MEES: know the risks

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Andy Miles and Chris Bennett highlight what valuers and lenders need to know about the Minimum Energy Efficiency Standards

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Following the Energy Act 2011 , the Minimum Energy Efficiency Standards (MEES) were established in 2015 to make it unlawful to let either residential or business premises that do not achieve a minimum standard, currently set at an energy performance certificate (EPC) rating of E. There will be a soft start to the implementation of the MEES legislation for all new leases after April 2018, and a ?hard start? to the implementation for all properties by April 2023.

How are commercial property valuers advising their lending clients with regard to risk?

The market has been aware of these proposals for the last 5 years, and it is clear that the majority of commercial funds and real-estate investment trusts have for some time been assessing their existing portfolios and the assets they have acquired. They now have plans in place for tackling the letting issues that will potentially arise in 2018.

But what about lenders who secure debt on commercial property assets? How do they view the implications that this legislation may have on assets that they either have already under charge or propose to take on? Are lenders fully considering the impact that this legislation has on both the value of the asset and future cash flows that service the debt? Furthermore, how are commercial property valuers advising their lending clients with regard to risk?

Risk

The single most important aspect for a lender when assessing credit risk is to consider the likelihood of repayment, both in terms of principal and interest, and the implications of the MEES are critical in this regard. Although there is an awareness of the MEES and in particular minimum EPC requirements, lending market convention has yet to evolve to cover all aspects of the credit implications. For example, there is inconsistency in approach to the assessment of space that becomes unlettable, both for the capital expenditure and the valuation implications of improving such space to at least an E rating.

In the majority of instances, lenders increasingly require the borrower to have valid EPCs available or prepared as part of the due diligence process, to demonstrate that the minimum rating is currently being achieved. This can be a condition of funding, and a lender can also require the implementation of asset management objectives and a programme of capital expenditure ? irrecoverable through service charge or sinking fund obligations ? to maintain or improve the EPC ratings.

However, lenders are in general still taking a light-touch approach to the MEES, in terms of both being consistent in credit policies and understanding the underlying EPCs themselves. For example, market practice would not tend to distinguish between individual EPCs in terms of their remaining duration or requirement for re-assessment and the duration of the loan to which they relate. It should be noted that there is the real likelihood that ?older? EPCs, which currently have a shelf life of 10 years, could easily mask risk. Where the EPC was prepared many years earlier, there is the potential that the asset could have a significantly poorer rating if it were re-assessed today, given the ageing of buildings and tightening of regulation. Some lenders will consider an EPC to be out of date if it is more than 2 years old and may require a fresh certificate be prepared by an approved assessor. It must be remembered, however, that the monitoring of EPC assessors remains unregulated.

Void periods

Returning to the original observation about credit risk and repayment, there is a significant chance that lenders are wrongly assessing void periods, in respect of vacant space that does not hold the relevant EPC rating, when they consider new leasing beyond April 2018. The impacts of this are twofold:

1. the introduction of voids ? and possibly other irrecoverable costs such as empty rates or service charge shortfalls ? will reduce the level of rental income with which to service the debt; and
2. the underlying security could become less valuable as a result of required capital expenditure that may be irrecoverable.

Both factors could adversely affect the ability of the asset to enable repayment of the loan at maturity. In this instance, the guidance of the lender?s valuation adviser is of significant importance in terms of understanding the implications of non-compliance with the MEES regulations.

Both issues are material because breaches in debt service levels affect loan ratings for regulated lenders, lessening the economic performance of loans in terms of the increased amounts of regulatory capital employed. Delays in repayment of the loan at maturity are also important for the deregulated sector, typically represented by close-ended debt funds with fixed investment and divestment periods. The materiality of these issues is compounded by the fact that properties with non-compliant EPCs would most typically be found in the secondary or tertiary sectors of the property market, with possible negative implications for the long-term availability of credit to these markets.

Valuers? role

From a valuer?s perspective, part of preparing a valuation report for ?secured lending purposes? is to ensure that the lender is advised of the risks to the potential future value of the asset and the cash flow it may generate.

EPCs are a potential source of risk, so certificates must be obtained where available and considered carefully before the valuation figure is prepared. At this juncture it is critical that the valuer does not:

- stray outside their area of competence; or
- proffer advice or make assumptions that then prejudice their own professional indemnity insurance.

The valuer may identify where risk exists, but must recognise their limitations and only incorporate likely capital expenditure charges, having obtained them from a reliable source and discussed them with the client; the report must refer to the source of figures.

So what should the valuer be seeking? If the property asset is being traded, then the valuer must request the EPC or EPCs; failing that, they should consult the [EPC Registers](#) . It is possible that, if the property is not being traded ? for instance, because it is being refinanced ? or existing lettings pre-date the 2008 legislation, certificates may not be available, although these situations are becoming rarer.

The valuer must ensure that they have sight of the ?recommendation? section of the certificate, because this often becomes separated from the rating page. That section will at least give directives as to what can be done in the short, medium or longer term to improve the rating of the asset.

Lenders should increasingly take a proactive approach to understanding the framework for MEES

Where a rating is edging towards the danger zone or is already in the F or G bands, the valuer should advise that the steps recommended to improve it be properly costed by a building surveyor or quantity surveyor, as it is probable that these expenses will fall to the landlord ? the borrower ? to meet at lease expiry.

If a property is being acquired on the open market, it is likely that the purchaser has already factored this risk into the price, although this should not be taken for granted. It is a situation that needs particular consideration with a refinancing, as a borrower may not have reflected the cost in their assessment of market value. In these instances the valuer will need to focus on ensuring that any risk is taken into account and the lender advised accordingly.

If preparing a vacant possession assessment, the valuer should certainly be looking to factor these costs in to it to ensure the hypothetical building is fully marketable.

Vigilant lending

To mitigate risks, lenders should increasingly take a proactive approach to understanding the MEES framework and its implications for their own loan portfolios, whether these comprise new or historical loans. Steps that should be implemented include obtaining EPCs in respect of all space subject to the MEES and considering the duration of the EPCs relative to loan length. For non-compliant EPCs, lenders should ensure that the borrower has set aside sufficient capital and should also obtain professional advice as to the feasibility of implementing the programme in terms of both cost and time.

All of the above demonstrates that communication between the valuer, the lending client and the borrower is paramount.

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Further information

- Related competencies include Leasing/letting , Sustainability and Valuation
- This feature is taken from the RICS *Property journal* (September/October2016)