QUARTERLY HOUSING UPDATE

Winter 2019/20

Contents

Foreword

As we go to press, the full consequences of the spread of coronavirus on the housing industry are only beginning to materialise, but it is already clear that across the sector we are all going to have to get used to doing things differently.

Our teams have already written and spoken about the implications for governance and employment and their resources can be found at https://www.trowers.com/insights. Whilst our regular programme of training, seminars and attendance at conferences is on hold for obvious reasons, we will continue to update that material and post new insights over the coming weeks.

On a more positive note, it was a genuine privilege earlier in the month to join the judging panel for the Housing & Finance Institute's "Springboard" programme run in conjunction with the Local Government Association and which seeks to assist councils to bring forward housing development in their area; whether by direct delivery themselves, through jointly working with housing sssociations and/or the private sector or by facilitating others to deliver. What was so heartening from the day was to learn how positively councils can approach housing growth and – critically- how greater collaboration is accelerating delivery. We are looking forward to working with a number of participants in the programme.

Finally following the Budget it would appear that the sector can look forward to a healthy funding programme over the coming years and we hope to be able to comment on the detail in future editions.

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Building safety reforms – What impact on local authority landlords?

Building safety continues to be of vital importance to the housing sector and, following MHCLG's recent consultation, the expectation is that a Building Safety Bill will shortly be introduced to implement a new regulatory regime.

Local housing authorities will, of course, be subject to these new building safety reforms but what will this mean in practice? Much of the media attention has been on new residential high-rise buildings, especially those in the private sector. This has meant a focus on leaseholders concerned not just about their personal safety but also their service charge demands, mortgage availability and property values. The fact that the Grenfell tragedy involved a council-owned block undergoing extensive refurbishment reminds us how this is an issue which has direct and deep implications for local housing authorities too.

The current state of play

Local authorities are, of course, very familiar with building safety rules in their role as enforcement authorities under the Housing Act 2004 regime. As landlords, local authorities are also subject to the Fire Safety Order 2005 (which is also currently undergoing review by the Government).

But until very recently, local authorities had not really experienced external scrutiny on fire or other building safety issues. As registered providers, local authorities are regulated by the Regulator for Social Housing in relation to the Consumer Standards which include health and safety. In May 2019, following regulatory action taken against Gateshead Council, the chief executive of the Regulator issued a letter to all local housing authorities, reminding them of their health and safety duties under their Home Standard. Since then there have been breach notices issued to a further seven councils – though four of them, it should be noted, were joint 'owners' of an ALMO.

Of course, local authorities have always had their own health and safety systems, irrespective of legal and regulatory requirements.

> *"Nevertheless, the external 'environment' has changed and local authorities are having to demonstrate the effectiveness of their policies and procedures in ways that were not seen until recently."*

In-scope (and out-of-scope) buildings

The main elements of the new regime will apply to new (or substantially refurbished) residential buildings over 18 metres / 6 storeys high, with a gradual roll out of obligations to other in-scope buildings, i.e. those in occupation. Responsibility for in-scope buildings will lie with the "duty holder" (during construction or refurbishment) and the "accountable person" (during occupation). This liability may not be delegated. The new Building Safety Regulator will have tough enforcement powers where there is a failure to comply, ranging from fines to criminal prosecution.

Even those local housing authorities without in-scope buildings should be mindful of the new regime. The Government is still considering how widely the new standards should apply and has confirmed that there is potential for currently out-of-scope buildings to be brought within the regime in due course. Moreover, there are important aspects of the new regime which will apply regardless of whether or not a building is in-scope – for example, in relation to certain aspects of tenant engagement and redress, and also the extension of defects liability periods.

The fact that a building is not (yet) in-scope is unlikely to justify – certainly not as far as tenants are concerned - what could be characterised as an inconsistent, almost literally two tier, application of fire safety standards across a council's stock. It is for this reason that many local authorities are taking a broader approach when implementing new fire safety measures – that is going beyond the minimum required.

New costs?

The new building safety regime is likely to require considerable investment by landlords across all sectors.

Significant capital costs have been and will continue to be incurred by local authorities in upgrading buildings (and their elements) and installing compliant systems. The proposed building safety regime also contemplates new roles for staff and/or consultants (e.g. a building safety manager) – as well as tenant support - which will require revenue expenditure on an ongoing basis.

MHCLG has provided grant for some capital costs, but otherwise local authorities will need to look to their own resources and, in all likelihood, additional HRA borrowing. The fact that the borrowing cap has been removed is obviously only important where there is surplus revenue to service the debt – and the Section 151 Officer is comfortable with the overall exposure. Revenue Contributions to Capital

Outlay (RCCOs) are a helpful exception to usual capital/revenue rules but again there does, of course, need to be revenue to 'contribute' in this way.

Leaseholder contributions towards costs can cause difficulties - there are obvious sensitivities. And the terms of many Right to Buy leases do not permit the recovery of costs for 'improvements' – though we have identified scope for enforcing fire compliance covenants which should be explored before concluding that leaseholders should not contribute at all.

Conclusion

The new building safety standards will require important decisions to be made by local authorities about liability, resourcing, but most importantly, how to keep residents safe. Given the complexity of these issues, some local authorities have concluded that tower blocks are no longer a viable option and plan to demolish them. But the blocks are popular with some residents – and in any event, this is obviously no easy or cheap 'fix'. There is unlikely to be any one solution: various approaches will be needed, but, with the Building Safety Bill pending, all local housing authorities should be reviewing their stock and their HRA and deciding on the right approach for them so they can meet the upcoming challenges head on.

One final thought – the Regulator has made it perfectly clear that registered providers - including local authorities - should not wait for legislation in ensuring their properties are safe.

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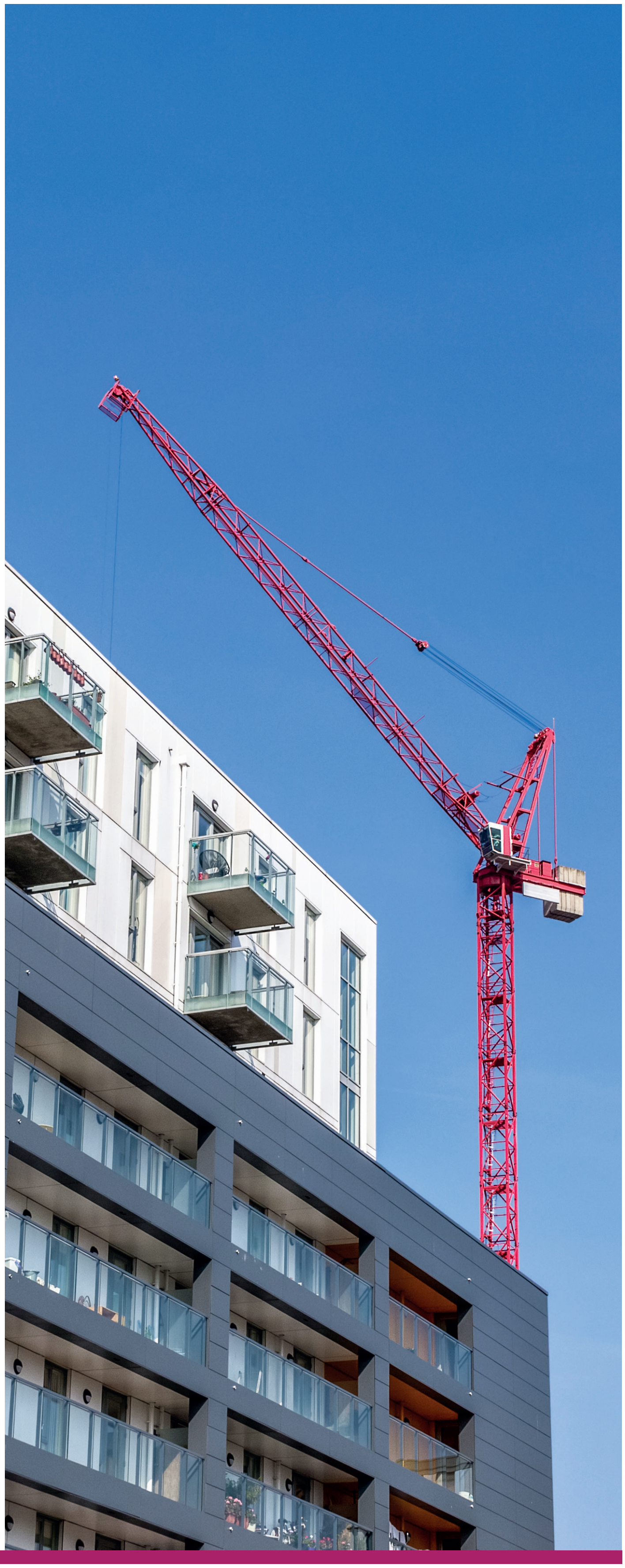

Is there value in building sustainable homes?

Housing is responsible for over 18% of the UK's carbon emissions and as the UK moves to a net zero carbon economy, both existing and new build properties need to be cleaner, greener and fit for the future.

The Government intends to implement its Future Homes Standard for new build properties by 2025 and recently announced a £5 million fund to help the financial services sector develop green home loan products. The aim is to incentivise home owners to either buy greener homes, or retrofit existing properties, but will builders or homeowners see a return on their investment? Anna Browne looks at whether; properties that are more energy efficient and sustainably built attract a premium to market value.

New homes – A 'green premium' for future homes?

The Future Homes Standard will require all new build homes to have low carbon heating sources and world leading levels of energy efficiency. Developers will be required to examine the materials being used as well as the construction processes employed to reach this standard, which is expected to result in homes emitting 75-80% less carbon than existing homes. A series of consultations are planned to inform the Future Homes Standard in terms of achievable energy efficiencies and anticipated costs.

Cost has undoubtedly been a barrier to the construction of energy efficient homes, but research published by RICS suggests energy efficiency is beginning to affect value and is likely to increasingly inform decisions by owners, occupiers and lenders. Individual property characteristics having an impact on energy efficiency, such as glazing, were found to be more influential value drivers than traditional measures like EPCs. A key factor in this could be the absence of quality data and good benchmarking for energy efficiency for purchasers. The REVALUE project found a green premium may be achieved through energy upgrades. Indeed, consumers may choose to pay a little more upfront, for the long term returns in reduced energy bills and green mortgage interest rates.

Existing homes – A 'brown discount'?

Individual home owners and landlords don't face the 'push' factors which builders and developers of new properties do. Only an estimated 3% of European residential stock is constructed to the highest energy standards. While it is long term owner occupiers who benefit from the resulting cost savings, a business case can be made for retrofitting on the basis of return on investment.

European studies have shown energy efficient properties may attract a 'green' rental premium for landlords. And if the 'green' rental premium isn't a sufficient incentive, the possibility of a 'brown discount' / deduction on the value of their assets provides extra motivation. Buyers in future wanting to take advantage of lower rates of interest on green mortgages and recoup the benefit of lower energy bills, may not be prepared to pay as much for homes that will need substantial retrofitting. Homeowners will, as their properties age, feel the impact of these changes.

The reality is, not everyone will be in a position to pay a green premium.

> *"The challenge to ensure affordability of these homes and retrofitting will require funding and commitment from developers Government and funders to drive this change."*

A number of leading lenders now offer eco mortgages, which carry a lower cost of borrowing for energy efficient properties.

Views from the sector

A number of recent initiatives have emerged, such as the Coalition for Energy Efficiency of Buildings and Social Housing Environmental, Social and Governance (ESG) Initiative, which aim to encourage financing for net zero carbon and climate – resilient buildings in the UK and achieve consensus on an approach to reporting ESG metrics within social housing. These initiatives have resulted from an increased focus by valuers and funders on the correlation between values and energy efficiency.

Savills was the UK representative in the REVALUE project which researched the link between energy efficiency and property values. A weak link was found between energy costs and housing costs and hence with valuations. On the other hand, evidence from Europe is that canny buyers/renters do take it into account. As a result, RICS issued guidance encouraging valuers to take sustainability into account, and the impact is likely to increase over time as market evidence accumulates that energy efficiency influences prices.

JLL note that consumers are already considering the environment when deciding where to live and there is a growing preference for new homes as they are typically more technically advanced and cheaper to run. They feel it is highly likely that buyers will start to turn to new options even more as the UK gets closer to 2050.

Looking to the future

Research suggests that whilst a 'green premium' may exist for energy efficient properties, the more notable consequence of the Future Homes Standard could be the risk of a 'brown discount', for properties which do not align with market expectations of energy efficiency. This risk is significant for investors and funders who may be providing finance against properties with below average energy efficiency. The effect on values may become more pronounced as individuals and shareholders begin to closely examine the wider implications of their spending and investment habits on the environment. To achieve the large scale retrofitting required to prevent properties becoming 'stranded assets', the onus will be on developers to build better homes and on the Government and funders to make green finance accessible and affordable, to drive the change we need to see to meet the challenges ahead.

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View points

Guy Morrell, Head Of Real Estate Investment, HSBC Global Asset Management:

"Building sustainable homes and other property types should generally have a positive impact on their value. Both owners and tenants are likely to prefer accommodation that is more energy efficient and built to higher environmental standards. Over time this is likely to be reflected by higher rents and prices. Several countries have introduced minimum energy efficiency requirements, which are expected to increase as part of the new net-zero targets. As a result, sustainability requirements are likely to increase. Existing buildings that fail to meet regulatory standards could trade at discounted levels."

Nick Whitten, Director of Research JLL:

"It is unlikely that building greener will generate a premium. However, it is highly likely that it will help in maintaining values as it aligns with growing consumer awareness around the climate crisis and increasing consumer demands to improve our environmental footprint. The housing industry must ensure that all new homes can satisfy a triple bottom line test and provide positive economic, social and environmental results."

What are for-profit registered providers?

When the Housing and Regeneration Act 2008 (2008 Act) came into force, it allowed profit making organisations to be registered with the social housing regulator for the first time.

Take up was initially slow, and there are still only around 50 profit making entities on the register, compared with around 1350 non-profit private registered providers (RPs). However, we have seen the pace of for-profit registrations increase greatly over the last two years, with many developer and investor clients who are entering the social housing sector for the first time choosing to do so on a "for-profit" basis. We have previously written about the reasons for this increased interest in the social housing sector from new entrants, but what is a "for-profit" RP and how do they differ from "traditional" not-for-profit RPs?

The most obvious difference is the "for-profit" basis of operation. Most for-profit RPs are established as companies limited by shares and – critically – are permitted to distribute dividends to their shareholders. There are no limits on the level of dividends that can be declared, although the board of the RP must be sure that the RP is able to continue to discharge its landlord obligations and comply with the Regulator of Social Housing's Regulatory Standards once the dividend has been paid.

All of the Regulatory Standards that apply to not for profit providers apply equally to for- profit providers, although there are some key differences in how these are applied. For example, the Governance and Financial Viability Standard and the related Code of Practice specify that non-social housing activity within a for-profit RP cannot exceed 5% of capital or turnover of the RP. Such "non-social housing activity" includes developing accommodation other than for use as social housing, market rental / sale activity and the provision of management / maintenance services to third parties and non-social housing assets held by the for-profit RP. The Regulatory Standards do not apply to the non-social housing aspects of a for-profit RP's business, but the Regulator would expect to understand the nature of these activities and how the RP manages any risks to its social housing assets that the non-social housing activities might pose.

Some of the Regulator's enforcement powers also operate differently where for-profit RPs are concerned. For example, in contrast to not-for-profit RPs, the Regulator does not have the power to remove / appoint board members, nor does it have the power to impose restrictions on the dealings of a for-profit RP or suspend / remove officers and employees during or following the use of its powers of inquiry.

> *"The Regulator has the power to transfer an RPs land when mismanagement is proven, but with for-profit RPs, this power only extends to its social housing and associated land."*

Unlike traditional RPs, for-profit providers are not required to notify the Regulator when they make certain changes to their constitution or organisational structure, nor when they dispose of any land which is not a dwelling.

It will come as no surprise that for-profit RPs are not eligible for the charitable status obtained by many traditional RPs, meaning they are not eligible for the associated charitable tax reliefs. RP status itself brings relatively few tax benefits in and of itself; both for-profit and non-charitable not-for-profit RPs are liable to pay Corporation Tax and SDLT. However, as with not for-profit RPs in receipt of grant funding from Homes England or the GLA are eligible for SDLT relief on land acquired with that funding. For-profit RPs in receipt of such grant funding must be mindful of the up-lift they may be liable to pay to the grant funder in the event that they dispose of the funded social housing assets, and the possibility that tenants then may be eligible for the Right to Acquire where the other conditions in the 2008 Act are met.

As for the acquisition of stock by for-profit providers, they are generally able to take affordable housing dwellings which have been mandated by a section 106 planning requirement (as long as the definition of "RP" in the section 106 agreement does not define "RP" as being a not-for-profit organisation). A number of the new for-profit providers have business models predicated on the acquisition of section 106 stock, or retaining the planning mandated affordable units on schemes which they are developing.

While not necessarily the case for those new entrants from the wider residential development and build to rent sectors, many of the new entrants do not have established housing management platforms and have looked to the traditional RP sector to outsource day-to-day housing and tenancy management. This is the first noticeable way in which for-profit and traditional RPs have interacted, although we are starting to see joint ventures between for-profit and traditional providers, as well as the discussion of sales of stock between traditional and for-profit RPs.

There are understandable questions being asked about the role of the new for-profit providers.

> *"Are they generating additional affordable housing, or pricing the traditional providers out of the section 106 supply that some of them had come to rely on?"*

Certainly, some new entrants have focused on section 106 acquisitions, but others have publicised development pipelines that if delivered, will see them at the top of the affordable housing development tables within their first 5 years of operation.

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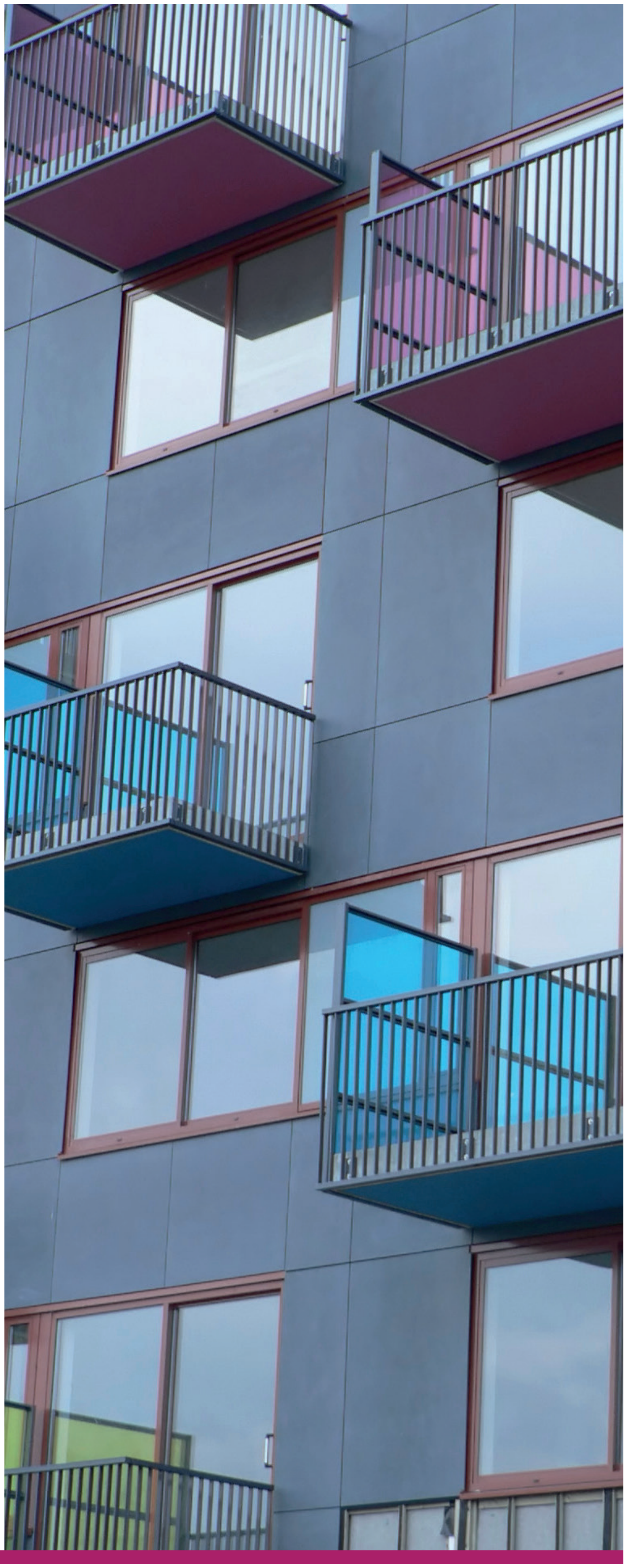

Medium Term Note programme vs. stand-alone bond issue

Should a housing association set up a Medium Term Note programme rather than issuing a stand-alone bond?

With LiveWest becoming the latest housing association to launch a Medium Term Note programme (MTN) programme, a number of finance teams have been asking whether their next issue should be through an MTN programme. To assess the best option for your organisation, it is important to understand the key costs and benefits between establishing an MTN programme and issuing a stand-alone bond.

How does an MTN programme differ to a stand-alone bond?

Both are methods of raising finance by issuing debt to investors on the capital markets and involve the promise to repay the holder of Bonds/Notes on a specified maturity date. Notes issued under an MTN programme or bonds can both either have an interest rate payable during the issued life of the Notes/ Bond (known as the coupon) or can be issued with no coupon, but discounted in value on issue (the former being the much-preferred type in the sector).

An MTN programme is essentially a platform for multiple issues of Notes. The instruments issued are called Notes rather than Bonds, but the name difference has little consequence in practice. Under an MTN programme, issuers can issue multiple series of Notes with a range of coupons (potentially fixed and floating rate) and tenures at different times. With a standard bond issuance (of the size usually seen issued in the affordable housing sector), bonds are issued with a set coupon and tenure. Further funding can be raised under a standard bond at future dates (through either the sale of retained bonds or tapping the bond); in each case, the maturity date and coupon of the bonds would be the same as for the original issue.

Assessing the costs and benefits

An issuer can of course create a new series of bonds with a different coupon and tenure when it requires a new line of funding. The important question for housing associations is whether they have the need to issue frequently enough and does the cost and management time saved in having the ready to go MTN programme for new issues outweigh the additional upfront work and cost in putting in place an MTN programme, and undertaking the yearly update that MTN programmes require if an issuer wishes to continue to utilise it?

Putting an MTN programme in place is more expensive than a stand-alone bond, but once a MTN programme is established, each issue does not as a matter of course require the publication of new admission documents or agreement of the various structural documents required for a bond (which are put in place on establishment of the programme). The commercial terms of each issue are dealt with by way of a pricing supplement, a relatively simple, pre-agreed form document setting out the pricing terms, and, usually, a subscription agreement. This saves costs and management time on subsequent issues and allows for issues at relatively short notice.

There are potential pricing advantages for a housing association that is able to issue at short notice, but the critical time path on most issues in the sector is the security charging – having a ready to charge pool of property, possibly as part of a rolling charge programme will be an essential accessory to a MTN programme. Early MTN programmes avoided charging causing delay by being unsecured, but issuers would have to consider the pricing consequences from offering unsecured notes.

There are housing associations that will benefit from establishing an MTN programme but for others the figures will not stack up. The smallest of current housing assocation MTN programmes allow for total aggregate issuances of up to £1billion, this gives an indication of the level, to date, where RPs have decided that the benefits outweigh the cost. This is an "up to" figure and any cost / benefit analysis was most likely not performed on this maximum amount, but this gives a rough indication as to whom it may benefit to look at the figures more closely.

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Brexit and insolvencies on construction projects – Part I

Turner and Townsend reported that in the 12 months to the end of June 2019, the construction sector had the highest insolvency rates of any UK sector[1] and we have seen some high profile insolvencies and reported financial difficulties most notably amongst the large tier 1 contractors.

As we move through the transition period the concern in the construction industry is that Brexit could lead to further decreases in demand; and increases in costs of labour and materials from the EU.

Both of which would put even further pressure on contractors' generally low margins and increase the number of insolvencies in the sector.

With the current heightened risk of contractor insolvency, how can employers seek to limit any potential exposure at the pre-contract stage?

The first step is to ensure that thorough due diligence is carried out on contractors so any insolvency risk can be evaluated pre-appointment and your contract negotiations can be well informed. We have set out below a number of key points to be considered in contract negotiations to seek to limit the effect of contractor insolvency:

- Ensuring that 'Insolvency' is widely defined and you have the right to:
  - terminate for insolvency as well as other grounds to enable you to terminate before an insolvency event for poor performance or delays;
  - make no further payments to the contractor on insolvency until the works are complete;
  - complete the works with a replacement contractor and claim additional costs back from the original contractor; and
  - enter the site and take control of plant, machinery and materials.
- A performance bond from a reputable UK provider can limit your exposure to its capped amount, although there will be an added cost. You should ensure that it is linked to the contractor's insolvency (rather than just a breach).
- Parent company guarantees (PCGs) do not generate an additional cost and can provide some level of protection, provided the parent does not also become insolvent.
- Obtaining collateral warranties with step-in rights. These create a direct contractual relationship between you and the sub-contractors/ sub-consultants so that any defect claims can be pursued and, if step-in rights are included, enable you to take over the contract to complete the works.
- Sanctions for the non-provision of PCGs, bonds and warranties to ensure they are provided.
- The payment provisions regarding the level of retention (or a retention bond), frequency of payments, the time between work carried out and payment and advance payment (or advance payment bond).
- A contractual obligation to provide accounts can keep you better informed as to your contractor's current financial position.
- Using a project bank account will increase administrative burdens and costs money to set up it but it may safeguard funds meant for the contractor's sub-contractors/ suppliers, which would otherwise be swallowed up in the contractor's insolvency (provided it creates a trust).

In the next edition of QHU, we will consider the legal and practical issues that arise if a contractor becomes insolvent during a project.

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1 https://www.turnerandtownsend.com/en/perspectives/uk-market-intelligence-q3-2019/

Trends in the student accommodation sector

Because of its highly profitable, yet steady, income for private landlords, UK purpose built student accommodation (PBSA) is often seen as an investment golden goose. But what are the challenges that PBSA faces in this current climate and how are we seeing the sector adapt to stay relevant?

The PBSA market has grown significantly in recent years, with currently a record 627,000 bed spaces in the UK (according to the UK Student Accommodation Report 2018 by Cushman & Wakefield). However, this has not kept up with the increasing numbers of students, with full-time student numbers outweighing these bed spaces by a 3:1 ratio.

> *"Student numbers from now until 2030 are forecast to grow by 220,000, indicating that a high volume of additional future student accommodation will be required to address this imbalance of demand and supply."*

Seventy-seven per cent (77%) of new 2018/19 bed supply was provided by the private sector, suggesting that universities are becoming increasingly reliant upon it to deliver the large volume of PBSA required.

Challenges of PBSA

Government concerns – the Augar Review, published on 30 May 2019, points out the 'widespread and significant concerns about the cost of student accommodation'. It recommends that the Government and the Office for Students (OfS) should work more closely with universities to be more transparent on the availability of certain types of accommodation and their associated cost.

Affordability – students expect high quality accommodation for an affordable rent. High-speed broadband, communal areas, gyms, cinemas and bars, are just as important at the bedrooms themselves. However, with costly tuition fees and rising living costs, students are always looking to reduce how much they pay for their accommodation. The London Plan has sought to address this by imposing affordable requirements on new build projects but this is simply seen as a further burden on viability for providers.

Community and wellbeing – even though students want independence, research shows that they still prefer to live with flatmates. Therefore the fact that the traditional multiple occupancy flats with en-suites sell out quicker than studio flats, suggests that students want to live with others, but in an environment which is comfortable and provides both private and social space.

Increase in construction costs – private developers usually build PBSA in the form of communal flats (bedrooms with a shared living room and kitchen) or private studios, which often include high end leisure facilities. Schemes which charge a lower rent to students, (typically sub £160 per week) have shared bathrooms and very little by way of extra communal space in accommodation. These schemes (although affordable to the majority of UK-based students) are proving to be unviable by private developers due to the increase in construction costs and these challenges put pressure on margins. However, the PBSA sector is quite well served at the higher end of the market. This is often taken up by international students who require high-end accommodation, absolute convenience, and can pay for it.

Addressing the challenges of PBSA

Focus on overseas students – developers may feel like they have no choice but to focus on the higher end of the student accommodation market. This will predominantly comprise the overseas wealthy students who can afford to pay premium rents for premium accommodation. Until that end of the market is saturated, most developers will likely focus on that £160 + price bracket.

Provide mass market solutions – there is no magic solution, however there are opportunities for developers and contractors to work out lower constructions costs by perhaps looking a modular construction, or by designing innovative accommodation with alternative room types. Otherwise, the balance of student demands with a profitable business model will not be met.

Collaboration between universities and the private sector – universities and student accommodation providers are now beginning to work more closely together to provide new and innovative accommodation that enhances wellbeing, promotes social interaction and contributes positively to a student's overall university experience. University guarantees have been used in the past to leverage financing but most are keen to keep accommodation projects off their balance sheet.

How will these trends develop?

There is an increase in demand for student accommodation within the UK, which is being let by the private sector. With the UK continuing to maintain its global reputation for higher education institutions, it is likely that there will continue to be a high demand of good student accommodation in prime locations from both UK-based and international students.

The heightened awareness for student accommodation to be of a greater quality, will push developers to have an increased focus on design, and work together with universities to make the accommodation an integral part of the student experience.

> *"Student mental health has become a top priority for both universities and policy makers; therefore it is likely that we will see this impact on student accommodation developments."*

We may even see the current pattern of providing high-end, studio schemes hitting a plateau, as student demand appears to be changing. It appears that students want a sense of community, therefore private developers and student accommodation providers need to find new ways of working together, to design buildings which accommodate these student demands, together with the balancing act of delivering viable schemes.

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Artificial Intelligence and discrimination

Artificial Intelligence (AI) is an attention-grabbing concept. From suggestions of workplaces being overtaken by robots, to being managed by computer, or to promises of automated efficiency and productivity, the promises are huge. Can AI in the workplace live up to expectations and are there dangers to be wary of?

The problem with algorithms

For all their effectiveness and potential advantages, it is important not to forget that algorithms are computer codes written by humans for human purposes. They are a set of rules which a computer follows to solve a problem.

> *"The problem with algorithms is that they can discriminate on the grounds of protected characteristics when they become tainted by the unconscious assumptions and attitudes of their creators, or as a result of unbalanced or prejudiced data which they are programmed to rely on and even learn from."*

Dangers of using AI alone

Using AI alone as a means of recruitment can be risky. Amazon has had to scrap an AI recruitment tool on the basis that it discriminated against women. The tool used algorithms to give job applicants scores ranging from one to five stars. After a few months of use, Amazon realised that the system was discriminating against applicants for certain jobs, the reason for this being that Amazon's computer models were trained to vet candidates on the basis of patterns submitted to the company over a ten year period.

As the majority of CVs came from men, reflecting a male dominance in the tech industry, the machines replicated these patterns and taught themselves that male candidates were to be preferred.

This algorithm was more likely to identify new employees who had similar experiences, backgrounds and interests as the current workforce. New recruits were therefore far more likely to be the same gender and race as existing employees. These biases are not necessarily easy to programme out, even once the programmers are aware of them.

Discrimination

If a job applicant is automatically rejected because they are different to existing employees, they may be able to bring a claim for indirect discrimination on the basis that the algorithm placed them at a particular disadvantage because of a protected characteristic. There may also be mileage for a direct discrimination claim if there is evidence that entire protected groups were systematically excluded from the recruitment process by the AI technology.

What steps should employers take?

While AI can certainly be used to make the recruitment process more efficient, employers will have to guard against any discriminatory elements it introduces into the process. "Automation bias", which occurs when humans give undue weight to the conclusions presented by automated decision-makers, and ignore evidence suggesting they should make a different decision, needs to be protected against.

Managers need to understand how the AI is making its selection decisions, and should be trained to treat them as recommendations only. This isn't always straight forward, with the software providers naturally keen to protect their IP and innovations. There should also always be HR involvement at an early point in the decision-making process to ensure that automation bias does not occur. Proper processes to vet potential candidates should be set up, involving a mixture of human involvement and AI to ensure that any potential claims of discrimination brought by rejected candidates can be robustly defended. Decisions produced by AI should also be kept under review over a period of time, and checked for potential discriminatory trends.

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Claims against Approved Inspectors – no-where to go?

Both before and following the Grenfell Tower tragedy, we have dealt with a number of disputes in relation to fire safety and non-compliance with Building Regulations.

We frequently get asked by clients whether, as a developer or freeholder, they can claim for the costs of remedial works against building control if they negligently confirmed that the design or construction of a building complied with Building Regulations?

In respect of claims against local authority building control (LABC), the short answer is no. There is no contract with LABC and so there can be no claim for breach of contract. Furthermore in Murphy v Brentwood DC[1], the courts shut the door on parties claiming for the costs of remedial works in negligence against LABC, holding that they had no duty in respect of such losses.

However, private companies registered as Approved Inspectors (AIs) can also now carry out building control functions [2]. No cases had considered claims against AIs until recently:

In the Court of Appeal case of The Lessees and Management Company of Herons Court v Heronslea Ltd and others[3] the court considered whether AIs had a duty under section 1(1) of the Defective Premises Act 1972. Under this section, a person taking on work for, or in connection with, the provision of a dwelling owes a duty to the employer or owner to see that the work is done in a workmanlike or professional manner to make the dwelling fit for habitation on completion. It held that the earlier case of Murphy indicated that this duty should not apply to LABC and there was no reason to treat AIs any differently.

In Zagora Management Ltd and others[4] the court considered various claims relating to defective construction work at a new-build residential development, including whether the AI had fraudulently mispresented that the development complied with Building Regulations in signing off the final certificate. Even though the Court found that the AI had knowingly or recklessly made a false representation in the final certificate, the claims:

- 1.1 by the leaseholders failed for lack of reliance on the final certificate; and
- 1.2 by the subsequent purchaser of the freehold failed as the AI would not have intended for them to rely on the representation. [5] Perhaps if the freeholder had been the original developer its claim could have succeeded?

A key difference between AIs and LABC is that they are usually appointed under a contract. If you have the benefit of a contract or warranty with the AI, then a breach of contract claim can be considered. That said, in practice AIs generally insist on clauses excluding much of their contractual liability.

Given the above, clearly it is very difficult to bring a claim against AIs. You should therefore ensure that you have robust suite of contractual documents in place so that claims in respect of breach of building regulations could be made instead against the contractor and/ or the design team.

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1 [1991] 1 A.C. 398
2 Under the Building Act 1984 and the Building and Approved Inspectors (Amendment) Regulations 2010
3 [2018] EWHC 3309
4 [2019] EWHC 140 (TCC),
5 The case recently went to the Court of Appeal but the decision in respect of the AI was not challenged.

Local authority borrowing

The surprise 1% hike in the rates of interest offered by the Public Works Loan Board (PWLB) in October last year has focussed attention on possible alternative methods of borrowing for local authorities.

In principle there is no reason why local authorities should not look to the private sector for borrowing both for housing and their general financing requirements. This article looks at some of the key features of each of these alternative types of financing and, where relevant, contrasts these with the products available through PWLB.

Loan agreements

Loan facilities may be on a term basis, where loans are drawn and remain outstanding until they are repaid, or on a revolving basis, which operates like an overdraft or a credit card.

As with PWLB, it is possible to structure term loans on an amortising basis or to provide that they are repaid at the end in one "bullet".

One innovative variant already used by two authorities is the "forward start" under which a council will commit to draw a loan at a specified point in the future but locking in today's interest rates. PWLB does not offer this option nor does it offer revolving credit. It also lends on a fixed rate basis only, whereas loan agreements could offer a range of different interest alternatives.

Private placement of notes

These are simply promises to pay specified sum(s) at a future date (essentially "IOUs"). They could have a maturity of up to 35 years or even longer.

It is possible to agree bespoke terms, for example issuing on a deferred basis and/or with a range of maturities, all in the same agreement.

As with PWLB, the principal risk of entering into this kind of arrangement is payment of "make-whole" on any early repayment. This requires investors be compensated for the interest that they would have received through the balance of the term of the Note - these costs could be substantial.

The private placement market is particularly well developed in the United States and councils may consider tapping this investor base. However, where a foreign investor buys notes in sterling, it will often enter into a swap transaction to manage exchange rate movements. An investor would typically look to pass on to the issuer the costs of breaking this swap in the event of early repayment. Entering into such arrangements could be a foreign currency borrowing, requiring Treasury consent under the Local Government Act 2003. This may limit the ability of councils to access foreign markets.

Public bonds

These are also IOUs, but listed on a recognised stock exchange. A credit rating is typically required. Bonds are typically fixed rate instruments although other variants (for example inflation-linked bonds) are possible. They can have a term of up to 30 years or longer and some of the bonds can be retained for an initial period to enable further funds to be raised later.

The set up and ongoing costs of a public bond are significantly more expensive than other types of financing, which means that we rarely see bond issues of less than £100 million and more usually issues will be in a minimum "benchmark" size of £250 million.

Unlike most bond issuers, a local authority does not benefit from the "quoted Eurobond exemption" under which issuers can pay interest to any bondholder without deduction of UK withholding tax. For this reason, it may be necessary for a council to issue a bond through a special purpose vehicle.

UK Municipal Bonds Agency

Many councils will not have a need to raise this kind of money in one hit. For them, the UK Municipal Bonds Agency offers a viable alternative means of accessing the capital markets. The Agency is planning to issue bonds for the exclusive purpose of on-lending to local authorities. This will offer a significant cost saving to authorities and will be simpler for a council than issuing on their own. Loans will be available on standard terms and each council will give a guarantee proportionate to the amount borrowed (the previous joint and several liability structure having been modified). The Agency is reported to be making its first issue imminently with Lancashire County Council as borrower. A second issue is also being reported which will create renewed interest.

Private finance alternatives v PWLB

For most councils, the interest rates available through alternative financing will be cheaper than PWLB. But this comparison does not take account of the complete picture.

Cost factors

Other than payment of interest, there are no costs associated with a PWLB lend, but with any alternative there will be fees payable to funders, intermediaries and service providers.

Speed of delivery

Raising PWLB debt has been likened to going to the cashpoint. Any alternative will take significantly longer. A bond issue, including the obtaining of a credit rating, is likely to take 4 – 5 months at least. A private placement will typically take a little bit shorter and a loan agreement could be put in place within weeks but in both cases a council will need to allow time to select its preferred funding partners, who will then have to go through their own internal approval processes.

Documentation

PWLB loans are issued with limited documentation and there is no negotiation. Any alternative will require detailed, technical documentation and key terms that can be negotiated. There will likely be a need to obtain external treasury and legal advice.

Terms required by investors

There are no on-going terms and conditions in a PWLB loan, other than to pay interest and to repay on time. It remains to be seen what terms funders in these various markets will offer to local authorities. Some lenders will look for compliance with financial ratios and all of them will expect to receive regular financial information. Some may want to discuss control on a council's activities, such as limits on the ability to on-lend or invest in joint ventures.

Understand the alternatives

Given the recent increase in PWLB rates, the headline interest rates available from other sources of borrowing look particularly attractive. But councils should take care that any comparison takes full account of all associated costs, the timing implications and the additional legal responsibilities that these structures bring with them.

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Commercial property: unleashing the full potential

Housing associations will inevitably hold some commercial property (which for the purpose of this article is anything that is not residential property and which can generate income).

This may be just a few small rows of shops, right up to an entire office building or industrial estate. It could have been acquired through stock transfers, developed as part of a mixed use development, or acquired during site assembly. Regardless of the type of asset or how it was acquired, there is usually a common issue, namely that the income generated can be enhanced. Commercial property has often been viewed as a non-core activity (or even worse as a distraction) by many housing associations, but in an ever-increasingly competitive environment, is now taken more seriously. It is also playing a bigger role in new developments.

This article looks at ways of doing this ranging from the straight forward, such as implementing rent reviews, to the more complex, like restructuring ownership. We appreciate that housing associations have an additional consideration that other property investors will not, being the need to ensure that appropriate services are available to their residents, and perhaps attracting (or preventing) use of commercial assets for particular purposes (as Guy Willetts explained in our Autumn 2018 edition.) These broader considerations will always need to be balanced alongside maximising income. Finally we look at what housing associations are doing with commercial property in new development.

Identification of existing assets

In the first place, it is a good idea to identify what commercial property is held. This may not be that straight forward, particularly for larger housing associations. Stock may have been acquired on a piecemeal basis with no detailed due diligence. However, a combination of a good commercial agent and working with your lawyers can get through this. Agents can physically inspect property to establish what units exist and who is in occupation. Lawyers can review deeds and undertake Land Registry searches to locate what leases are in place. Your agents should be able to use this data to provide you with a full portfolio and recommendations of returns can be enhanced.

Sweating the asset

An easy win can often be simply ensuring that rent, service charge and other amount due under the lease are all collected from commercial tenants. These can sometimes be overlooked, particularly amounts which are not rent. Over time and across a large portfolio, such oversights can add up to considerable sums.

> *“In addition, rent reviews may not have been implemented and could entitle you to an uplift in rent if the open market rental for the property has increased.”*

It is not uncommon to find tenants staying quiet about paying rents that have not changed for 15 or 20 years.

Some tenants may be prepared to “regear” their lease, which in short means entering into mutually beneficial arrangements with the landlord. This is what commercial property investors term “sweating the asset”. This could be as simple as removing a tenant break right in exchange for a rent holiday, or substantially varying existing terms and granting a lease extension to commit the tenant to the property for a longer period. These arrangements could enhance the reversionary value of the asset and the yield, as well as improve the tenant’s terms.

Vacant units and other space

Unlet units can also be identified, which may well be vacant units within estates that have gone unnoticed. You could be paying rates and other property costs on these when there may well be willing tenants, even if these are ‘meanwhile tenants’ or let as ‘pop up shops’ (or even converted to residential use). There could also be less obvious potential. There may be demand for open spaces year round, for example for sporting events or open air cinema in the summer and Christmas markets in the winter. These uses also benefit residents, and the leases can be structured on a ‘turnover rent’ basis so the more successful they are, the more the housing association will benefit.

Restructuring

You may consider restructuring your ownership of your commercial property. One method of doing this would be to transfer it all to a subsidiary special purpose vehicle. Many of the properties involved are likely to be parts of residential blocks and therefore, a lot of the transfers would be achieved by way of long leases (which can still be done on a cost efficient basis). Standalone commercial premises can be transferred by a simple freehold transfer. The special purpose vehicle could be incorporated as a limited company, not subject to regulatory or charitable restrictions and able to dispose of property freely. Profits made by the company can be gift-aided to a charitable group member. The company could enter into agreements with managing agents and sales/lettings agents to manage the portfolio. These fees will be far more cost effective spread across an entire portfolio. Additionally, the company would be free to raise debt secured on the portfolio for acquisition or development of further commercial property. Ultimately, you would also have the option to sell the company itself to a third party investor, with the added attraction to them that such a sale would avoid the 5% SDLT rate on commercial property and instead only be subject to stamp duty on purchase of company shares of 0.5%.

Taking this idea a step further, the benefits and economies of scale could be significantly enhanced if two or more housing associations pooled their commercial property together. Again, a special purpose vehicle could be incorporated to hold the property, with each registered provider involved holding a share in the company. A joint venture agreement can be prepared setting out the obligations and profit shares of each party depending on the value of stock each has contributed.

Developing new commercial property

Housing associations are becoming more savvy in how commercial property forms part of new residential led developments, both in its specification and the intended tenants.

> *“Higher quality spec for some commercial units is being built into the development with a view to achieving better tenants and higher rents.”*

Ever more flexible spec is also often used in the planning applications and designs, to ensure a wider market of tenants. Flexible user is also being applied for. Instead of simply applying for A1 and D1 use, a planning application will ask for commercial units to allow all class A uses, D1, D2 and B1. Housing associations are also not afraid of new covenants, which other landlords might shun for more established (but less innovative, useful and frankly interesting) tenants. In choosing to let to new covenants, a rent deposit or guarantee can be taken to mitigate the risk involved. There is also the consideration of a good tenant mix. Housing associations can, and are, taking this to new levels, even setting up their own collaborative “WeWork” style offices, giving opportunities outside city cores for new businesses that otherwise might struggle for accommodation and which can contribute to genuinely mixed and sustainable new communities.

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