executive, board and governance arrangements to ensure the structures and processes are effective in process as well as design.

Analysis

Thorium's plans were too ambitious - it tried to do too much, too quickly. It got so involved in its plans that the basics of management and control got lost in the 'noise', and both the Board and the executive failed to engage in appropriate risk management. Then when things started to go wrong, Thorium's recovery plans were similarly complex and over ambitious.

The Board had not heeded warning signs over a number of years. When its governance shortcomings were pointed out, both by consultants and by the regulator, the Board did not accept it. It was a classic 'board in denial'. It took a crisis of confidence by the regulator and resultant regulatory action to jolt the Board into acceptance of the need for change.

The problems at Thorium were not insoluble, and a more measured approach might have saved the situation without any of the ensuing drama. In the event, it took virtually a complete change of executives and non-executives to turn Thorium around. The much more sober approach by the new team demonstrated in the second half of the timeline enabled Thorium to work systematically through the issues and reach appropriate solutions. This was assisted by the measured approach taken by the regulator.

Conclusions

Once again the key lesson for associations is the importance of proper systems for the identification, control and management of risk, and the exercise of proper controls. These underpin everything else that the Board does. There is no evidence here of a strong audit committee's influence and control either, which might have provided a brake – or at least a salient reminder – to the Board when things were spiralling out of hand.

The procurement problem illustrates how seemingly unrelated things can go awry when there is not an appropriate culture of control and overview. Although many organisations would attempt to explain this sort of issue as a one-off, perhaps down to a rogue employee, time after time the evidence points to it being the organisational culture which creates an environment that allows or even encourages such incidents to happen.

Chapter 7: Carbon Group - complexity and contentiousness

Background

A group structure with a non-stock holding parent Carbon, and a number of subsidiaries, one of which (Silicon) is very much larger than the others. The Group is without a permanent Chief Executive, and there is an interim in post.

The group considers its future strategic direction following a consultant's report setting out structural options. Differences arise between Carbon and Silicon regarding the future of the group, with Silicon wanting to de-couple from the group and the remainder wanting to collapse the group. The governance structure is so arranged that the members from Silicon can block the group board from taking action, and an impasse is reached.

Timeline

Year 1	
Month 1	A short notice inspection of Silicon by the Audit Commission identifies 4 out of 5 areas where weaknesses outweigh strengths, and comments adversely on governance and executive leadership difficulties which impact on service delivery. The regulator holds an internal case review to consider this and also notes: ➢ A recent review of governance which identifies a number of weaknesses and recommends a collapsed group structure ➢ The difference of opinion over the structure and strategic direction of the group and the impasse reached at board level ➢ The constituency composition of the Carbon board which has the potential to allow any subsidiary to block any vote requiring a 75% majority – as is currently the case with Silicon and the revised group structure ➢ The continuing absence of a permanent Chief Executive and the destabilising effect this is having on the staff team and on services ➢ A number of breaches of the NHF Code of Governance, to which Carbon subscribes.
Month 3	The regulator accepts a joint voluntary undertaking from Carbon and Silicon. The key actions agreed are: ➢ Carbon will commission a detailed governance review, and the group will accept and implement its findings ➢ Carbon will appoint four new independent members to its Board ➢ A steering group comprising mainly the new members will oversee the governance review process.
Month 6	The governance review is underway. Three independent members are co-opted to the Carbon Board.
Month 7	The Chair of Silicon resigns from the Carbon Board and indicates their intention to step down from Silicon as well.

Month 8	The Group Chair announces their intention to stand down. Recruitment gets underway for the permanent Chief Executive. Consultants present their draft report, recommending collapse of the group. Early indications are that it is well received.
Month 9	The final governance review is presented and all the boards agree the proposals to collapse the group. An implementation plan is developed, which the steering group continues to oversee.
Year 2	
Month 1	A new Chief Executive starts work, and a new Chair of Carbon is appointed. A problem is identified with the group structure proposal in that the need for lenders' consent is likely to trigger re-pricing of the loan book. In the current economic climate this is not an acceptable proposition. With its legal advisers, Carbon develops an alternative plan to create an administrative/operating structure which mirrors collapse without implementing the legal structure that would need lenders' consent. This is Phase 1; Phase 2 remains the long term intention to formally collapse the structure, when market conditions allow.
Month 6	The administrative structure is in place, and the new combined board has been established and is about to start to meet. It comprises ten common members, with one additional separate member for each of Silicon and the other subsidiary boards.
Month 8	Re-structuring the senior management team is complete. This reduces the team from five operational directors to three strategic directors.
Month 10	The regulator confirms that the voluntary undertaking has been discharged and Carbon returns to routine regulation. Carbon is to be upgraded for governance shortly.

Analysis

As at Argon, it was the problems with governance which led to the failures of service delivery. In this case it was not the complexity of the structure so much as the conflict in the relationships which caused the problems:

- The various boards were at odds with each other, and relationships were strained;
- The board membership structure gave too much weight to the subsidiaries, leading to a position where an individual subsidiary could over-ride the wishes of the remainder of the group;
- The group had been without effective executive leadership for some time. The permanent Chief Executive had left, and temporary internal arrangements had been made prior to the appointment of an externally sourced interim Chief Executive some considerable months later. Strife was evident within the management team.

This case was resolved relatively quickly, particularly in the light of the somewhat dysfunctional state of affairs at both executive and non-executive levels at the beginning of the case study. It is notable as an effective example of the concept of the 'virtual collapse' of a group.

The regulator considered using its regulatory and enforcement powers to make statutory appointments to the Board, but instead decided to accept a voluntary undertaking from Carbon. The undertaking required Carbon to make voluntary co-options to the Board so as to restore the balance of power to the parent organisation, and also to commission a detailed governance review. Extensive changes were then made to the structure and membership of the common group board, including reducing representation of the subsidiaries down to one per subsidiary.

It is clear from the regulator's internal documents that it was very conscious of the need to get the voluntary undertaking right. It took legal advice to ensure that the undertaking complied with its statutory powers and with the published guidance. It also wanted to ensure that its hands were not tied, if things went wrong. It was a step in the dark for Carbon, too. In the event, all parties worked well together and the choice of a voluntary undertaking was successful in achieving everyone's objectives. In particular, it precluded the need for formal regulatory action, with its concomitant repercussions for Carbon.

The concept of a virtual collapse of a group structure is now quite widespread. There are a number of reasons why actual collapse may not be possible, but at the time of this case study there were particular problems with lenders threatening to re-price loan books as the quid pro quo for giving consent to constitutional change. The creation of a combined board with a majority common membership and minority subsidiary membership worked well for Carbon. It was a creative and effective solution to an otherwise messy problem. Since the end of the case study, Carbon has been able to revise its legal structure, as well.

Conclusions

In creating a group structure, it is essential to ensure that the parent organisation does actually have effective control over the subsidiaries. This should of course be written in to the various bodies' constitutions and the intra-group agreement, and reflected in governance policies and practices. However the Carbon case study demonstrates the need to check carefully to ensure that this is the case and that there is no accidentally built-in ability for the 'tail to wag the dog'.

The regulator was evidently aware of a number of issues by the time the Audit Commission inspection outcome precipitated an internal case review. With hindsight, particularly being aware that Carbon had been without a Chief Executive for a considerable period, perhaps it should have been keeping a closer eye on events. However, once the regulator did pick it up, it was dealt with speedily and with marked success. The case provided an excellent example for both regulator and regulated as to how effective a voluntary undertaking process can prove to be.

Chapter 8: Ujima Housing and the bridge too far

Background

Ujima is a long established association with a history of occasional regulatory engagement, but also of significant achievement as a community based organisation, and a flag carrier for associations with a Black and Minority Ethnic (BME) focus. It is a development partner and has an unusually large development programme relative to its size.

It is named in this volume, as all the events described are in the public domain, and were the subject of an independent inquiry, the report of which was published.[15]

In the past few months, a new Chief Executive (who comes from outside the sector) has recently taken up post. This is Ujima's fourth Chief Executive in as many years. The entire executive team of eight has been replaced, and only three have housing sector experience. The new team develops a innovative and ambitious business plan which aspires to expand the range of business streams to include a number of arm's length commercial subsidiaries, and to develop many more new homes. This is approved by the Board.

Ujima's board is small. Three experienced members have left and not been replaced. While it has strong community links and some members have relevant skills, overall it does not have the full range of skills required to oversee the implementation of such a business plan.

The regulator has already placed Ujima on its 'watch list' because of potential weaknesses highlighted in an external review and some poor relationships with development partners. Ujima currently has the top regulatory status, although the most recent viability assessment highlights some concerns, while noting that Ujima's financial position could, if necessary, be improved relatively quickly by scaling back on development.

Timeline

Year 1	
Month 1	Various allegations are sent to the regulator regarding a range of matters at Ujima. The regulator asks Ujima to investigate. Ujima does not respond positively and complains to the regulator about the way in which it has handled the allegations. Ujima's development programme appears to be slipping. Ujima gives the regulator assurances that targets will be met. The regulator classifies Ujima as medium risk and embarks on a strategy of enhanced regulation, including requesting sight of all Ujima's board papers. However these are not supplied, or only sporadically.
Month 3	A new capacity model is submitted to the regulator but does not incorporate the new business plan, the detail of which is still being worked up. There are errors in the model and Ujima is asked to review it.

[15] Now available at: http://webarchive.nationalarchives.gov.uk/20080912120601/http://www.housingcorp.gov.uk/upload/pdf/Ujima_report_FINAL.pdf

Month 5	A further updated model is submitted but still does not incorporate the financial detail of the new business plan. The regulator holds a meeting with Ujima's auditors to discuss the late sign-off of Ujima's accounts. An extension is agreed. The regulator considers downgrading the association's management because of failure to achieve a post-Audit Commission inspection improvement plan. Ujima challenges this, including the regulator's motives, and the regulator agrees to allow them a further three months.
Month 6	The development programme is slipping significantly. The regulator asks Ujima to update forecasts for completions and expenditure. The regulator considers downgrading development but instead asks Ujima for an action plan for delivery.
Month 9	The accounts are signed off. The Audit Management Letter raises serious concerns about Ujima's development capabilities and expertise, about accounting practices and a possible covenant breach. The regulator requests a formal response from Ujima, which is not received until year 2 month 1. Revised development forecasts have proved to be inaccurate and do not relate back to the capacity model. The regulator asks Ujima to review them yet again.
Month 10	The regulator completes its viability review and gives Ujima a green light. However it notes concerns about the aspirational business plan and growth projections. The reports on the earlier allegations conclude either that there is no substance to them or that evidence is insufficient to take matters further. Nevertheless the reports highlight a number of procedural, policy and internal control weaknesses. The regulator asks Ujima to put together an action plan to address them.
Month 12	The development programme performance has slipped still further. The regulator downgrades Ujima's development traffic light to red and withdraws Ujima's development partner status.
Year 2	
Months 1-3	Further allegations are received by the regulator regarding staffing issues and possible Schedule 1 breaches. The regulator asks Ujima to investigate but this is never completed.
Month 2	In the light of the downgraded red light for development the regulator issues a new assessment, with all the other traffic lights remaining green.
Months 3-5	Following the poor development performance, the regulator decides to undertake a review into governance. The conclusion of the review is that the Board of Ujima is not maintaining adequate oversight of the organisation's development function, and that the Board is not providing effective leadership.
Month 5	Ujima tells the regulator that it will not be able to sign off its accounts on time. A one month extension is agreed. Questions arise as to whether Ujima is working to the most recently approved version of its Rules. It is doubtful if existing and proposed new board members are properly appointed. Next month's AGM is cancelled.

Month 6	The regulator holds a formal case conference and considers all of the above, and Ujima's failure to cooperate. It decides to place Ujima in supervision. Three statutory appointments are made to the Board. The AGM goes ahead after all, at very short notice.
Month 7 **Week 1**	The regulator meets with Ujima's auditors again. The auditors and Ujima are in dispute over the accounts. The auditors are concerned that transactions in the accounts will place Ujima in breach of loan covenants and lenders have not been advised. It is also concerned about impairment. Ujima submits a Section 9 consent request for a substantial loan. The regulator is unable to process it because the documentation is inadequate and because the previous year's accounts are still not filed. The regulator now has serious concerns about Ujima's short term cash position.
Month 7 **Week 2**	Legal advice confirms that apart from the appointees and the tenant members, all other board members have been invalidly appointed over the last 4 years. The appointees and the tenant members act together to constitute a new Board with a substantially different membership. This new Board suspends the Chief Executive and the Finance Director, and commissions an urgent independent inquiry into Ujima's financial position.
Month 7 **Week 4**	The review reveals unexpected operating loss for the previous year and significant further deterioration of Ujima's financial position during the current year, including the likelihood that Ujima will run out of cash in Month 8. It appears that some part of that deterioration in Ujima's financial position may relate to the purchase of land and continuing unsubsidised development activity following the withdrawal of development partner status, and the investment of significant sums in the renovation of Ujima's headquarters offices. The Board concludes that its financial position means that the association is in breach of its loan covenants and is not in a position to raise further funds. The Board agrees that Ujima cannot sustain an independent future. Following consideration of a number of proposals, it agrees that the best option is to transfer the stock of Ujima to another housing group. Board members work behind the scenes with the regulator and legal advisers to consider options in more detail.
Month 8 **Week 3**	A stock transfer proposal is put to shareholders at a special general meeting, and the motion is lost.
Month 8 **Week 4**	Ujima presents a winding up petition to the court on the basis that it is no longer able to meet its debts as they fall due. The following day, secured creditors serve Notices to the regulator and then take the steps necessary to appoint a receiver. This triggers a 28 day moratorium under Part I of Housing Act 1996, which means the regulator may put proposals to Ujima's secured creditors to ensure tenants homes are not put at risk, protect public investment in Ujima's housing stock and safeguard the interests of Ujima's creditors.

Month 9 Week 3	The regulator considers the options including possibility of transfer to one of several associations who have expressed an interest. It selects one as being the best possible option to deliver the regulator's statutory obligations to tenants, creditors and the taxpayer. The regulator puts the proposal to Ujima's secured creditors and it is agreed. An insolvency manager is appointed, and two days later the transfer is completed.

Analysis

Following the collapse and receivership of Ujima the regulator sets up an independent inquiry. This analysis draws on the conclusions reached by the Inquiry.

How the problems went undetected

At the heart of this case study is a management team which was collectively out of its depth, and a board which was weak and inexperienced and not able to recognise, let alone control, what was happening. Ujima pursued an aspirational growth plan without the resources or experience to manage existing services, let alone deliver an ambitious development programme.

Neither Ujima's board nor the regulator was provided with sufficient and reliable information to understand the scale of the financial problems. The Board was uninformed, under-informed or misinformed on key issues. Both the Board and the regulator took assurances from management too readily. Despite the lack of adequate information, subsequent examination of board agendas and papers does reveal:

- An identified £7m overspend on the development programme
- The Chair of development committee had resigned and no development committee meetings were held after Year 1 Month 3
- The response to pressure from the funding agency regarding delivery was to land bank;
- No management accounts were presented for a period of about nine months
- For a period in excess of 12 months, Ujima had not considered risk at board level.

But the Board itself did not pick up on these issues as raising alarm bells – interestingly three of these points relate to events or reports which should have been routine, but which didn't actually happen. The Board did not spot the gaps. The Board had insufficient expertise, and the loss of three experienced members seriously undermined its subsequent effectiveness. Only one member really made any challenge but as a lone voice, this was not sufficient. The regulator did not follow through on its request for sight of board papers, and so it too missed out on this vital information. Awareness of these issues would have ratcheted up the regulator's concerns.

The Inquiry concluded that in the latter part of Year 1 it was unwise for the regulator to discount financial viability as a potential concern. However, even after downgrading development to red in Year 2, the regulator did not amend the other traffic lights. This gave a confused message to Ujima and to the outside world. It encouraged Ujima to think it could develop its way out of problems.

Conclusions

Ujima's collapse was caused by its own bad management and an ineffective board. However, the outcome may have been different if the regulator had taken more decisive and earlier action.

The regulator did have serious concerns, but was unwilling to take action without what it considered sufficient evidence. It considered all the issues individually but did not conflate them. On individual issues the regulator felt they were not serious enough, or there was not enough evidence, or that it was a business rather than a regulatory matter (the ambitious business plan) or there was scope for improvement without supervision. The constant obstruction, challenges and threats of legal action from Ujima did not help the regulatory process, either. With the benefit of hindsight, the regulator adopted an over-cautious approach and should have intervened earlier as a series of signals indicated mounting problems.

Once the regulator did intervene, its role was successful inasmuch as none of the funders and creditors lost money, and the tenants kept their homes. However the Inquiry concludes that this success was dependent on two factors – that the defect in the appointment of board members meant that effectively a new board could be appointed who were willing and able to work together to find a solution, and secondly, that there was another association able and willing to take Ujima on. As the Inquiry concludes, these were two fortuitous circumstances which cannot be relied on to recur in any similar situation.

The Inquiry also considered the extent to which the law and practice regarding insolvency was effective and appropriate for housing associations. It identified a number of problems with the insolvency process which it considered unsuited to an organisation that has public services to deliver, but which could not be delivered if its assets were to be sold off by a receiver acting for a lender. The Inquiry made a number of other recommendations for change, which go beyond the scope of this review.

Chapter 9: Neon Group: problems with property

Background

Neon is a provider with an expressed commitment to investing in communities.

There is a history of regulatory concerns, including a challenge to the Audit Commission and subsequent poor response to its findings, and a finding of severe maladministration by the Ombudsman. The regulator has been keeping a close watch on Neon over an extended period of time but has not taken any enhanced regulatory action.

These events take place at a time of economic crisis, with credit very tight and property values falling sharply. Neon has a substantial programme of sales of homes, and also holds considerable development land which either has no planning permission or no allocation or both.

Timeline

Year 1	
Month 1	The regulator downgrades viability as a result of: ➢ An on-going inability to service interest payments from operating cash flows ➢ Inaccurate forecasting ➢ A very poor Audit Management Letter Neon's investment partner status is withdrawn. Neon is asked to put together a brief for a governance review, focusing on financial management, audit and controls. The regulator meets with Neon's Board to explain its expectations and to advise of a forthcoming internal case review. The Board is asked to recruit new members with relevant skills, in advance of the review's findings.
Month 2 **Week 1**	One of Neon's lenders contacts the regulator explaining that no further drawdowns will be permitted because of the viability downgrade, and until Neon complies with various information requests including management accounts. The regulator contacts Neon's Chair to discuss, and it becomes apparent that the Chair is not aware of the situation. This causes the regulator to question the relationship between the executive and the Board. Neon is due to meet another lender this same week to finalise another drawdown. It appears that unless this facility is agreed and drawn, Neon will run out of cash in less than two months.

Month 2 **Week 2**	Neon advises the regulator that two new board members have been appointed. However the regulator remains concerned about the strength of the board and notes that the governance review has not yet been commissioned. The regulator holds a case conference. It has concerns about governance: ➢ Lack of skills & experience on the Board ➢ The Chair's ability to control the association ➢ The relationship between the executive and non executive teams. And about finance and development, in particular: ➢ Liquidity ➢ Loan covenants and relationships with lenders ➢ The budget position ➢ Land banking and impairment; ➢ Unsold homes and cash flow implications ➢ Mixed messages about future development The regulator notes that whatever actions it takes may cause difficulties because of the economic climate, and notes that putting Neon into intensive regulatory engagement may precipitate a loan default and lead to insolvency. However its deep concern about how Neon has handled the last few days is such that it nevertheless decides to place Neon in intensive regulatory engagement and to make statutory appointments to the Board. The regulator writes to Neon to inform it, and requires Neon to put together an action plan addressing the points above.
Month 3	The communications with the regulator cause Neon's board to question the association's management. Following a board meeting it is agreed that the Chief Executive will leave the organisation. Three appointees join Neon's board. A review of Neon's development programme highlights significant exposures in the pipeline, relating particularly to the value of its land bank and to potential abortive development costs. This has a major impact on its accounts. Neon is in discussion with its auditors about finalising those accounts on a going concern basis. This is complicated by the fact that the draft accounts lead to breaches of covenants with lenders which need to be remedied by letters of waiver from the lenders. The lenders are being robust, both in respect of their information requirements and the pricing of their loans. If Neon is not able to continue to draw down cash from the lenders it could continue to pay bills for around one month, but the Board would clearly be in a difficult position regarding trading. The regulator undertakes a confidential piece of internal work to identify possible rescuing partners and is confident it can achieve this if necessary.
Month 4	Neon's board decides to seek a merger partner. The Chair, disagreeing with this course of action, resigns. The accounts – now late – have still not been signed off, because the 'going concern' issues are not yet resolved.

Month 5	An experienced interim Chief Executive starts in post. Neon, with the help of consultants, continues its search for a merger partner.
Month 7	The accounts are finalised and signed off by the Board and the auditors without qualification. The business plan is accepted by funders and the principal lender is prepared to back the cash flow requirements, at least for the short term.
Month 8	The interim Chief Executive is successful in stabilising operations. Neon holds a beauty contest and chooses its preferred partner. A very quick merger timetable is agreed, with the intention being to complete the merger by the end of month 11.
Month 9	The partner's board approves proposals to bring Neon within its group.
Month 10	Neon's AGM approves the rule changes necessary to bring about the merger.
Month 11	The regulator considers the business case for the merger and gives consent to the rule changes.
Year 2	
Month 1	Neon becomes a subsidiary of the partner association. The statutory appointees stand down and Neon is removed from intensive regulatory engagement.

Analysis

Neon had a history of challenging the agencies with which it had dealings, and of not accepting their findings and criticisms. The Board lacked the skills needed to manage the association, and this was exacerbated by the fact that it was not fully informed about some key issues. This was an extremely dangerous combination, and meant that there was inadequate control over the executive. Neon got itself into a position which was not tenable in either a financial or regulatory sense.

There was a particular lack of financial skills and expertise on the Board, and a consequent failure to appreciate the wholesale lack of financial performance and management. The Board did not control the financial risks that it was taking. The Board was not challenging the executive. There are strong similarities to Ujima here.

The appointments to the Board were crucial to steering this along the tracks, since the lack of skills on the Board beforehand was one of the key causes of Neon's situation. The departures of the Chief Executive and Chair were also critical.

An interesting move made by Neon early on was to appoint two new board members, and this seems to have been an attempt to head off the regulator's possible regulatory action. However it was an ill-conceived, rather knee-jerk reaction which had the opposite effect, causing the regulator to have additional concerns. It seemed to characterise the rather peremptory way in which Neon went about things, without giving enough thought to its actions.

The period spanned by this case study is incredibly short, and shows what can be done when needs must. From entering into intensive regulatory engagement to completion of the merger took less than a year, and from choice of preferred partner to completion of merger took less than four-and-a-half months, including all necessary consents. Once it was clear that rapid and drastic action was needed, all the stakeholders involved, including lenders, moved quickly and cooperatively to achieve it.

The situation in this case study, like many of the others, was made much worse by the global economic crisis. Had the situation arisen a few years earlier, Neon might have been able to manage its way out of it by means of higher land values and readier asset sales. However the economic crisis was not the cause of the problem, but just one of the circumstances surrounding it.

Conclusions

Whilst this is a prime example of just how quickly things can be done, the question remains as to whether the regulator should have acted earlier. Neon was clearly on the radar much earlier, and with hindsight there were perhaps enough warning signs which meant it should have been escalated through the internal case management system before it became an outright crisis. Nevertheless once the crisis did materialise, the regulator was very proactive in addressing it and achieved a very satisfactory outcome.

The regulator also took steps behind the scenes to put in place a rescue merger, should it have been needed. In the event Neon managed the process of selecting a partner itself. Nevertheless the regulator did a good job in developing a Plan B, not just for the benefit of Neon but for the sector as a whole.

For associations, the lessons are once again about having the skills and expertise on the Board that enable the Board to make constructive challenge, ask the right questions and ensure that actions are seen through once begun.

Chapter 10: Osmium Community Housing and the 'soap opera of shenanigans'

Background

Osmium is a small locally based association.

Timeline

<table>
<tr><th colspan="2">Year 1</th></tr>
<tr><td>Month 1</td><td>There has been a history of problems within Osmium, including whistle-blowing allegations about maintenance and lettings. Osmium is in regular contact with the regulator. The Board responds by initiating various reviews and audits, which although generally finding the allegations not to be true, do highlight poor controls and poor practice, particularly in maintenance. The regulator holds an internal case review -which notes that:
➢ Osmium has been without a Chief Executive for around eight months, since the Board dismissed the previous Chief Executive
➢ There have been complaints about the Chair
➢ There has been a series of internal and special audits with limited assurance and showing lack of internal controls
The regulator decides to put Osmium in intensive regulatory engagement, and repeats previous advice to the Board that it needs to be strengthened. The Board approaches various consultants for assistance.</td></tr>
<tr><td>Month 4</td><td>A new Chief Executive takes up post. Two former board members are brought back onto the Board. Another potential member is invited as an observer for six months. A governance review is in progress which includes recruitment of further independent members.</td></tr>
<tr><td>Month 6</td><td>An action plan is to be developed which brings together the actions from the various audits and investigations, and a consultant is brought in to manage this process.</td></tr>
<tr><td>Month 11</td><td>Following the governance review, the Board agrees to adopt the NHF Code of Governance, and adopt a retirement plan which would make it compliant with the 'nine-year rule' within two years. Three new members are recruited to join Osmium's board, but are required to join as observers for six months. The consultant's report is due on the action plan, but has been delayed due to the absence of the Chair.</td></tr>
<tr><td>Month 12</td><td>There is evidence that the Board is wasting time on trivial issues and not prioritising key concerns. A paper by the Chief Executive due to go to the Board as a preliminary to restructuring is 'pulled' by the Chair without good reason.
A consultant's report is also scheduled for this meeting but is also not discussed, apparently because a former board member has made a complaint about the consultant.
The board meeting does not finish all the business on the agenda and a further ad</td></tr>
</table>

	hoc meeting is called for three weeks later. This second meeting lasts nearly three-and-a-half hours but still does not complete all the business. It is suggested at the meeting that the Chair should stand down in the best interests of the association, but this is rejected. It becomes apparent that the relationship between the Chair and Chief Executive has broken down. The Chief Executive indicates he may not be able to carry on for much longer. There is a risk he will leave the organisation, leaving it again leaderless
Year 2	
Month 1	The consultant's report highlights governance weaknesses as well as personnel and procedural problems. One of the observers drops out because of concerns about how the Board operates, one observer is not accepted into full membership for reasons which are unclear, and an existing board member resigns. The core of the Board is now six members all with between 12-23 years on the Board (although two have a break in service), two other independent members and two observers.
Month 2	Osmium responds neither to the membership situation nor to the consultant's report. The regulator writes to Osmium setting out deadlines for actions and setting out expectations. In relation to board membership, the regulator points out that after 20 months of trying to recruit new members, only two genuinely new members have actually joined, and that the six-month observer status is hindering the process. Meeting the retirement plan looks unlikely. Other issues raised include: ➢ Osmium is still without a settled senior management team, and that this is impacting on service delivery ➢ The audit committee has only met twice in the last year and is not making a valuable contribution to assurance or risk control ➢ Management accounts are not being regularly monitored ➢ There has been no individual or collective board assessment in the prior year The letter makes clear that regulatory enforcement action will follow if Osmium's responses are not deemed appropriate.
Month 3	Another three members are recruited and are expected to join the Board straightaway. The Chair agrees to stand down at the next AGM. Osmium commits to dealing with all the outstanding actions over the next couple of months.
Month 6	Osmium completes a new business plan which provides the focus for a programme of reform to address the remaining weaknesses. A restructuring of the organisation is also under way, an essential element of which is reorganisation of the maintenance function.

Month 8	Externally facilitated recruitment of a replacement Chair is in hand, ahead of the AGM. The regulator and Osmium's Chief Executive meet and agree that progress is being made. The key governance issues are moving forward and the board papers indicate that the Board is getting the necessary information to exercise proper oversight of the business. The regulator confirms that Osmium is now meeting the regulator's standards in relation to viability and governance.
Month 9	Progress continues to be made, and the regulator removes Osmium's intensive regulatory engagement status .

Analysis

Osmium ended up in intensive regulatory engagement as a result of what the regulator's documentation describes as a "soap opera of board shenanigans", and a complete breakdown of relations between the Board and the Chief Executive. The regulator's eventual threat of enforcement action did force through changes at board level, and other problem areas improved rapidly as a result.

At the heart of this case study is a board which has been in place for too long, without a clear idea of what good governance looks like, and without fresh ideas and thinking being brought in from outside. The regulator's description of this as a "soap opera" seems particularly appropriate. There were long standing failures of governance and management which had not been tackled. The Board is insular and lacks understanding of its governance role to the extent that it failed to monitor services provided to tenants and to assure itself about controls and risk.

The lack of board turnover and renewal was a key factor in the poor governance at Osmium. The core board membership – those with the very long service – effectively impeded progress, even though this did not appear to be a deliberate strategy. The lack of turnover meant that the Board could comfortably keep repeating mistakes it had made previously – board recruitment, relationship with the executive, unresolved personnel issues, unmonitored services – in a form of collective group think. Often where there are very longstanding boards, the problem is that a cosy relationship builds up between executives and non-executives, with a lack of challenge. Here the opposite happened – not so much lack of challenge as simply creating bad feeling and preventing executives from getting on with their jobs.

Osmium adopted the NHF Code of Governance part way through this case study. But although it adopted it in theory, there was little evidence of any changes in practices to achieve compliance. The Board had not made effective arrangements to review governance and to appraise its own performance, nor to review recruitment practice. Its requirement for a six-month observation period not only hindered recruitment of new members in the sense of causing delay, it also created a situation where observers who did not like what they observed could decide not to go ahead, without feeling the commitment to stay and resolve problems which might have influenced them had they been full members.

The regulator finally lost patience with Osmium. It was not until the threat of formal action that Osmium did take steps to bring new members in straight away, and for the Chair to agree to step down; from then on things did improve.

Conclusions

This case is another where the lack of board renewal is the underlying cause of the problems which arose. Effective governance policies and practices are essential underpinning, and were absent. The absence of policies on membership, terms of office, succession and recruitment, and the lack of an effective system of board and individual member appraisal allowed a highly unsatisfactory situation to simply roll on, unchecked. The regulator's eventual loss of patience should probably have happened earlier. While this is understandable, the prompt response to the threat demonstrated that taking earlier action would probably have resulted in earlier resolution. It was not necessary to go all the way to formal action, a sharper reminder proved to be enough.

Chapter 11: Zirconium Housing - risk and subsidiaries

Zirconium is a small association, which has set up a number of subsidiaries carrying out community based activities. Serious concerns arise about financial viability which are in some considerable part due to the losses made by the subsidiaries. There is an evident lack of financial control and risk management. The Board accepts the need for change and sets about it with some vigour. Changes in board and management team accelerate this still further, but investigations also bring to light other problems.

Timeline

Year 1	
Month 1	Concerns about governance arise when it becomes clear that Zirconium is not operating an effective risk management framework, particularly in relation to its business expansion. In addition Zirconium is not offering tenants sufficient opportunity to influence group strategy and direction. Further concerns arise about financial viability. Deficits incurred by subsidiaries lead to a cash flow crisis and a consequent loan covenant breach. There is evidence that financial management and internal controls are not operating effectively. The regulator downgrades viability and governance, and asks for weekly cash flow statements. The Board accepts the need for change, and takes rapid action to alleviate cash flow exposure and renegotiate loan facilities. Zirconium begins a strategic review and develops a governance improvement plan. The regulator considers the actions taken give it comfort and that there is no need to take further formal regulatory action, although Zirconium is under intensive regulatory engagement.
Month 4	The investigations by the Board are highlighting previously unidentified performance concerns, and these are creating further pressure on resources.
Month 5	The Chair and four other longstanding members stand down. New members are recruited. A new Chair of Audit is appointed.
Month 6	A new business plan is developed. The strategy is to reduce in size and focus on housing. Zirconium decides to close down a commercial subsidiary immediately, and starts to take steps to divest itself of two other subsidiaries. A group cost improvement plan is agreed, including overhead reduction.
Month 9	The cost improvement plan is in progress. The two subsidiaries leave the group. The Chief Executive leaves Zirconium.
Month 10	A new Chief Executive and new Finance Director start in post. Zirconium adopts the NHF code of governance starts works to implement this, prioritising frameworks for risk management and controls. A tenant engagement strategy is developed and a tenant member is co-opted onto the Board.
Year 2	
Month 2	Work on the accounts indicates that the loss for the previous year is likely to be

	significantly higher than expected. It becomes apparent that Zirconium has not achieved target rents and has not applied for an extension or exemption.
Month 3-4	Work continues to complete the governance improvement programme and restore financial stability.
Month 5	Various positive steps forward are taken: ➢ A commercial tenant is found for an office surplus to requirements, thus reducing risk ➢ A longstanding employment dispute is settled in relation to one of the former subsidiaries ➢ Treasury advice is taken in relation to loans due to be re-financed shortly ➢ Application is made for an extension to rent convergence
Month 7	Zirconium successfully concludes funding negotiations, and loans are available that will provide certainty of funding for at least the next five years. The regulator upgrades viability. Zirconium is removed from intensive regulatory engagement.
Month 9	The regulator comments in its published judgement returning the provider to a compliant rating that throughout a difficult period, the Board has shown commitment and leadership.

Analysis

At the beginning of the case study, the Board seems to have lost its way. Subsequent events demonstrate that the Board had not been exercising its risk management functions effectively, and was not sufficiently focused on internal controls and assurance. The business had expanded into a number of areas peripheral to housing which proved to be loss making, but the Board's financial management was not effective either in foreseeing this or taking appropriate action when it occurred.

Zirconium's organisational structure was complex and this placed too much strain on the association's relatively small resources. Reducing the number of subsidiaries was important to ease both the financial and administrative burden, and allowed Zirconium to improve its cash position. Zirconium has continued to slim down the structure even further.

Zirconium's board had a number of longstanding members which was a contributory factor. The situation at the beginning, and the problems which subsequently became apparent, are all indicative of a board which did not sufficiently question or challenge the information put to it by the executive. This is a typical feature of boards and executive teams which have worked together for too long without sufficient changes in the personnel involved to shift the dynamics of the relationship.

Although the Board reacted promptly to the initial contact from the regulator, momentum really built up after the changes to the Board. The updated board consisted of 12 members, of whom five (including the Chair) were new. There was a significant reduction in the average length of time which board members had served, and at the same time the introduction of new skills and experience. Members were able to challenge some of the thinking and practices which had prevailed for a very long time.

On a positive note, Zirconium demonstrates that things can deteriorate to a really quite poor position, but yet be turned around quite quickly without the need for statutory appointments and enforcement action. Once the regulator gave Zirconium a sharp spur, it set off with a will and was able to make the necessary changes themselves with only minimal intervention. The key to this was the new Chair and executive team, who demonstrated an open and constructive approach to Zirconium's relationship with the regulator. As a result the regulator was content to allow Zirconium the time and space it needed to make the changes. Both Zirconium and the regulator deserve credit for this.

Conclusions

Once again we see the importance of having effective governance practices which allow the Board to exercise proper oversight and control. Here there were deficiencies in risk management and in internal controls and assurance, which frequently go hand in hand. It took a third party to point the deficiencies out to Zirconium – it should have been able to find it out for themselves if it had the Board had appropriate models for risk and assurance, and system for assessing whether it was adhering to the models.

Allied to this is the importance of board renewal. The NHF Code of Governance provides the basis for developing an appropriate policy using the nine-year rule as a starting point. This did not happen here because Zirconium only adopted the Code as part of its response to the problems. As with the risk and assurance, a more proactive approach to governance might have prevented the problems.

Chapter 12: Strontium Housing Company and its long troubled history

Background

Strontium is an organisation which since its foundation has had difficulties in meeting its business plan. It has struggled with viability issues and has been subject to regulatory action in the past. It is placed in intensive regulatory engagement again with a range of issues across the whole spectrum of finance, governance and management of the association.

Timeline

Year 1	
Month 1	Strontium is placed in intensive regulatory engagement because of its failures to meet its business plan and viability concerns.
Month 10	An Audit Commission inspection awards zero stars, with uncertain prospects for improvement.
Year 3	
Month 7	A further Audit Commission inspection awards 1 star, with excellent prospects for improvement.
Month 8	The regulator raises concerns about financial viability, the main issues being continuing failure to achieve business plan targets, particularly in two key areas of asset sales and costs of estate renewals. The Decent Homes position is unsatisfactory.
Month 10	A new CEO starts.
Year 4	
Month 5	Problems come to light in relation to procurement. Strontium's Chair resigns because of loss of confidence from the Board. A governance review commissioned, and the brief is agreed with the regulator. Two new directors start.
Month 6	A new chair starts – a former appointee of the regulator, recently co-opted back again.
Month 7	A new Company Secretary starts, and leaves again within 5 weeks.
Months 8 & 9	Five board members resign in period of two months, two apparently because of concerns about internal controls and loss of confidence in the association. Strontium is having difficulty in holding quorate meetings.

Month 9	The regulator has continuing concerns about viability, which are essentially unchanged since the previous year. The regulator notes past financial performance against previous business plans has been poor, and that Strontium has key challenges over the short to medium term to ensure its viability: ➢ Maintaining financial performance within the agreed business plan parameters, with the potential to breach covenants if not achieved ➢ Delivering the accelerated DHS programme within the resources identified ➢ An apparent absence of contingency plans which can be readily realised
Month 10	Following recruitment, the Board is back up to adequate numbers. The regulator holds an internal case review. It has concerns relating to viability, and to governance and management: ➢ The Board does not have the skills or structure required to govern the association ➢ A number of allegations have been made, from a variety of sources ➢ Relationships with unions are deteriorating and staff morale is low ➢ Relationships with the local authority are deteriorating ➢ There are service delivery failures ➢ The AC action plan is not completed; among the key actions still outstanding is the customer care strategy The regulator concludes that Strontium's board does not have sufficient strength to give proper consideration to the organisation's strategic future. However it decides to defer a decision about making statutory appointees until after the Board's imminent away day, which is to consider the governance review. On the day of the board away day, further allegations are received by Strontium's Chair. Strontium takes urgent legal advice. The away day proceeds and the Board decides it does not have an independent future and that it will look for a merger, preferably with a locally based partner.
Month 11	Further allegations are made. An independent external investigation into all the allegations is commissioned. The regulator considers that in order to execute its intention to find a merger partner, it will need additional strength on its board. Accordingly, Strontium is put into intensive regulatory engagement and appointments are made to the Board. The regulator's expectations of Strontium are to: ➢ Develop an action plan for delivery of the partnership decision ➢ Implement a strategy for satisfactory governance and management of the company, including control over financial affairs ➢ Complete the investigation into the various allegations ➢ Complete the inspection action plan
Month 12	The regulator attends a board meeting to outline its expectations and introduce the appointees. Two executives leave the organisation. Strontium appoints experienced interim staff to cover.

Year 5	
Month 1	Consultants are appointed to assist Strontium with the process of finding a partner.
Month 3	Strontium receives a substantial number of expressions of interest from other providers. The Board agrees its selection criteria and after preliminary submissions, agrees a shortlist of three.
Month 6	Strontium selects its preferred partner, and due diligence begins. A key issue emerges as to whether the partnership arrangements will be a 'material event' triggering a loan book re-pricing. Lenders appear to be taking a tough line.
Month 9	Negotiations with lenders continue.
Month 12	An in-principle deal is agreed with lenders, and preparation of final loan documents commences.
Year 6	
Month 3	Lenders belatedly seek to widen the loan agreement to include terms relating to possible future mergers and transfer relating to the parent as well as Strontium; Strontium and the preferred partner resist. The preferred partner is increasingly uncomfortable about the lenders situation and wants a strong focus on a date for resolution. In operational terms the two providers are now working together very closely. Central services are being supported by the parent designate and progress on integration is moving ahead.
Month 5	Negotiations with the lender reach a satisfactory conclusion.
Month 6	Progress is made on the service improvement action as a result of the joint operational working. The regulator: ➢ Gives consent to the rule changes necessary for the merger ➢ Stands down the statutory appointees ➢ Removes Strontium from intensive regulatory engagement

Analysis

The history of problems and the wide range of issues currently facing the associations meant that the only realistic way forward was merger with another association.

The rapid turnover of senior staff was destabilising for the organisation. This was combined with what appeared to be an unhealthy organisational culture from the top, and would have made it difficult for staff especially at middle management level to operate in an effective way.

There was also a very rapid turnover of board members, and there were no contingency plans for dealing with a sudden exodus of members. The Board needed to recruit quickly, and the new membership did not have the skills and expertise required to operate effectively.

For both executive and non-executive teams, the rapid turnover meant a loss of knowledge about the organisation as well as a lack of continuity.

The number of changes to key personnel and sheer range of issues needing to be addressed gives the impression of an organisation in almost perpetual turmoil. The situation was just too multi-faceted for Strontium to resolve on its own. The appointees were crucial to the resolution of this case. Not only did they bring some stability, they brought skills and experience which were essential to decision making in relation to taking the merger forward.

An interesting situation arose near the end of this case study, when operational integration got rather ahead of the legal formalities. This was a potentially dangerous situation. If the loan negotiations had not reached a successful conclusion – and they had been dragging on for months – it might have proved quite difficult for both merger partners to unpick.

Conclusions

Strontium existed for less than 10 years, with two extended periods of intensive regulatory engagement. Throughout most of this time tenants got a sub-standard service. Once an association has been removed from intensive regulatory engagement, there is understandable reluctance to put it back. On this occasion, perhaps with hindsight it should not have been taken out of intensive regulatory engagement in the first place.

Chapter 13: Erbium Housing, Nickel Group & Antimony Homes - Chief Executive pay and severance packages

From the early 2000s increasing media attention has been given to public sector pay, both the size of salaries, and also pay offs to departing executives. A brief search of *Inside Housing* reveals regular negative articles regarding the size of pay offs for housing association executives and the so-called 'reward for failure'. The MP expenses scandals and the ongoing rows over bankers' bonuses have ensured a continuing climate of hostility towards bonuses and pay offs, even in circumstances where pay-offs may objectively seem justifiable.

The press's inclination to manipulate the figures to make the facts appear much worse than the reality has meant that even more attention needs to be paid to public relations aspects of how payments may appear to the public – and, for housing associations, how they may appear to tenants.

We set out here three case studies, all illustrating how associations got it wrong in determining a pay-off to a departing Chief Executive. Each had significant consequences for the association concerned, and all were avoidable.

Erbium Housing Association

Erbium had a history of strong organic growth. Looking to raise significant finance for a regeneration project, it sought and found a larger association as a merger partner. One of the consequences of this merger was that Erbium's Chief Executive would leave post-merger. The Board delegated dealing with a severance package to a sub-committee.

The sub-committee considered a paper regarding the package, at short notice. A paper was circulated the day before the meeting, and then substantive changes made on the day itself. Both versions contained significant inaccuracies. Initial legal advice, obtained on the day of the meeting, was not circulated to members nor was it discussed at the meeting. The sub-committee agreed the package in principle. The minutes were submitted to the next full board meeting but rejected, so the substantive matter was not discussed. The legal advice urged Erbium to discuss the package with the regulator. This was not followed up.

The matter was discussed again at the next board meeting, on the basis of the sub-committee minutes. The Board agreed a substantial payment. The settlement agreement was drawn up using different solicitors, who were not asked to give advice, just to draw up the agreement.

Some weeks later Erbium asked the first solicitors to give advice as to whether the payments already made were contractual. Despite the narrow brief, the solicitors' advice contained a number of wider warnings. It drew attention to several matters of concern, and made reference to the regulatory and reputational position. This advice was circulated by email to all board members but elicited no further discussion or response.

When the regulator became aware of it, they were indeed interested in the settlement. Erbium engaged consultants to carry out an investigatory review. The review concluded that:

- A substantial part of the settlement was not contractual;
- The Board gave so much weight to expediency and the commercial aspects of its decisions that it failed to properly consider its wider role as a housing association and charity, including regulatory and reputational considerations;

- Use of advisers was not appropriate. Advice was not taken at the appropriate times and the brief given was too narrow; the Board then ignored key warnings flagged up in the advice;
- the Board placed too much trust in the limited information it was given;
- The Board was not on top of its key role in determining executive pay and conditions;
- The administration of governance fell short – notice of meetings, supporting papers, minutes, board approval of committee actions.

The regulator concluded that the Board had not exercised adequate control or fully assessed the risks associated with the level of the payments it agreed. It downgraded Erbium's governance to a non-compliant grade. Erbium entered into a voluntary undertaking, under which it would:

- Review board membership and succession planning;
- Take legal advice on whether board members had acted in breach of charitable law;
- Review governance administration; and
- Take further specialist and legal advice on executive remuneration and other HR related matters.

The entire board of Erbium resigned. Once the various actions were complete and a new Board and Chair in place, the regulator gave consent to the merger. The regulatory judgement lapsed as it was no longer relevant after the merger had taken place.

Nickel Group

The longstanding Chief Executive of the Nickel Group of associations decided to retire and gave in his notice. A couple of weeks later, the Board held a confidential meeting immediately prior to the start of the scheduled board meeting to approve the payments to be made to him. No supporting papers were presented, and members were unaware that the item was for discussion until just before the meeting. The Chair set out verbally what the terms of the contract were and what the CE's entitlement would be.

The contractual terms included 12 months' notice or pay in lieu and an additional 12 months' termination payment. These terms had in fact been agreed by a sub-committee some years previously, though this had not been referred to the Board. The Chair also proposed a significant salary bonus.

The Chair advised that they had no choice regarding the first two items, so the Board moved on to discuss the proposed bonus. One member raised whether it was appropriate as a not-for-profit organisation and there was some discussion about potential adverse publicity. But the members agreed to pay the bonus. The minute of the discussion was brief and records little of the debate.

Neither legal nor HR advice was sought before the board meeting which agreed the payments. Extensive legal advice was sought by the Chair in the following two months, but no change was made to the settlement terms despite warnings from the solicitors regarding the totality of the package, and the likely regulatory and reputational impact. The Board only became aware of a potential problem when the auditors queried the accounting treatment, and the regulator got to know about it shortly thereafter.

The regulator asked Nickel to undertake an investigatory review, and Nickel gave a voluntary undertaking to do so. The review's findings regarding the payments were that:

- The notice period and the severance payments were contractual. However a contract with 12 months' severance payment on top of 12 months' notice was out of line even at the time it was agreed. In effect it amounted to 24 months' notice. If not unique, this was certainly rare. The Board was remiss in agreeing to it at the time;

- The introduction of the 12 month payment triggered when the employee (rather than the employer) gave notice when over 60 years of age was anomalous;
- Once the contractual terms became clear after the CE gave in his notice, the Board should have taken issue over them;
- A bonus payment was a contractual term but the exercise of it was discretionary. The Board was remiss in deciding to award a generous bonus on top of an already generous notice period and severance.

The review also made the following general points which cover remarkably similar ground to those in the case of Erbium:

- The Board had not discharged its key role of determining executive pay and conditions;
- There was a culture of complacency and lack of challenge. This was compounded by close working relationships formed as a result of the long service of a number of board members;
- The Board had not kept itself up to date with either regulatory guidance or best practice;
- Use of advisers was not appropriate. Advice was not taken at the appropriate times, and not actually considered by the Board
- The Board did not make an adequate assessment of the risk it was taking in agreeing the payments;
- The administration of governance fell short – supporting papers, minutes, evidence trails, terms of reference, board approval of committee actions.

Nickel accepted the findings of the review. The regulator downgraded Nickel's governance rating, albeit to a compliant grade. The Chair and several other board members resigned, including all bar one of the sub-committee who agreed the original contractual terms. Six new members were recruited, under new service agreements and with a new suite of governance policies and procedures. The regulator monitored the new Board's progress for a couple of months and then upgraded Nickel's to full compliance.

Antimony Homes

Antimony's relationship with its Chief Executive of many years broke down, primarily over a particular major project. The Board decided that the relationship had broken down irretrievably and authorised a sub-committee to deal with negotiations for the CE's departure. It was agreed between Antimony and the CE that the departure would be publicly described as early retirement.

Antimony notified the regulator by telephone that the CE was taking early retirement. A few days later the regulator received an email repeating that message, sent the same day as a press release to the same effect. The departure and the package were discussed a few weeks later in a telephone conversation between the Chair and the regulator. The precise content of the call was not followed up in writing by either party. Whatever was said or was not said, the regulator continued under the impression that the departure was properly speaking a retirement matter for some months, and did not know the extent of the package until the draft annual accounts were available.

At that stage the regulator took the view that Antimony had not been open, neither with the detail of the CE's departure, nor the financial settlement which Antimony had agreed. The regulator asked Antimony to undertake an investigatory review, and Antimony gave a voluntary undertaking to do so. The review cleared Antimony of deliberately trying to mislead the regulator but was critical of its lack of transparency in the dealings with the regulator. The review concluded that:

- The Board was unaware of the custom and practice within the housing sector, and the use of informal channels of communication during such sensitive episodes to keep the regulator openly informed and "on side"
- The negotiations with the departing CE in respect of the package were conducted responsibly, although not faultlessly. The sum paid complied with Schedule 1, and although high, was considered by legal advisers to be less that the possible cost of defending and settling a claim.

As a result of the review's findings:

- The regulator issued a regulatory judgement downgrading Antimony for governance
- Three board members resigned, including two of the sub-committee involved and
- The Chair indicated an intention to stand down at the next following AGM.

Lessons

Although the three cases are about pay-offs, there are common themes which emerge about governance which are evident in other scenarios throughout our case studies:

- The exercise of proper control
- Adequate assessment of the risk involved in a course of action
- Boards making appropriate inquiry and challenge to officers
- The importance of board renewal to avoid complacency
- Proper use of external advisers
- Good governance administration and particularly keeping clear records
- Transparency in relations with the regulator
- Ensuring that terms of reference, policy, regulatory guidance etc. are in line with one another and that practice reflects principle
- Once the regulator looks closely at one issue, it is often the trigger for looking at others.

The lessons specific to pay offs are:

- Ensure that executive contracts are regularly reviewed and terms re-negotiated if necessary
- Be mindful that contract terms which may appear to protect the organisation in some respects – for example, long notice periods - can also operate to ratchet up payments to departing executives
- When considering settlements, take legal advice early, from suitably experienced advisers and with an appropriately wide brief
- Consult with the regulator as soon as possible, certainly before agreeing settlement terms
- Be open with the regulator about the reasons for the departure
- Consider the totality of the payment as well as the constituent parts
- Consider the regulatory and reputational impact of the Board's decision
- Ensure that even if a sub-committee handles the preliminaries and the detail, the whole board makes the final decision with full knowledge of the situation.

Chapter 14: Caesium Support - the contract culture & its risks

Background

Caesium operates nationally and provides supported housing. Caesium is small; its turnover is only around £15m pa, with the bulk of its income coming from support contracts. In the year before this study begins it had made an overall deficit of £1.8m due to restructuring and a surge in repair costs, and in the year before that it also made an operating deficit of £0.7m. This is in contrast to previous years when it produced operating and overall surpluses. At the start of this case study Caesium had a compliant viability rating. Its last two Audit Management Letters have raised controls issues, which have not been addressed.

Timeline

Year 1	
Month 1	Caesium advises the regulator that the management accounts are projecting a deficit for the year of approaching £1m, in variance to a projected surplus of a similar amount. Given its small size, this is potentially serious. It will reduce revenue reserves to only £2.6m. Caesium puts together an action plan which includes an external investigation into the shortfall, measures to strengthen internal controls and a review of the budget for the year just started. At the present time Caesium believes the variance is due to shortfalls in Supporting People (SP) income. The regulator asks for the external investigation brief to be widened. It is concerned that the management accounts did show significant variances some six months previously and this was not picked up by the Board.
Month 3	The external investigation outcome is presented to Caesium's board. Key findings are: ➢ Budgeting and internal control failures – a 'systemic failure' ➢ Governance – weaknesses are found arising from its structure, reporting practices and missed opportunities to question financial performance ➢ A failure of leadership and management, particularly within the finance function ➢ Weaknesses are highlighted both within the finance team and in its relationship with Caesium's operational teams The review notes that the AMLs for the last two years have referred to the need to centralise SP contracts, but this action is still outstanding. This is not just a matter of document housekeeping but an important tool for the proper management and review of the contracts and of income. Caesium puts together a recovery plan. The Finance Director leaves the organisation.

Month 4	Caesium starts to send weekly cash flows to the regulator. The regulator is concerned that solvency issues threaten the medium and long term viability of Caesium. The Board approves a revised budget for the year in progress but asks the executive to seek a further £0.5m of savings.
Month 5	The projected deficit for the year recently ended has increased to nearer £2m, and one lender's covenant has been breached. Caesium and its consultants meet with the lender. Although the lender is broadly supportive, the breach is waived only on agreement to revised commercial terms. The current AML is in draft. It notes that considerable information is still awaited by the auditors and that the lack of, and inaccuracy of, information and record keeping is such that the auditors are considering giving a qualified audit opinion. The auditor is not yet able to provide a view on 'going concern' as the levels of expenditure reported are not sustainable going forward. The auditors consider that management accounts presented to the Board were not prepared on a 'reasonable basis'. The draft statement of internal controls refers to a 'severe breakdown' in the effectiveness of internal controls in a number of areas. The consultants who helped Caesium to put together the current year's budget are still of the view that Caesium can achieve it, albeit with very firm cost control. At the end of the first quarter Caesium has a small positive variance. Nevertheless the Board, consultants and the auditors remain concerned because of the long history of poor control and poor record keeping. The regulator holds an internal case review. It decides against intensive regulatory engagement for the moment, primarily because the Board has been proactive in dealing with the issues and is working in a very co-operative way with the regulator. Five Board members step down and Caesium decides not to replace them, so as to keep numbers down as recommended by consultants. Caesium does however appoint one new independent member with experience of change management and turnaround.
Month 6	Following the provision of further information, the auditors feel able to sign off the accounts on a going concern basis and without qualification. The Board considers an options paper by its consultants. Its options are constrained by its heavy reliance on SP income and lack of opportunity for diversification. Future success as an independent organisation will depend on very tight financial controls, and first class skills in contract negotiation, management and monitoring, not areas in which Caesium has excelled in the past. The Board decides that the best way forward is to seek a merger partner. It starts the process of partner selection.
Month 11	Following an initial long list selection and then short listing with detailed proposals, presentations and interviews, the Board decides on its preferred partner, a national association with a strong focus on special needs.
Month 12	Due diligence begins, and the process of obtaining consents.

Year 2	
Month 3	The merger becomes effective.

Analysis

Caesium was in a specialist sector undergoing rapid political change, with a number of specific risks including serious threats to future income streams. Caesium did not have an approach to risk which allowed it to identify or foresee the risks, and to develop appropriate strategies for addressing them.

Problems had been evident for at least a couple of years prior to the events outlined above. It was clear that Caesium's executive management and leadership were weak, particularly in relation to finance, and there was no culture of control. The Board had not challenged the executive and had not been proactive in ensuring that once problems were identified, the resultant remedial actions were followed through.

The Board was large, indeed overly large, and needed to be slimmed down to become a more effective decision making body. It did include a number of people who appeared to have relevant skills and experience which should have enabled appropriate challenge. We would speculate that - as has been our experience with other specialist associations – the Board was very much focused on the client groups and the quality of the services provided to them, to the detriment of the practical aspects of running a business.

Although the Board was slow to pick up and deal with the problems, so was the regulator. Problems were known but Caesium rather slipped below the regulatory radar for more than a year. Once the regulator did engage with Caesium, its approach was both effective and proportionate. But by then the outcome was almost a foregone conclusion.

Caesium lost its independence as a result of cumulative failings which lead to a situation from which there was no realistic comeback. Had firmer action been taken earlier, independence might have been maintained, but by the time the severity of the situation was realised it was already really too late. Even then, Caesium might have been able to struggle on alone, but it would have been a hand to mouth existence and unlikely to have been in the best interests of its customers. The Board was right to make the decision that it did.

Conclusions

For associations the lessons are once again about the Board focusing on the business, ensuring that control is maintained and that the organisational culture supports an environment of controls assurance and risk management. Over time, a lack of appropriate challenge at board level is likely to foster a similar environment amongst the staff group, with potentially very serious outcomes.

A positive message for associations, also in common with other case studies, is that positive and proactive engagement with the regulator often means that the regulator decides not take regulatory action to the next formal level. This is important for a number of reasons, not least that it may avoid a situation where a 'material event' clause in its loan agreements automatically triggers a default.

Turning to the regulator, there were undoubtedly other larger and more immediately serious regulatory problems which needed to be managed but the regulator needs to be proactive in keeping a closer watching brief on the smaller associations with known problems, particularly where the type of problem combined with the size of the organisation leaves so little margin for error.

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