In collaboration with

Net zero social housing: a just transition through a perfect storm

Executive summary

Royal London Asset Management and Friends Provident Foundation conducted an engagement campaign with eight housing associations and one finance aggregator, seeking to better understand the challenges faced by the sector and determine how, despite observable and often competing claims on housing associations' finite resources, the sector can best achieve a just transition to net zero.

As long-term lenders it is clear to us that gaining a better understanding of the sector's transition plans, and the extent to which the transition will impact the balance sheet and cash flow of housing association issuers, is central to making well informed lending decisions.

Under the current circumstances, social housing's route to net zero is poorly defined and unfair as it risks diverting resources from other essential priorities, such as new affordable homes. We do not believe that addressing decarbonisation to the detriment of housing association's other requirements is a solution. Therefore, after outlining housing association's priorities, good practice, and key challenges, we conclude with summary recommendations for policy makers, fellow financers and housing associations themselves.

Introduction

For years Royal London Asset Management and Friends Provident Foundation (FPF) have maintained that the climate transition must be a just transition. A just transition ensures that climate action also supports an inclusive economy and avoids exacerbating existing injustices or creating new ones.

Royal London Asset Management, as part of the largest mutual life insurer and pension provider in the UK and a significant long-term funder of the sector, and FPF, an independent charity which promotes a fair and sustainable economy, wished to understand the challenges facing the sector. Together we have engaged on just transition in the energy utilities sector, successfully resulting in the increased consideration of these social matters and seeing utility providers publish just transition plans.

In 2022 we also commenced engagement with British banks on just transition. We believe companies that integrate social considerations in their climate plans are better equipped to deliver them and can play a role with governments in maintaining the social acceptability of the transition.

The problem – a perfect storm

The latest government statistics show that as of 2020, 18.7% of housing association (HA) residents in England live in 'fuel poverty'[a]. Given the energy crisis and current inflationary pressures, we believe that this number today is likely significantly higher. We want to ensure that these and all vulnerable residents are at the heart of any decarbonisation efforts, as the required energy transition represents a once-in-a-generation opportunity to eliminate fuel poverty and lower fuel bills, while creating more comfortable homes.

> **"The number of residents experiencing it [fuel poverty] has grown exponentially"**
>
> **Director of Business Development, Housing Association**

Crucially, we believe that the social housing sector's ability to reach net zero is correlated with its credit risk, therefore understanding asset quality and the cost of decarbonisation has clear implications for Royal London Asset Management's investment decisions.

[a] A household is 'fuel poor' if they are living in a property with a fuel poverty energy efficiency rating of band D or below, and when they spend the required amount to heat their home, they are left with a residual income below the poverty line.

The independent review[1] of the UK government's approach to delivering its net zero target states clearly that the UK's current policies for buildings need to go further and faster to reach net zero. Current energy efficiency policies and the high upfront costs for retrofitting mean that those least able to pay are more likely to feel the pain of these changes. Social housing is on average better insulated, with 62% of dwellings already having wall insulation, compared to just 32% of privately rented dwellings[2].

However, we are concerned that competing demands on the limited resources available to HAs may adversely impact their ability to provide for their residents and to remain financially sound. Alongside the government-mandated decarbonisation, structural issues of fire safety, a lack of affordable housing and substandard housing quality are compounded by the current cost-of-living crisis, inflationary pressures, and rising funding costs.

What we did

As part of our ongoing credit research, we regularly meet and engage with social housing bond issuers and the Regulator of Social Housing, and we are acutely aware of the sector's challenging outlook. With an aim of gathering greater perspectives on the social and financial implications of decarbonisation, we wrote to nine parties requesting to meet.

Royal London Asset Management and FPF lend to all the parties included but, more meaningfully, the HAs demonstrated a diverse range of attributes including size of the association, location of operation (England, Scotland, and Wales; national and regional; urban and rural), type of housing stock, type of residents, and emphasis on development. We held meetings with company management in H2 2022, discussing our questions with CEOs, CFOs and specialist sustainability staff such as Directors of Sustainability.

Through our letter and meetings, we asked the HAs:

1. **What specific aspects of the decarbonisation process do you see as the most challenging for your organisation?**
2. **How are competing capital allocation decisions being made?**
3. **What are your views on government policies, and how the government decarbonisation funding has been assigned?**

As a result of the research and engagement conducted, this report aims to outline what priorities HAs are having to balance, before providing recommendations to policy makers, funders and HAs. The report signposts a number of resources which provide further depth.

What are housing associations' priorities?

When confronted with a multi-objective strategy of improving the climate credentials of the housing stock, our meetings showed that HAs are aware that aspects of their business will require prioritising. The consultation and the announcement of a 7% cap on social housing rent, whilst seen as reasonable by housing associations, still means that housing associations will have their revenue base increase proportionally less than their cost base. The HAs we spoke with indicated this would necessitate prudent spending allocation.

> **"If the government requires EPCs and rent caps, then the result is you provide less social housing"**
>
> **Finance Director, Housing Association**

Furthermore, housing development was a clear area highlighted by nearly all HAs as something they would look to cut back on. This was especially true for the HAs who develop their own sites. A slowdown of housing development would appear counter to what is required, due to the shortage of residential housing that currently exists in the UK – with this problem particularly acute in the social housing sector. This strikes us an overt illustration of how solving one outcome – improved environmental performance – can have an unintended social impact. Solving one to the material detriment of another is not a solution.

An estimated 145,000 new social homes need to be built annually to meet demand (with 90,000 of these being social rent)[3]. It has been estimated that this will require an average of £21.6bn in new borrowing annually[4] and illustrates the importance for the sector to maintain financial viability, including access to private funding.

> **"Health and safety is the top priority"**
>
> **Tax and Treasury Director, Housing Association**

More positively, a common thread across all our meetings was agreement that investment in health and safety would not be cut. This is aligned with what appears to be a greater focus on resident care, but also likely buoyed by the passing of the Building Safety Act[5] and expected passing of the Social Housing Regulation Bill[6]. A reoccurring theme was that spend relating to fire rectification was non-negotiable. This appears consistent with the high levels of investment in existing stock observed by the Regulator[7].

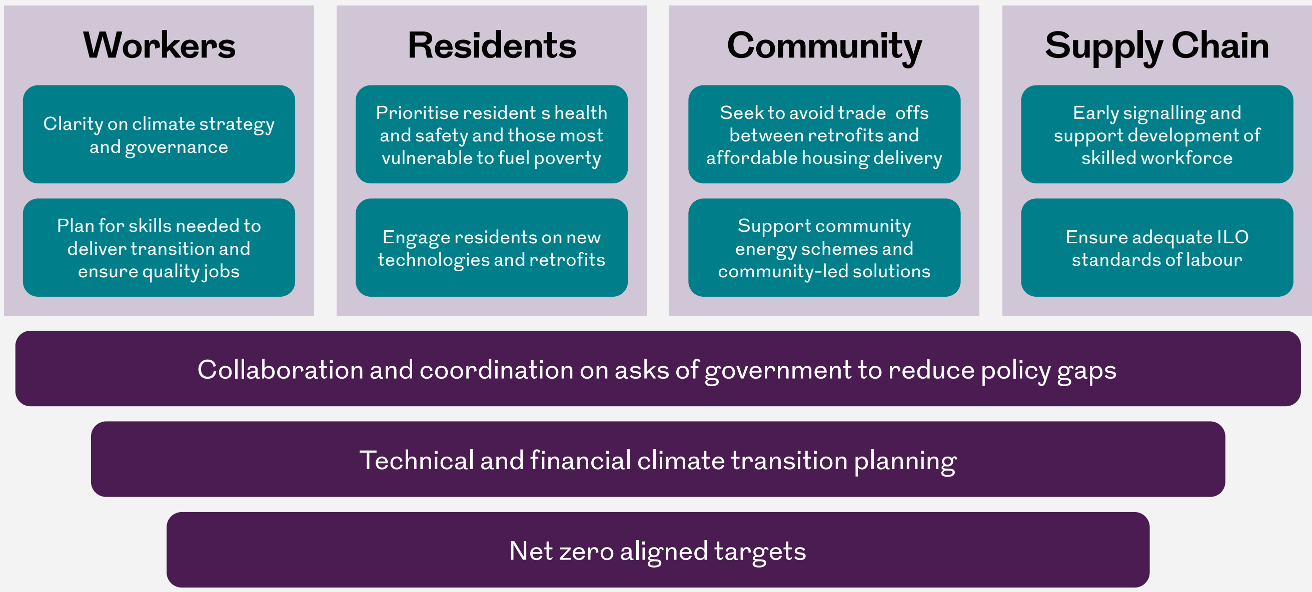
Energy efficiency of housing stock and reducing emissions were described by most HAs as another priority. Yet there were considerable differences in the strategies pursued, the level of spending allocated to the transition, and progress so far. The UK is legally bound to reach net zero by 2050, which will require buildings emissions reductions of 98% to 100%[8]. To make this happen, the Government's Heat and Buildings Strategy[9], and an associated briefing for HAs[10], outlines the targets of:

- Fabric first energy efficiency activity that brings as many homes as possible up to EPC (Energy Performance Certificate) C by 2030 for social and fuel-poor homes (2035 for other homes) where cost effective, practical and affordable[b,c].
- Heat pumps and heat networks should make up a large proportion of heating in all scenarios and should be deployed as soon as possible where they are obviously the right solutions regardless of future trajectory.

Positively, the EPC targets appear within reach for all the HAs we met. One HA, albeit with favourable circumstances, managed to achieve EPC C across all housing stock earlier in 2022. However, EPC ratings have limitations and are insufficient for achieving net zero[11]. Measuring the cost associated with heating, rather than energy efficiency, EPC ratings are a blunt proxy which can incentivise solutions mis-aligned with net zero. Alternative metrics such as Space Heat Demand[d] or scope 3 emissions from residents' consumption are being tested by several of the HAs, with a cited benefit being the metrics' better relation to residents' comfort and lived experience. Nonetheless, the HAs we spoke with considered EPCs an imperfect yet preferred metric due to its widespread use and awareness.

In the context of unclear government guidance, we found that larger HAs, due to increased capabilities, or need for long-term strategic clarity and planning, have made significant strategic calls. For example, one HA decided to solely implement fabric measures and not clean heating technology up to 2030, due to perceived technology risk and achievable EPC C requirements. In contrast, the smaller providers did not always appear comfortable in making these strategic decisions. Despite their heterogeneity, the HAs shared many common challenges relating to decarbonisation.

Just Transitions expectations for Housing Assocations: Integrating key stakeholders in the delivery of their climate plans



[b] The devolved governments have set differing EPC targets for social housing. In Scotland a target exists to reach EPC B by 2032. In Wales, the target is EPC A by 2033.

[c] The target year of 2030 does not align with the 2028 advised by the Climate Change Committee in the Sixth Carbon Budget.

[d] Space Heat (or Heating) Demand is a metric for thermal performance which describes the amount of heat required (usually in kWh/year) to heat a building to maintain the inside of a building to a particular heating profile for a given set of weather conditions.

Challenges to delivery of net zero

Lack of certainty on policy, pathways and funding:

All HAs interviewed cited the lack of stable or consistent national campaign and clarity on what net zero means for the sector, longer term finance, the penalty for inaction, and guidance on decarbonisation solutions. Nevertheless, the HAs also acknowledged the complexity of establishing such guidelines, and credited the Department for Business, Energy & Industrial Strategy (BEIS) for their efforts.

Financial limitations:

Financial barriers included access to capital, longer term certainty of financing, and especially the lack of return from investments in retrofits[12]. In total the government has earmarked £3.8bn in funding through its Social Housing Decarbonisation Fund (SHDF), yet estimates indicate that at minimum nearly 10 times this amount (£36bn) will be needed to reach net zero targets by 2050 in England alone[13]. With redline requirements for the sector to invest in asset condition (fire safety, damp & mould) at a time of high-cost inflation and higher funding costs, non-revenue generating investment will undermine financial viability and access to funding if unmitigated or government funded.

Resident engagement:

A lack of resident buy-in was named as a significant challenge, usually due to a lack of perceived interest, knowledge or understanding. One HA anecdotally described that half of their residents' offered retrofits have refused to have work done on their homes. This also highlights the barriers to incremental approaches to decarbonisation that rely on repeatedly gaining access to residents' homes.

Supply chain constraints:

HAs have experienced challenges with varying parts of the supply chain. The most common issues related to the lack of skilled labour to carry out work. The allocation mechanism of the SHDF was also pointed to as a potential accelerant of bottlenecks, as all funding is distributed at the same time. Additionally, one larger HA cited complications of suppliers only providing one component required in decarbonisation. The larger HAs consider it their responsibility to stimulate and provide certainty to the supply chains.

Limited sector coordination:

The sharing of information and knowledge throughout the social housing sector and its value chain is poor. A large proportion of HA's decarbonisation pilot projects appear to have been conducted in isolation, despite previous learnings existing. Emerging examples of coordination amongst HAs are driven by the need to scale solutions, rather than pilot.

Although the HAs we engaged with have on average achieved EPC C in around 75% of their housing stock, Table 1 demonstrates how the cost of achieving EPC C in remaining housing stock may necessitate a significant proportion of currently raised debt. Table 2 demonstrates our sector-agnostic 12 indicators, which we use to assess climate plans (for further detail on these please see our Net Zero Stewardship report). While the HAs we spoke to had generally not produced or made public their net zero plans, there was often a good focus on working together to bring the entire supply chain to net zero. Just transition as a concept was not mentioned by the HAs, but we were pleased to find that all to varying degrees discussed social implications of the environment and climate changing, and/or the requirement to decarbonise. We have tried to showcase some of this and other good practice in Table 1.

Table 1. Potential financial burden of retrofits and examples of good practice

Housing Association	Homes at EPC C and above[e]	Estimated cost range of achieving EPC C[f]	Estimated cost as % of gross debt	Select examples of good practice
HOUSING ASSOCIATION 1	73%	£91.7m-£458.7m	2.9%-14.3%	1. Developing a data-driven tool for packaging health and safety & energy efficiency retrofits and prioritising work between tenants. 2. Working to disclose scope 3 emissions from residents living in their properties.
HOUSING ASSOCIATION 2	70%	£187.3m-£936.5m	4.5%-22.6%	1. Using responsive retrofits as immediate help for fuel poverty. 2. Developing archetypes of homes to bundle retrofit solutions.
HOUSING ASSOCIATION 3	70%	£104.0m-£520.2m	3.3%-16.3%	1. Partnering in EU projects encouraging adoption of low-carbon heating. 2. Developing clear understanding of net zero homes requirements beyond EPC C by 2030.
HOUSING ASSOCIATION 4	75%	£9.7m-£48.4m	4.0%-20.1%	1. Creating homes at 'Passivhaus' and subsequently their own standard to balance sustainability and affordability. 2. Developing shared air source heating at small scale for well-insulated rural homes.
HOUSING ASSOCIATION 5	79%	£58.8m-£294.0m	1.8%-8.8%	1. Approaching resident engagement proactively, and consulting over 1.7k residents on sustainability strategy. 2. Trialling Space Heat Demand to measure comfort of residents and prioritise retrofits.
HOUSING ASSOCIATION 6	100%	£0	0%	1. Upgrading 4,000 properties to EPC C at a cost of £140m 8 years ahead of government deadline. 2. Trialling solar self-generation and deciding not to invest on offsets but prioritise real decarbonisation.
HOUSING ASSOCIATION 7	73%	£76.6m-£382.8m	6.7%-33.3%	1. Founding member of 'Greener Futures Partnership', helping HA's share knowledge and pool resources. 2. Ensuring a structured approach to resident engagement through demonstrator homes
HOUSING ASSOCIATION 8	70%	£115.1m-£575.5m	2.1%-10.5%	1. Working with Science Based Targets initiative to develop a definition of net zero by 2050, a climate transition plan, and a cost profile. 2. Creating robust plans for new-build properties, including embodied carbon assessments and heat networks.

[e] These figures are taken from public disclosures and our meetings, and may have been adjusted to account for the provision of management services.

[f] The upper range uses estimates of retrofitting homes by THFC of £25k per home, whereas the lower range is calculated as £5k using the CCC's figure of £55bn to achieve EPC C targets, providing £9bn for social housing according to THFC's calculations.

Table 2. Analysis of HA's climate plans

	Set a target aligned with 1.5 degrees ambition			Bring others to Net Zero				Demonstrate climate action now					Net Zero Investment Framework
	1. Aligned to 1.5 ambition	2. Set targets encompassing all scopes of emissions	3. Only offset residual emissions	4. Commit to scaling up technology	5. Lobbying	6. just transition	7. Invest in adaptation measures	8. short term targets & delivery	9. Board, management incentives	10. Developing an action plan	11. Align capex, accounting practices	12. Disclose transparently	
Housing Association 1									N/A				Aligning towards a net zero pathway
Housing Association 2									N/A				Aligning towards a net zero pathway
Housing Association 3									N/A				Aligning towards a net zero pathway
Housing Association 4									N/A				Not aligned
Housing Association 5									N/A				Not aligned
Housing Association 6									N/A				Aligning towards a net zero pathway
Housing Association 7									N/A				Not aligned
Housing Association 8									N/A				Aligning towards a net zero pathway

Recommendations for a just transition

The recommendations in this section are not exhaustive but consolidate our findings for good practice and inform a guide for each party to move the climate and just transition agenda forward — including ourselves.

Government

Credible cross-government net zero strategy and investment plan for social housing (BEIS, DWP, Treasury, Regulator of Social Housing)

Cohesive government strategy on the route to net zero for the sector, and the medium and long-term financing opportunities available is critical. As the pressure on HAs continues to grow, they will have to make trade-offs amongst competing goals, and clarification on what are acceptable trade-offs should be provided by the sector regulator. Further government coordination is needed, including on topics such as the application of VAT[14] for green technologies, and finding self-sustaining funding mechanisms for retrofits. There is a case for a more holistic view of the benefits of adequate social housing for reduced government spending on health, energy and education. For example, the 'ESCO' or 'Energiesprong' approach[15], sees the costs of retrofits being paid off using housing benefits which would otherwise be used to cover energy bills. Unfortunately, current Department for Work and Pensions (DWP) regulations do not allow this cross-subsidy.

Develop a national voice on decarbonisation and energy efficiency

Resident education and engagement should not be the sole responsibility of HAs; the government should run a national awareness campaign that provides insights into decarbonisation, new technologies and the reasons for their use. This would benefit the wider public, as well as those in social housing.

Price rent cap: earmark savings for energy efficiency upgrades

As the government will be the principal beneficiary from the rent cap, it could earmark these funds towards HAs' energy efficiency measures and recoup benefits through energy security and lower electricity bills. Private finance can only go so far and without government financial support there will have to be compromises.

Integrate net zero into Decent and Future Homes Standard[g] & develop net zero standards

The government should include in its current review of the Decent Homes Standard relevant decarbonisation aspects, as they are intrinsically linked to the quality of the housing stock. For example, having suitable ventilation is necessary for both extreme heat adaptation as well as moisture and damp control. Additionally, as suggested in the Net Zero Review[16], the immediate mandating of the Future Homes Standard and creation of a 'Net Zero Homes Standard' and 'Net Zero Performance Certificate' would provide invaluable clarity to HAs (as well as the wider sector).

Address supply chain shortage

The government should utilise the UK's excellent secondary and tertiary education to bridge the skills and supply chain gap around construction and heating technologies described by HAs. Doing so can help the entire building sector decarbonise by the 98% to 100% required[17].

Housing associations

Look beyond 2030 and define what net zero means for the association

Many HAs we spoke to feel that the previously described government targets of 2030 are within reach. The decades from 2030 to 2050 are currently full of unknowns and lack of action today may mean HAs and residents will be left behind. Resources required to get to EPC C may not be useful in the longer run to reach net zero, which is wasteful given the context of limited resources. We expect that foresight now will enable a better transition to net zero post 2030.

HAs should align their scenarios with currently best agreed practice even in the absence of clarity from government of a sector pathway to net zero. Doing so creates a position from which future strategic choices can be made. The UK's Climate Change Committee have published what is required from the wider housing sector[18] to reach net zero, and subsequently the National Housing Federation (NHF) have created a briefing which should be valuable to housing associations[19].

[g] https://www.gov.uk/guidance/decent-homes-standard-review

Partner with others inside and outside the sector, particularly on heating

HAs can learn a lot from peers and partners in the supply chain. We have seen discrepancies around HAs' expectations and understanding of technologies or regulatory change. Such misunderstandings often result in inaction and inefficiencies, which partnerships such as the Greener Futures Partnership[20] can resolve. Further consolidation of the sector may facilitate coordination. For example, jointly engaging with energy utilities to accelerate solutions, or reaching out to parts of a fragmented supply chain to build-up skills and extract more value could lower costs. Enhanced focus around community energy schemes, district heating networks and smart local energy schemes could unlock further at scale solutions for heating decarbonisation.

Engage with residents and prioritise most vulnerable

HAs should see the decarbonisation of housing as an opportunity to help reduce fuel poverty and lower fuel bills while also creating more comfortable homes. This will build trust and reduce reputational risk[21].

HAs should be aware of residents' concerns and viewpoints and explain in accessible language why it is in residents' best interest to embrace change for energy efficiency and low carbon. It is crucial that residents are supported and given the opportunity to learn about the technology and materials which will be used in their homes. Without resident buy-in, net zero may be blocked.

Report on your progress and difficult decisions

Investors, regulators, supply chains and residents want to know what progress HAs are making. Being transparent and signposting any known uncertainties will be appreciated by wider stakeholders. The Sustainability Reporting Standard (SRS) for Social Housing[22] is a useful tool to achieve this and is seeing frequent refinement to optimise its efficiency. We believe the added value of SRS is to choose specific material indicators from the suite of recommended alternatives and develop targets around these. With finite resources and competing demands, HAs are regularly making difficult trade-off decisions already. Explaining how the capital allocation decisions are made, and if decisions have potential environmental, or social implications are important for investors and policymakers to understand the sector's stress-points and long-term viability.

Finance

Incorporate just transition into climate transition plans

Banks, asset owners and asset managers should include just transition considerations in their net zero plans, as this helps support positive social impact and avoid potential unintended social consequences of decarbonisation of our portfolios. Financers should avoid starving social housing sector of financing purely to meet portfolio emission reduction targets.

Ensure relevance of existing financing products & create new solutions

Are labelled and sustainability-linked bonds truly living up to their names, and are the targets stretching enough? Finance should use its human capital to think of innovative finance solutions for the sector to the benefit of all parties, for example the work carried out with Northern Ireland's Housing Executive by the Grantham Institute at the London School of Economics to develop a just transition bond[23]. Investors with further risk appetite can provide (more) flexibility on returns investing for impact. Local and national government institutions can develop blended finance mechanisms.

Engage and understand HA challenges

Understand stress-points and decision-making the HAs you lend to are undertaking, and help increase operational efficiency by outlining, for example, what disclosures are of value to investors. Creating channels for communication is mutually beneficial.

Royal London Asset Management and FPF

While we have a different status in this area given that we are investors, we have identified our own next steps to support this process.

Engage with relevant parties

Royal London Asset Management and the FPF will engage with HAs, Regulator of Social Housing, National Housing Federation and Sustainable Reporting Standard to develop investor expectations on just decarbonisation plans, a definition of net zero and suitable targets.

Work collaboratively with other investors

With other investors, through the Financing the Just Transition Alliance and the London School of Economics' Grantham Institute, write to the UK government's newly founded Energy Efficiency Taskforce to ensure social housing features prominently in the implementation of their stated aim of reducing energy demand in buildings by 15% over the next eight years, against 2021 levels.

Support innovation

Provide feedback and support to the Financing the Just Transition Alliance and other actors working to develop social bonds with local authorities and innovating just transition financing products.

Conclusion: private sector can only go so far

Under current circumstances, social housing's route to net zero is unclear and potentially unfair. Improving the environmental performance of the sector is imperative, but it must not come at the cost of social impact. Greater sector efficiency and effectiveness is attainable, yet the sector cannot commit to non-revenue generating investment without negative consequences to viability or social housing delivery. Private finance can only stretch so far before HAs will see viability and rating consequences materially increase the cost and reduce the capacity for funding. Without appropriate government support, both financial and strategic, there will be significant compromises and failings, as evidenced by the recent Better Social Housing Review[24].

Royal London Asset Management is committed to supporting the sector within the context of our fiduciary duty to clients; to achieve attractive returns for observable risks. Our engagement has highlighted the pressure HAs are under, but also the immense effort they make to provide safe, comfortable and affordable housing to their residents. Yet risks are clearly increasing. For instance, in December 2022, Royal London Asset Management wrote to over 50 HAs, requesting they addressed concerns on potential damp and mould build-up.

It is hoped our recommendations and examples of existing good practice help provide some guidance and resources to reach the increased efficiency and effectiveness the sector can achieve; but the necessity for government to enact its responsibility is apparent. There is further work ahead for many stakeholders but with support and collaboration, we believe it is possible to have a just transition to net zero social housing.

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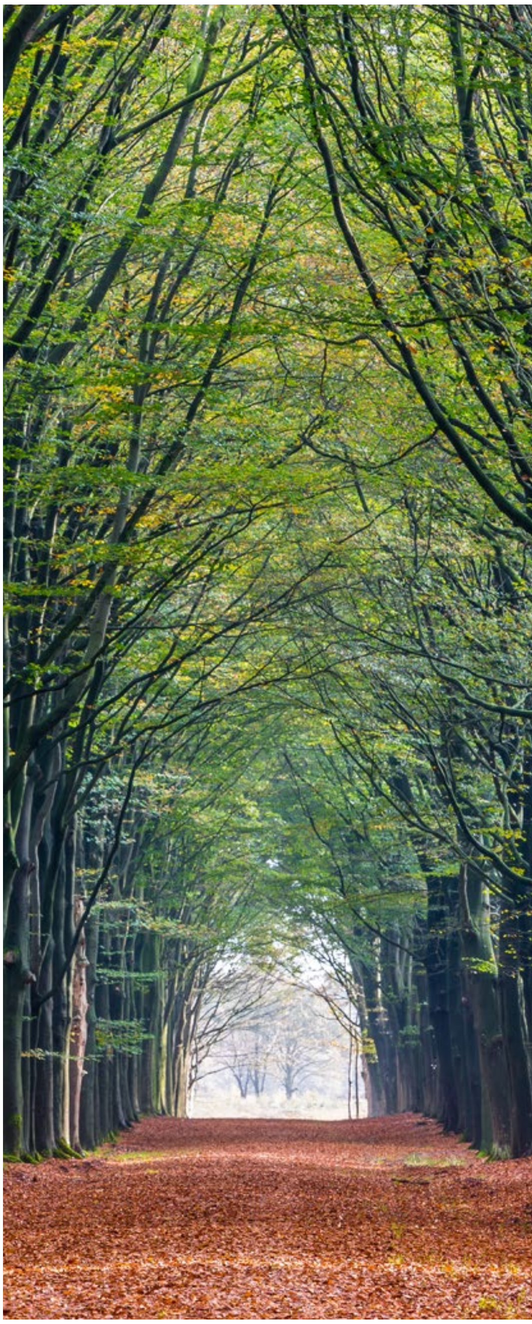

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Issued in March 2023 by Royal London Asset Management Limited, 80 Fenchurch Street, London EC3M 4BY. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

Ref: PO RLAM PD 0024

111010 05 2023