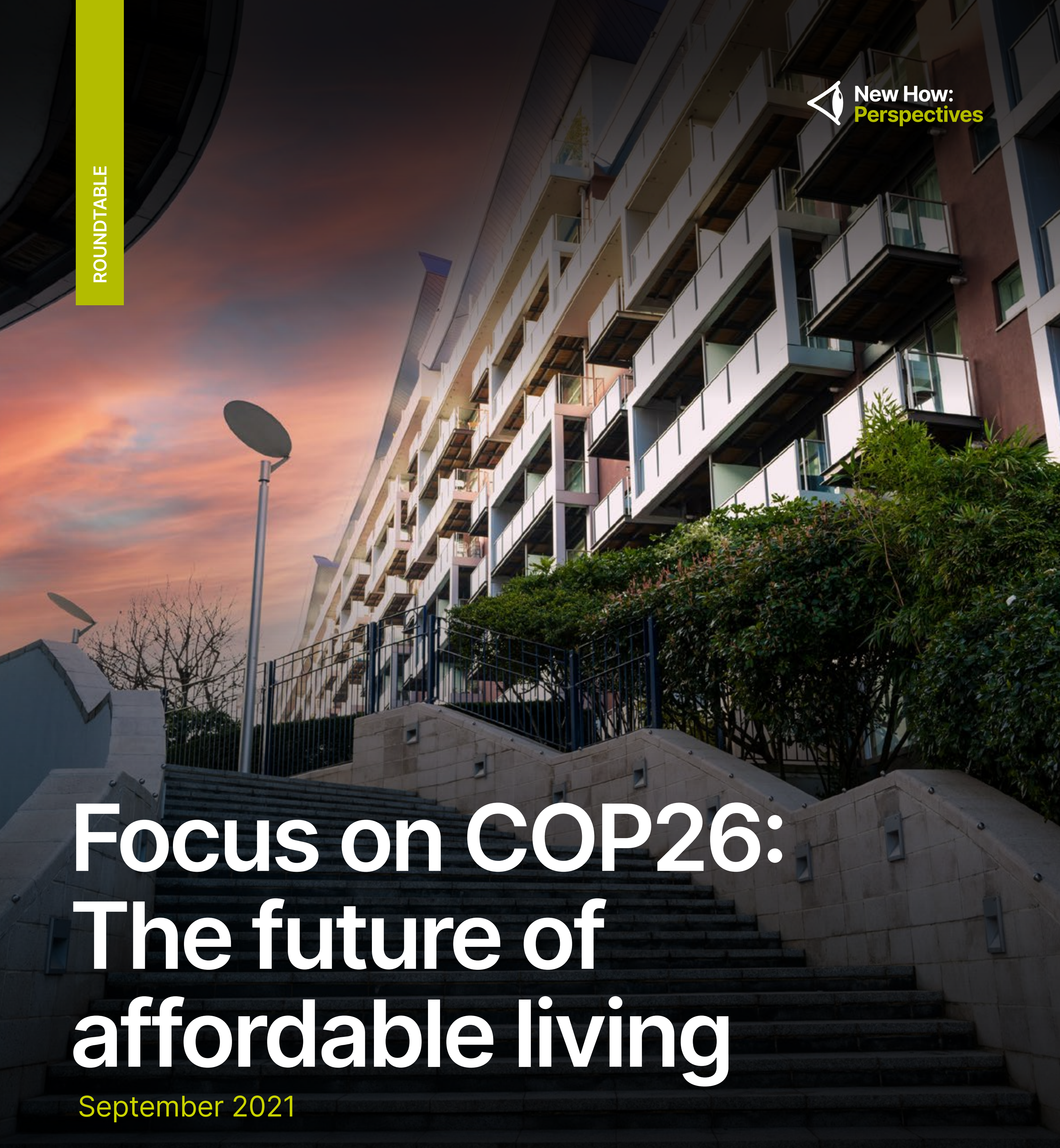

ROUNDTABLE

New How: Perspectives

Focus on COP26: The future of affordable living

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Introduction

The hosting of COP26 in Glasgow this year shines a spotlight on the UK in relation to sustainability performance, applying more pressure on organisations to demonstrate their green credentials and to encourage the development and usage of sustainable technologies in the race to net zero.

One sector in particular that is leading the charge on decarbonisation is the affordable housing sector, but barriers exist and challenges endure. Sustainability-linked loans are in their infancy and the prevalence of ESG frameworks in social housing organisations is patchy. A lack of resource to deliver sustainability measures at the small-to-medium end of the market means take-up of green finance is not straightforward, and the lack of specific decarbonisation metrics makes lending criteria and measurement an ongoing problem. And there has also been the small matter of a global pandemic that has hindered progress.

The pursuit of lower carbon housing is nothing new though, with sector stakeholders having focused on the issue for a number of years already. As a result, the sector has established a level of knowledge on green initiatives and technologies but there is a recognition that it now needs to kick on and accelerate the pace of learning and implementation. Organisations of all types need to work together to share views and, with support of government, ride the wave of COP26 and the wider sustainability agenda to position affordable living at the cutting edge of positive change.

Shoosmiths coordinated a roundtable debate on these issues and more, during which participants offered their thoughts on what the sector needs to do to maximise the benefits of the UK's hosting of COP26. The following pages give a summary of what was discussed in what makes for a really interesting read. I hope you enjoy it.

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The participants:

- **Marcos Navarro**, Director & Sustainability Lead – NatWest
- **Julie Watson**, Head of Capital Investment – Kingdom Housing Association
- **Allan Briggs**, Director – Valuation Advisory – Affordable Housing – JLL
- **Gill Henry**, Operations Director – Ecosystems Technologies
- **Fiona Cameron**, Banking Partner – Shoosmiths
- **Chair: Sheelagh Cooley**, Real Estate Partner – Shoosmiths

Has COP26's Scottish location had any impact on decision making in the social housing sector?

Julie Watson – From a Kingdom perspective, we've been promoting low carbon housing for a number of years now. In 2010, we developed the first passivhaus for social rent in the UK, for example. But it is not just about the wider environmental benefits, it is also about the benefits to our tenants in terms of improved living, affordability issues and driving down energy costs.

Marcos Navarro – The location of COP26 in Glasgow naturally puts pressure on the city, and it has probably expedited some of the plans in the region. It has also put a spotlight on the UK. The fact that it is being hosted here has led to lots of organisations being asked what they are doing in the run up to the event, so it has put pressure on some of the larger organisations in particular, which naturally filters down. Plus, it has put pressure on local authorities, which is perhaps why we have seen more traction with plans being taken forward and not waiting for central government. All of which I see as a positive.

Gill Henry – The opportunity that COP26 presents is fantastic from our perspective. Ecosystems is a major demonstrator at the Sustainable Timber district on the 'After the Pandemic' site. We will have a number of significant projects all showcasing the benefits of using high quality, sustainable home-grown mass timber products. Our collaboration with the Construction Scotland Innovation Centre and Edinburgh Napier University, along with many others, will culminate at COP26 when we introduce our Gen Zero classroom for the Department of Education, the SNRG duplex and the Near Home project for Transport Scotland and Scottish Government, which will deliver small sustainable office hubs in empty retail spaces to drive forward the 20-minute neighbourhood agenda. So, we're really excited about COP26.

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What has been the reaction of / engagement from the social housing sector with green / sustainable loans?

Marcos Navarro – More social housing organisations are now aware of the benefits of sustainable finance in terms of being able to access additional capital or capital at a lower level of cost. We've sponsored the Social Housing Sustainability Reporting Standards, which has got an amazing reaction from the social housing industry across the UK. It's probably fair to say that the larger social housing organisations are more advanced in relation to putting in place sustainability-linked loans; it is easier for larger organisations to allocate resource and develop proper ESG frameworks. This is why we supported the Sustainability Reporting Standards, hopefully to make life easier for social housing organisation of all sizes.

> "The social housing sector is more advanced than a lot of other sectors and is leading the way."

Allan Briggs – The progress of sustainability-linked loans would be a lot further along if it were not for Covid. It was being talked about back in 2019 as a big issue for the industry and it should be further along now and more mature than it is. We are playing catch up, but we are now seeing the first sustainable loans coming through in Scotland. Admittedly, the difference between the previous traditional pricing and what is considered ESG / green loan pricing is not wide enough at the moment as to make it eye wateringly good, but sustainable loans are certainly a bit more competitive. As the market matures, we can expect to see that spread get wider, which is what needs to happen in order to get people's ears picked up because, as Marcos says, the small and medium sized social housing organisations just don't have the time or resource to dedicate to this. We need to get across the entire spectrum of the social housing sector, not just the big organisations. I know in Scotland the regulators are looking at a standardised metric for ESG compliance that will be universally accepted, which would be great for the sector.

Marcos Navarro – I agree that Covid has delayed decarbonisation strategies for many social housing organisations, but one thing that has certainly been emphasised throughout Covid is the 'S' in ESG. Prior to Covid, a lot of organisations, including banks, just focused on the 'E'. However, as shown by the level of social bond issuance during Covid, people have become more aware of the importance of communities and the value of 'social'. Going forward, we'll continue to see more sustainable loans with social KPIs, rather than just environmental. But more broadly, the social housing sector is more advanced than a lot of other sectors and is leading the way, and this is down to the people behind it day in, day out.

From a valuation perspective, is decarbonisation a specific metric and how do we anticipate this changing in the short to medium term or as a result of the conversations around COP26?

Allan Briggs – COP26 puts a spotlight on the sector but, as Julie mentioned, we've been doing this for over fifteen years now. However, we can expect it to be a political football though. We have just seen that the Energy Efficiency Standard for Social Housing (EESSH2) is going to be beefed up in 2023, which is an example of the agenda having changed since when it first became an enforceable policy last year. From a valuation perspective, it is all about the technologies and the cost implication to an organisation – for example, an air source heat pump system is a lot more expensive at the moment than a gas boiler replacement. As we start to see demand grow, we'll see the cost go down as bulk manufacturing increases. The economics have to be right, but we are not immediately factoring in the cost as we are assuming that, over the next 5-10 years, the economies of scale will drive the cost of production down and the technologies will catch up.

Has NatWest's sponsorship of COP26 helped to accelerate the bank's move to support green / sustainable loans?

Marcos Navarro – NatWest has been quite advanced in supporting the sustainability agenda for a number of years, assisting organisations who have either a track record of reducing carbon emissions or a transition plan in line with the Paris Agreement. In terms of numbers, our previous sustainable finance target was £10 billion between 2018 and 2020, and we doubled that to £20 billion between 2020 and 2022. Our sponsorship of COP26 is more of an additional commitment and it perhaps influences our direction of travel, but it doesn't change the fundamentals of our approach to sustainability, which pre-dates the event. As an organisation, we made our own operations net zero carbon in 2020 and we want to be climate positive by 2025.

How is technology helping to address decarbonisation challenges in this sector and how key is government policy and support to the uptake of new technologies?

Gill Henry – Registered Social Landlords have generally tended to lead innovation in technology in the housebuilding sector, but only as far as cost allows within the current funding regime. Greater use of sensors in new homes will allow for monitoring, recording and reporting, as well as drive continuous improvement. Focusing more consciously on 3D modelling and off-site manufacture will drive the reduction of waste, as will harnessing local supply chains. 'Housing to 2040' presents the opportunity for the Scottish Government to incentivise or mandate changes to the affordable housing sector and how homes are funded and delivered. Hopefully, there will be some really interesting initiatives over the coming months and rewards for those who embrace innovation and drive change. The challenge will be doing this within a restrictive procurement system, which needs greater flexibility to allow new companies and ideas to come forward without having to demonstrate their previous track record and ability to meet the many procurement hurdles in ESPDs etc.

Julie Watson – Scottish Government support and regulatory changes are key to help ensure that technologies become mainstream; getting more people on board within the housing and construction sectors will help drive down capital costs and make the systems more affordable. But we also need to be undertaking more post-occupancy evaluation of these technologies to ensure the as-built performance is as good as we expected it to be at design stage. We need to be confident that we're investing in the right technologies from both a performance and end-user perspective. We have the Heat Standard coming in 2024, which means consented properties will not be allowed to install gas central heating systems after 2024, but we shouldn't have to wait until 2024 - we should be doing it now. We need to be getting that experience, driving down prices and increasing demand for these products. We also need to put tools in place to help educate our tenants to ensure they aren't scared of new technologies and that they get the maximum benefit from the technologies installed in their homes.

> **Getting more people on board within the housing and construction sectors will help drive down capital costs and make the systems more affordable."**

Marcos Navarro – The biggest challenge is behavioural change. I'm part of the Manchester Retrofit Taskforce and we've found that the sell for tenants and organisations isn't necessarily the cost saving, but more the health and social benefits. Where I am in the north west, death rates from Covid have been 25% higher than the rest of the UK and a lot of that is linked to poor living conditions. So, for me, the sell is on the social and health side and that is all about behavioural change.

Furthermore, in relation to procurement, it is interesting to see that, in the north west, the government wants to install 600,000 heat pumps per year. However, if that was actually to happen, the entire labour force would be fully utilised within a month. There is a clear disconnect between ambition and reality.

Allan Briggs – That's a great point – you don't just go out and find thousands of specialists who are experts in ripping out gas systems and installing air source heat pumps. There is a whole new sector that needs to emerge to support this ambition.

What are the obstacles to achieving net zero targets or at least in achieving certainty on the substance behind the targets?

Fiona Cameron – The obstacles we are seeing in deals are primarily around target setting and cost. It is clear that the sector has really bought into sustainability and everything that lies behind COP26, but the target setting piece is really difficult. The lack of an agreed industry-wide set of KPIs makes measurement really hard, as well as getting in the way of creating a culture of shared learning. There is a real dearth of market data, or certainly a variance in the data, in relation to existing housing stock, particularly where organisations have been through mergers. Organisations are required to set targets that work strategically for both the lenders and the organisations themselves, but those targets are not necessarily the same, so there is a real body of work that needs to be done to bring an alignment with those targets before you even get to the loan stage.

There can also be a reluctance to commit to KPI targets for the full term of the loan due to the fact that regulation and technology is changing so often, so perhaps the loan market needs to move a little to allow organisations to swap in and swap out covenants, depending on where the market goes. The LMA offers guidance on the principles governing green / sustainable loans but they are quite wide-ranging and interpreted differently by different lenders, which gives borrowers real issues, particularly when there is a loan syndicate and you need to get all of your lenders on board. But it has also made it difficult for borrowers to go out and get a bilateral loan and do a like-for-like comparison on the features of the loans they are offered. So there needs to be a validation exercise but, unless you are a larger organisation, you don't necessarily have that resource in-house and so it becomes another added cost.

These loans do offer a solution, but they are still in their infancy and to some extent a barrier for some housing organisations to deliver against their ambitious ESG plans. I suspect we are just not far enough along to entirely overcome the obstacles that exist.

Marcos Navarro – How NatWest tends to work is that we set KPIs based on an organisation's sustainability report. We don't dictate KPI targets, they will be reflective of an organisation and what it is looking to achieve. We do follow the LMA principles, which ensure targets are stretching, measurable and achievable. In terms of timeframes, we tend to set KPIs on a loan for a period of 3-5 years and, at any point, any organisation can come back to us within a year and change the KPIs. One of the things we don't do currently in this sector is charge a penalty for not hitting targets; we only offer a discount for meeting targets.

Gill Henry – The new build programme is probably a lot easier to deliver on than the retrofit one. With the new build programme, it should be relatively straightforward for the Scottish Government to set new affordable housing build quality and sustainability standards (sizes, performance specs etc) that are required for grant funding and are tied back to loan agreements. We have never got to standardised affordable house types and tend to reinvent the wheel time and time again, wasting money on fees rather than collaborating and investing in testing and innovation, which is a major issue. We should be looking at the buildings, the technologies, the functionality and the adaptability so that people can stay in their homes when their physical needs change. We need wholesale change in how we develop, and for clients, industry and academia to collaborate much more closely and draw on each other's skills, knowledge and expertise.

Julie Watson – The Scottish government is going through a subsidy review at the moment, with the outcome expected shortly. Consideration has been given to the additional costs of achieving enhanced sustainability standards and it is hoped that this additional subsidy will be made available to encourage reduced carbon measures. The detail is not yet known but this could help with some of the issues we've discussed today.

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Do you see modern methods of construction playing a role in supporting the social housing sector to achieve net zero targets?

Gill Henry – I would challenge the perception that modular construction is significantly more expensive. Not only does MMC reduce waste and improve quality, modular and volumetric construction can help value engineer foundation costs, as the structures are lighter and can offer different approaches that a standard build cannot. Building the superstructure in factory conditions, whilst groundworks are being delivered, can offer programme efficiency and reduce prelims. It will also help develop local supply chains in a completely different way and will introduce a wide range of new jobs and skills in the construction industry, creating greater gender equality and access for people with disabilities. There are so many changes that MMC can facilitate, which we haven't really begun to harness. We need to question more widely: "how do we do this differently?". All we are doing at the moment is reinventing the wheel and very gradually bringing technologies through without looking at the whole system.

Allan Briggs – We're still behind the curve with Europe in terms of accepting 3D modular and other sorts of modern methods of construction, and there are still barriers in place. If you were looking to build in Scotland, you would need BOPAS accreditation, NHBC and every planning document under the sun in order to comply with requirements and enable a valuer to get comfortable. It is going to come, but at the minute the sector is in limbo, however COP26 and the sustainability agenda will accelerate that.

Marcos Navarro – There is a willingness to support modular from a lending perspective. The challenge has always been on the valuation side. At the moment, we haven't seen the scale to enable the social housing organisations to really push the banks, but we are beginning to see more of it.

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