ESG IN UK SOCIAL HOUSING INVESTMENT

SIGNATORY TYPE
Investment Manager

ASSETS UNDER MANAGEMENT
£270 bln (of which £168 bln is in fixed income) as at 31 March 2015

OPERATING COUNTRY
United Kingdom

M&G Investments is an international asset manager with an active, long-term approach to managing clients' investments across all major asset classes. ESG issues are integrated into our investment processes wherever they are likely to have a meaningful impact on risk or return.

The PRI's Fixed Income Case Study series highlights examples of interesting and innovative approaches to responsible investment. Written by fixed income practitioners from around the world, the case studies cover topics such as integrating ESG, negative and positive screening, thematic investment and engagement.

Sharing these examples will enable investors to collectively build a concept of emerging good practice. The PRI aims to publish a set of these short pieces every quarter. If you would like to learn more or contribute your own case study please contact us.

WHY ESG RISKS MATTER IN SOCIAL HOUSING FINANCE

The very long-term nature of institutional lending to the social housing sector, where some illiquid investments have tenors of up to 40 years, means that ESG risks can have considerable impact. Almost every investment has a complex interplay of environmental, social and governance (ESG) issues.

Debt investors place utmost importance on timely repayment and the quality of homes posted as collateral against borrowing.

Lenders must assess whether a housing association's tenants can, in the face of changes in long-term employment patterns and welfare payments, afford rental payments that rise annually with inflation.

The value of the homes posted as collateral can change materially over the long-term. Social, as well as economic, factors play a part: evolving patterns of wealth distribution and employment (at local, regional and national levels) can influence demand for social housing, and therefore the capital values of the housing stock.

Many housing associations are small organisations and corporate governance standards vary dramatically. Investors need minimum levels of reporting and engagement over many decades.

Environmental risks can also play an important role. Regulation continues to increase the minimum green building requirements for existing and new stock, necessitating capital expenditure by housing associations. This can affect creditworthiness, but can also boost the long-term value of collateral and improve its energy efficiency, making a tenant's rental payments more affordable.

HOW WE ANALYSE AND ENGAGE OVER ESG RISKS WHEN LENDING TO HOUSING ASSOCIATIONS

ANALYSIS

We consider ESG risks within credit analysis, due diligence, investment and engagement processes. Such risks affect both creditworthiness and collateral value.

An association's creditworthiness and ability to repay debt depend on the ability of tenants to meet long-term rental payments. These in turn are directly influenced by:

- Proportion of tenants receiving state welfare payments;
- Impact of changes in long-term welfare policy;
- Activities by the housing association to help tenants claim welfare payments (and guide them on debt and other financial matters);
- Activities by the housing association to help tenants enter or maintain employment;
- Geographical concentration or diversity of the housing stock;
- Activities by the housing association to build sustainable communities, as opposed to merely providing housing.

These risks can be addressed through the detailed modelling of rental payment flows under a wide range of stressed scenarios.

Good corporate governance plays a crucial role: poor management decisions, unfair treatment of tenants and inadequate reporting can all expose an investor to interruptions in income.

Any deterioration in quality, and therefore value, of the homes posted as collateral can materially reduce an investor's recovery rate in the event of a borrower defaulting. Analysis of the quality of a portfolio of houses includes:

- The percentage of stock meeting the legal decent homes standard;
- Plans to reduce numbers of non-decent homes and to prevent homes becoming non-decent;
- Bespoke standards that exceed the legal minimum;
- Housing association management practices and capabilities.

Credit work also looks at the broader ESG factors that can influence supply and demand, and future value of collateral. This varies greatly between regions and between individual housing associations but would often include analysing: wealth distribution, housing availability, housing affordability, homebuilding plans (at individual association, regional and national levels), and national government policies.

All of these change substantially over time – supply and demand for social housing will most certainly wax and wane over the life of 30- or 40-year loans – and all of these changes must be assessed and modelled.

ENGAGEMENT

Detailed credit analysis can uncover significant issues that can only be addressed by extensive, long-term engagement. Recent examples include:

- Too high a proportion of the borrower's existing stock being of non-decent standard;
- A housing association reporting strong financials but with high levels of tenant dissatisfaction, caused by a poor repairs service.

Engagement starts as part of the initial analysis and lasts through the life of the loan, irrespective of tenor, to address the ability of the borrower to repay and the quality of the collateral. Performance monitoring is continual.

Corporate governance is a major focus of engagement. Social housing borrowers are not-for-profit entities, with no shareholder oversight, and few have extensive experience in raising capital. Protracted, detailed conversations are required to determine whether governance levels are sufficient to merit and maintain investment. This includes:

- Avoiding poor cost management;
- Maintaining formal reporting;
- Monitoring desired and mutually-agreed improvements in performance.

Engagement also addresses the quality of an association's management. There are many high-quality individuals and teams in the sector, but some management teams have required assistance in meeting the challenge of managing large portfolios of accommodation rented to often vulnerable people. In such instances, engagement must quickly identify where management teams require most support (something often linked to home maintenance and home building procedures) and which initiatives can maintain or enhance a borrower's creditworthiness.

Successful engagement acts not only as an early-warning signal for problems (alongside the alarm bells triggered by any covenants embedded in a lending agreement), but also encourages better management practices and disclosure. This helps protect the interests of investors, tenants and the housing associations.