ESG and real estate

Effects of the Sustainable Finance Disclosure Regulation and the Taxonomy Regulation on the real estate industry

Freshfields Bruckhaus Deringer

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Introduction

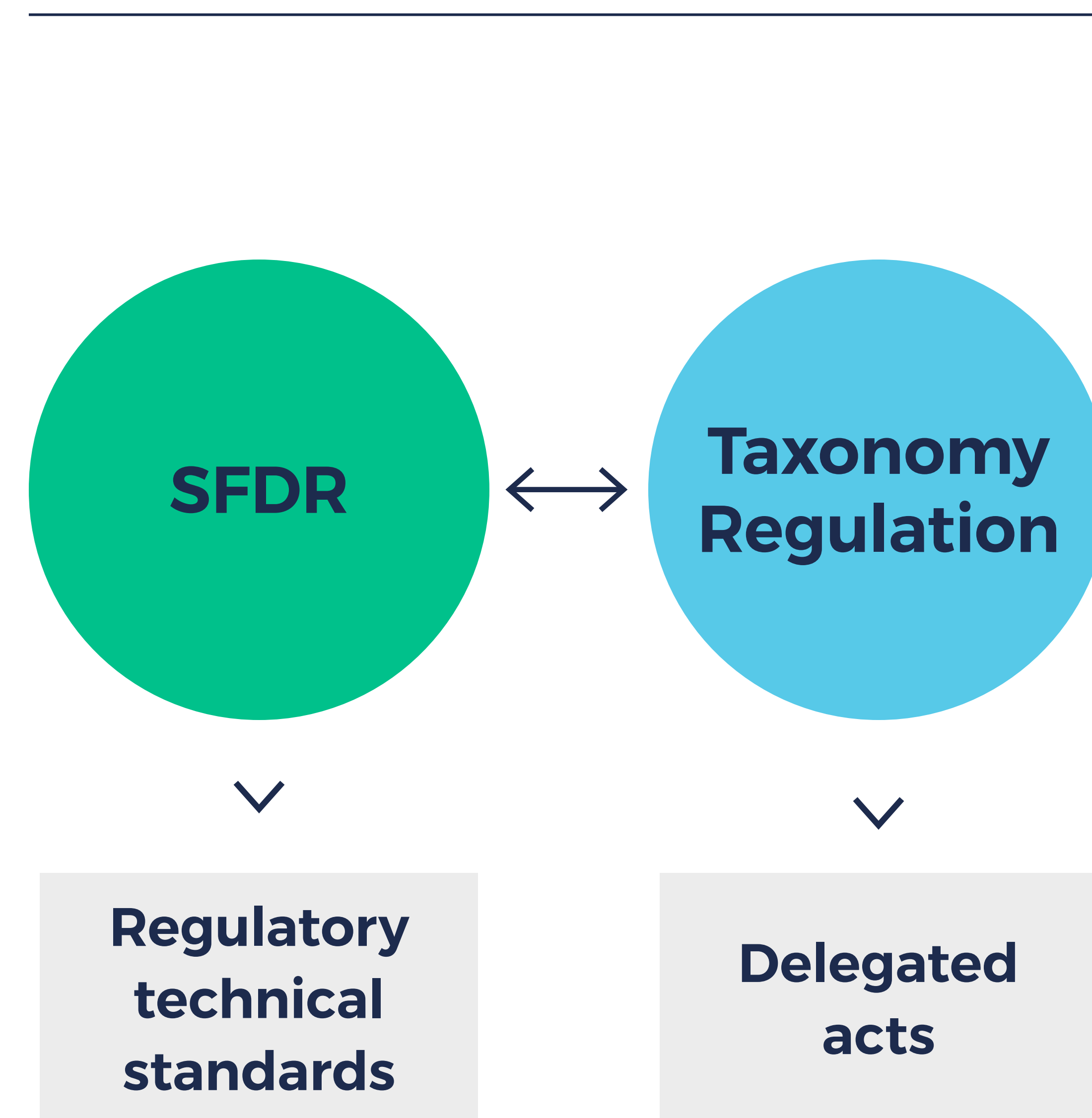
The European Union has ambitious sustainability goals in the areas of *Environment*, *Social* and *Governance* (***ESG***), to which the financial sector should also contribute by investing in these fields.

The legislative tools for increasing sustainable investments are the *Sustainable Finance Disclosure Regulation* (***SFDR***)[1] and the *Regulation on the establishment of a framework to facilitate sustainable investment* (***Taxonomy Regulation***).[2] The regulations also have a significant impact on the real estate industry.

This briefing provides a general overview of the European regulations, their specific impact on the real estate sector and an outlook on future development.

1 Regulation (EU) 2019/2088 (link).
2 Regulation (EU) 2020/852 (link).

I. Regulatory framework



The regulatory framework is made up of the SFDR and the Taxonomy Regulation, which are specified by regulatory technical standards (***RTS***)[3] and delegated acts issued by the European Commission (***Commission***). Both regulations are closely linked and refer to each other.

The SFDR obliges financial market participants to disclose the sustainability or non-sustainability of investments and the impact of sustainability risks on investments and to report on the corporate handling of sustainability issues. It covers the three areas of ESG and thus goes beyond sustainability aspects in the environmental area.

The Taxonomy Regulation, on the other hand, primarily determines whether an economic activity is 'environmentally sustainable'. In its current state, the regulation only contains provisions on the area of *environment*. So-called 'greenwashing' is to be prevented.

The RTS for the SFDR are currently still at the draft stage and are expected to come into force by 1 July 2022.

The regulations do not directly require financial market participants to make sustainable investments; they only oblige them to provide information and to make disclosures. However, the broad availability of standardised sustainability information is intended to increase the demand of investors for more sustainable financial products. This is supposed to go hand-in-hand with an increase in corresponding offers.

1. Sustainable Finance Disclosure Regulation

a) Scope of application

The SFDR imposes obligations on financial market participants and financial advisers. Those falling under the term 'financial market participant' are conclusively listed in the regulation.[4]

A financial market participant is anyone who acts in a certain way with regard to a particular financial product, eg as a provider, manager or manufacturer. This includes, among others:

- an alternative investment fund manager (AIFM);
- an investment firm which provides portfolio management;
- an insurance undertaking which makes available an insurance-based investment product (IBIP);
- an institution for occupational retirement provision (IORP);
- a pan-European personal pension product (PEPP) provider;
- a manager of a qualifying venture capital fund;
- a manager of a qualifying social entrepreneurship fund;
- a management company of an undertaking for collective investment in transferable securities (UCITS management company); and
- a credit institution providing portfolio management.

The aforementioned activities are generally regulated in the EU. They therefore usually require registration with or authorisation by a national or European supervisory authority in accordance with the respective EU regulatory law or its implementation in the member states. As a first step, the question of whether the SFDR is applicable can be approached with the following consideration: has the financial entity applied for registration or authorisation under the relevant EU regulatory law or member state implementation for their actions in connection with the financial product? If corresponding applications have been made, this then indicates that the SFDR applies.

In addition, under the SFDR, the manufacturer of a pension product[5] is also considered a financial market participant. This activity is regulated, but unlike the above-mentioned products, it does not require separate registration or permission.

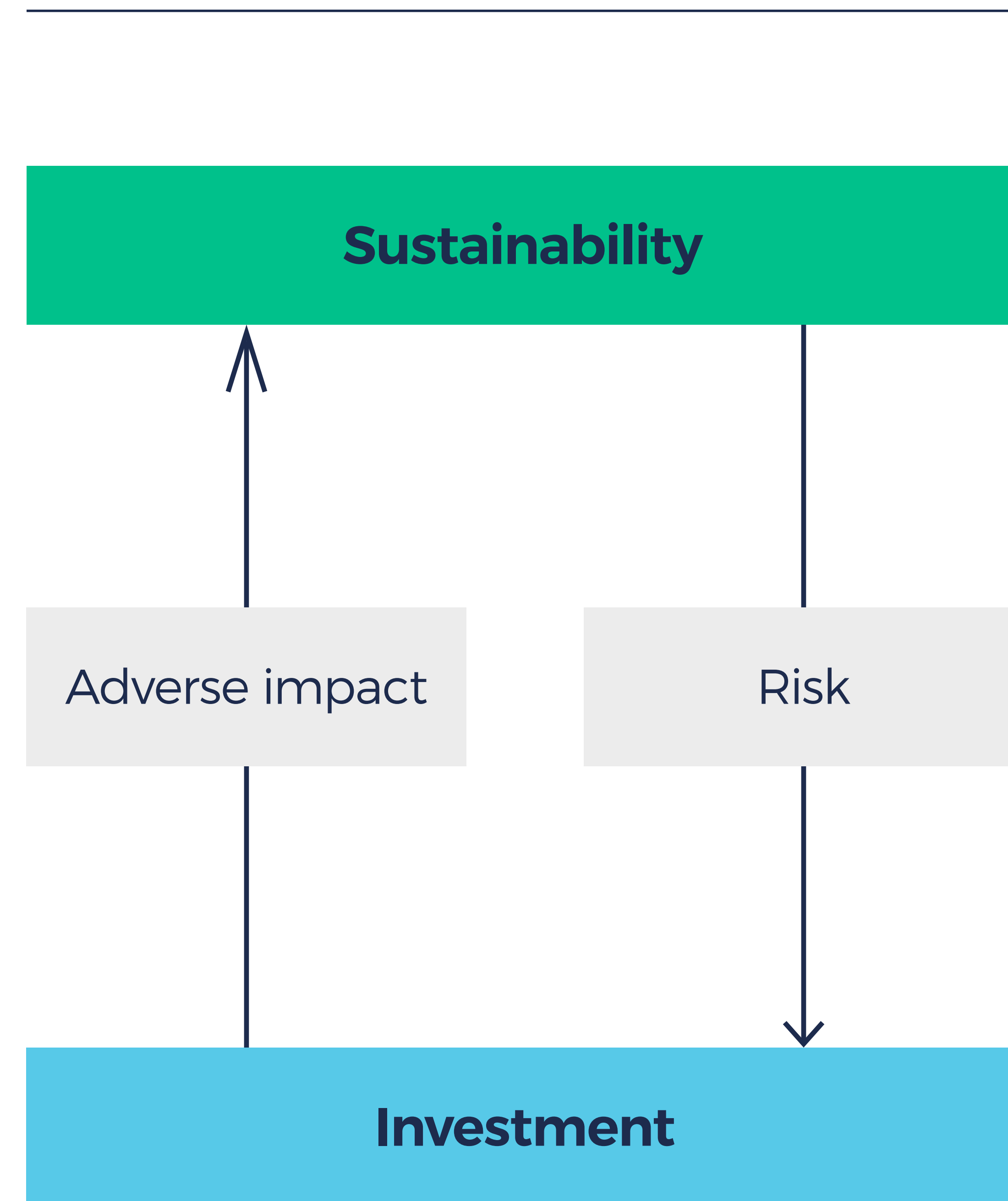
The obligations of the SFDR apply in any case if a financial market participant or financial adviser carries out its activity within the EU and addresses the European market, ie if it wishes to offer the financial products it produces to European end investors or provide investment or insurance advisory services to them.

In contrast, the applicability of the SFDR has not yet been conclusively clarified if financial market participants have a third-country connection.

According to the Commission, the scope of application of the SFDR can in principle also be opened for financial entities from third countries. This should be the case if an AIFM domiciled in a third country addresses end investors in an EU member state via a third-country access (*national private placement regime*). The Commission assumes that in this case the third-country AIFM is subject to the obligations of the SFDR. Conversely, this should mean that, for example, a private equity fund located in a third country that acquires a property via a subsidiary in the EU but does not want to address European end investors is not covered by the scope of application of the SFDR. The extent to which financial undertakings from third countries are subject to the obligations of the SFDR in other constellations with a connection to the European market is to be determined on a case-by-case basis.

3 Letter of the Commission (link); the RTS for the SFDR are currently at the draft stage and are expected to come into force by 1 July 2022.
4 Article 2 No. 1 SFDR Regulation.
5 Article 2 (2) (e) and (g) of Regulation (EU) No 1286/2014.

I. Regulatory framework



b) Legal obligations

The Regulation imposes transparency obligations on two levels: entity-related and product-related obligations.

In this context, the SFDR generally distinguishes between the obligation to disclose the impact of sustainability risks on the investment and the obligation to disclose the impact of the investment on sustainability factors.

Sustainability risks are environmental, social or governance events or conditions that could cause an actual or a potential material negative impact on the value of the investment.[6]

Sustainability factors are environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.[7] A negative impact on sustainability factors exists, for example, if an investment has environmentally harmful consequences.

Finally, the SFDR imposes special information and reporting obligations on financial products designated as sustainable.

Entity-related obligations

The most significant entity-related obligation of the SFDR is that financial market participants must publish the principal adverse impacts (*PAI*) of investment decisions on sustainability factors and additionally provide a statement on their due diligence policies regarding those impacts.[8] This information is to be published on the financial market participant's website. The content, method and presentation are to be specified by an RTS. Smaller financial market participants (< 500 employees) may choose not to publish any information (***opt-out***) if they do not consider adverse impacts on sustainability factors.[9] This decision must be explained. This method is called *comply or explain*.

Besides this the SFDR requires financial market participants to publish their strategy for incorporating sustainability risks into their investment decisions on their websites.[10] The published information must be kept up to date.[11]

Financial market participants must also publish the extent to which their remuneration policy is consistent with the inclusion of sustainability risks.[12]

Product-related obligations

Financial market participants must disclose precontractually how sustainability risks will be included in future investment decisions and what impact they will have on the return of the financial product.[13] If sustainability risks are not relevant for the financial product, for example, because it is unrelated to a sustainability issue, the precontractual disclosure shall include a clear and concise explanation of the reasons therefore.

As of 30 December 2022, financial market participants must disclose adverse impacts of a financial product on sustainability factors, unless they exercised the opt-out.[14] In doing so, sustainability information on the products and the method of assessment must also be published on the website. This is to be specified by an RTS.

Extended reporting and information obligations

In addition, from 1 January 2022, if a financial product is promoted with environmental or social characteristics[15] or the financial product has sustainable investments as its objective,[16] precontractual disclosures regarding the environmental objective (see I. 2. a) and a description of how and to what extent the investment is sustainable must be provided.[17] Detailed reports on their sustainability impact must also be provided on a regular basis.[18] This is to be specified by an RTS.

Additionally, the reporting and information obligations from the SFDR have been extended by the Taxonomy Regulation.[19] The extent to which a financial product is ultimately sustainable is also determined by the Taxonomy Regulation for the environmental sustainability objective.

6 Article 2 No. 22 SFDR.
7 Article 2 No. 24 SFDR.
8 Article 4 SFDR.
9 Article 4 (1) b), (3), (4) SFDR.
10 Article 3 SFDR.
11 Article 12 SFDR.
12 Article 5 SFDR see also recital 22 SFDR.
13 Article 6 SFDR.
14 Article 7 SFDR.
15 Article 8 SFDR.
16 Article 9 SFDR.
17 Article 10 SFDR
18 Article 11 SFDR.
19 Article 5–7 Taxonomy Regulation.

I. Regulatory framework

2. Taxonomy Regulation

In order to determine the sustainability of a financial product, the Taxonomy Regulation introduced a uniform classification system for the *environmental* sector.

In addition, the Taxonomy Regulation extends certain obligations of the Corporate Social Responsibility Directive (***CSR Directive***) for large capital market-oriented undertakings in the real economy (> 500 employees)[20] and obligations from the SFDR for financial market participants.

a) Sustainability of financial products and economic activities

A financial product is sustainable if it is based on a sustainable economic activity.[21] This economic activity must achieve an 'environmental objective'; the Taxonomy Regulation determines six of them:[22]

- climate change mitigation;
- climate change adaptation;
- the sustainable use and protection of water and marine resources;
- the transition to a circular economy;
- pollution prevention and control; and
- the protection and restoration of biodiversity and ecosystems.

Whether an economic activity has a positive impact on one of these environmental objectives is regulated in abstract terms in the Taxonomy Regulation and specified in delegated acts by 'technical screening criteria'. Delegated acts have been established so far for the environmental objectives of *climate change mitigation* and *climate change adaptation*.[23]

Furthermore, environmental objectives must not be significantly harmed by the activity. A negative impact is deemed to exist if a 'Do Not Significantly Harm' (***DNSH***) criteria is met. These criteria are also defined in the delegated acts. In addition, a defined minimum level of protection of human rights and labour standards must be complied with.[24]

b) Legal obligation

On the one hand, the Taxonomy Regulation extends the reporting and information obligations for sustainable financial products from the SFDR.[25]

On the other hand, the Taxonomy Regulation introduces transparency obligations for the real economy. To this end, it ties in with the personal scope of application of the CSR Directive, which introduced a non-financial statement obligation for large capital market-oriented undertakings (> 500 employees). This obligation will be extended in the future.[26] Undertakings are obliged to disclose on how and to what extent their economic activities can be classified as environmentally sustainable within the meaning of the Taxonomy Regulation. All non-financial undertakings shall disclose the proportion of their turnover and investments that are related to environmentally sustainable economic activities. The content and presentation of these obligations are specified in a further delegated act.[27]

c) Temporal scope

The Taxonomy Regulation came into force on 12 July 2020. The sustainability of an economic activity can only be determined once the corresponding delegated acts have been published by the Commission. This has been done for the environmental objectives of *climate change mitigation* and *climate change adaptation*. For the other environmental objectives, it is expected to take place by 31 December 2021. The provisions will apply to the already specified environmental objectives as of 1 January 2022, and to the other environmental objectives as of 1 January 2023.[28]

3. Enforcement

The Taxonomy Regulation obliges the member states to establish legal rules on measures and penalties in the event of infringements.[29] With regard to the obligations arising from the SFDR, there is no comparable regulation. However, corresponding legal bases for sanctions are usually issued by the member states. In the insurance sector, which also covers pension funds, there are already specific administrative offences.[30] Additionally, supervisory intervention powers have already been established in some cases to enforce the disclosure requirements.[31]

In addition, civil liability seems possible. A prospectus liability towards the investor may be applicable. Obligations arising from the SFDR and Taxonomy Regulation must be included in a sales prospectus in accordance with the German Investment Code (Kapitalanlagegesetzbuch).[32] Furthermore, the members of the management board of a stock corporation may be liable to the company within the scope of internal liability.[33] This liability also covers, among other things, damage to the company's reputation, which may arise in the event of non-fulfilment or incorrect fulfilment of transparency obligations.

20 CSR Directive 2014/95/EU (link).
21 Article 3 Taxonomy Regulation.
22 Article 9–15 Taxonomy Regulation.
23 C(2021) 2800 final Annex I (link) and II (link).
24 Article 18 Taxonomy Regulation.
25 Article 5–7 Taxonomy Regulation.
26 Article 8 Taxonomy Regulation.
27 C/2021/4987 final (link).
28 Article 27 (2) Taxonomy Regulation.
29 Article 22 Taxonomy Regulation.
30 Section 332 (4k) German Insurance Supervision Act.
31 Section 136 (3) sentence 2 nos. 6 and 7 German Investment Code, Section 35 (1) no. 9 German Insurance Supervision Act.
32 Section 165 (2) no. 42 and section 306 of the German Investment Code.
33 Section 93 (2) German Stock Corporation Act.

II. Effects on the real estate industry

The entire value chain of the real estate industry is directly (in particular, real estate funds, pension funds, AIF managers) or indirectly (eg project developers, asset managers) affected by the regulatory effects of the SFDR and the Taxonomy Regulation.

1. Implementation of transparency obligations

The product and entity related disclosure obligations go hand-in-hand with the obligation to collect, evaluate and present sustainability data.

For financial market participants in the real estate industry, it is initially significant to become aware of the scope of the obligations.

In the future, real estate funds will have to disclose on their website their strategy on including sustainability risks in their investment decisions and investment advice. Financial market participants who did not exercise the opt-out must disclose the principal adverse impacts on their website (see I. 1. b), entity-related obligations). According to the draft of the corresponding RTS, this includes, for example, investments in energy-inefficient buildings or in buildings for the extraction, storage or transport of fossil fuels.

For financial products, the impact of sustainability risks on returns must also be disclosed. If real estate funds are promoted with environmental or social characteristics or the financial product has sustainable investments as its objective, additional extended information on the environmental characteristics must be provided on the website and regular reports must be given regarding the extent to which the characteristics and the objective have been met. In order to comply with these obligations, it may be necessary to carry out extensive data collection. This can cause problems, particularly in respect of existing properties.

2. Sustainability in the real estate industry

Whether a real estate economic activity is sustainable within the meaning of the Taxonomy Regulation has already been defined by delegated acts for the two environmental objectives *climate change mitigation* and *climate change adaptation*.[34] If an investment finances an economic activity that is qualified as sustainable by the delegated act, this investment can later be designated as sustainable. For this purpose, the real estate sector was divided into four areas of economic activity[35] (in the following using *climate change mitigation* as an example):

1. Construction of new buildings: primary energy demand at least 10 per cent below the threshold set for low-energy buildings.
2. Renovation of existing buildings: energy savings of 30 per cent or in line with the EU Building Directive.
3. Individual measures: investments in building insulation, the installations of wind turbines, photovoltaic systems, charging stations for electric vehicles etc.
4. Acquisition and ownership: acquired building has low energy demand (energy demand top 15 per cent of national or regional stock).

3. Effects on the market

The regulations already have a significant impact on the pricing of real estate. This will presumably increase in the future.

Although there is no direct obligation to operate sustainably, it can be expected that properties and investments that promise a high degree of sustainability under the Taxonomy Regulation will generate higher demand among market participants and may also be subject to better financing conditions. The sustainability criteria of the regulations are therefore likely to increasingly become value-creating factors. Measures for ESG value creation will become established in asset and property management, for example through measures to reduce and monitor environmental impacts, certification of the building, green leases[36] and other tenant measures. The continuous monitoring and management of sustainability factors thus will become important and price-setting. From a business perspective, these aspects should already be included in the due diligence process.

Portfolio owners are advised to check the sustainability of their properties and, if necessary, plan adjustments in the upcoming years. A well-thought-out subsidy strategy may be helpful. Especially in the building sector, sustainability objectives and criteria can be achieved with subsidies, which will regularly be reflected in an increase in the value of the property. For example, the ‘Immediate Action Programme for Buildings’, which is intended to promote the energy efficiency of buildings, was increased by the German government to €11.5bn, thus almost doubling its former volume.

34 See footnote 22.
35 C(2021) 2800 final Annex I (link).
36 See for this: Freshfields Green Lease – The Green Lease for Germany (link, in German).

III. Outlook

In the near future, delegated acts on the other four environmental objectives (*the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control,* and *the protection and restoration of biodiversity and ecosystems*) will be adopted in the framework of the Taxonomy Regulation. This will expand the possibility of identifying financial products as sustainable. However, this would also be accompanied by an extension of the obligation to collect and publish sustainability data. The extension of these obligations will not be limited to the environmental objectives mentioned above. The 'Platform on Sustainable Finance' established under the Taxonomy Regulation[37] is currently developing further proposals for extending the taxonomy to include social objectives. Due to the broad understanding of the term 'sustainability', various parts of corporate activities will be covered, including, for example, the area of taxes.

37 Article 20 Taxonomy Regulation.

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