ESG Update

May 2022

CREFC Europe

Meeting agenda

- Work stream updates
  - Due diligence questionnaire(s) for borrowers
  - ESG signposting framework
  - Debt funds and SFDR
  - Second opinion providers
  - ESG and valuation
- Other updates
  - CRREM/PCAF webinar (and potential follow-up)
  - EEFIG Energy Efficiency First Working Group
  - Other initiatives and collaborations

Work stream updates

CREFC Europe

DDQ(s) for borrowers

- Background
  - Starting point is our existing 2021 climate-related due diligence tool
  - The ambition is to create a CREFCE Charter that lenders can sign up to for sustainable lending best practice – based on a pragmatic standard for lenders to use for due diligence (based to some degree on the 2021 document)
- Key considerations/questions
  - Coverage (E, or E, S & G?) and level of ambition (reduce 'first mover disadvantage')
  - Core plus peripheral DD questions? Differentiate by sector/type of asset?
  - Link to emerging data, assessment and disclosure standards (CRREM, PCAF)
  - Assume ongoing engagement with borrowers and build in accreditation / second opinion provision
  - Focus on appropriate inputs (rather than on what lenders do with them)
- Next steps
  - Sub-group developing a draft; next discussion at sub-groups' 9 May meeting

ESG signposting framework

- Progress to date
  - A draft structure of the document, scope and issues to be covered has been shared amongst the working group for comment
  - The aim is to be selective (best in class resources) and targeted (relevant for real estate lenders), but also comprehensive
- Next steps
  - Draft structure to be shared with wider ESG working group for feedback
  - The document will then be populated with summaries and signposts (links)
  - Sub-group developing a draft; next discussion at sub-groups’ 9 May meeting

Debt funds and SFDR

- Progress to date
  - EVORA have created a draft introductory guide that explains key considerations and suggests guidelines for how to approach SFDR classification for debt funds
- Next steps
  - Volunteers (especially debt fund managers, but ideally also investors and other advisers) sought to review and offer feedback over the coming weeks
  - Next discussion at sub-groups’ 9 May meeting

Second opinion providers

- Progress to date
  - Aviva Investors have put together a short note with guidance on selecting and working with ESG second opinion providers – this is a key component of effective and credible green / sustainability-linked lending frameworks
  - The note covers:
    - Scope – defining the purpose of the second opinion provider, with suitable KPIs that are relevant, material and ambitious; the relevant benchmark or reference framework (e.g. LMA principles), and clarity as to whether the assessment focuses on the collateral, the sponsor more broadly or both
    - Ongoing monitoring – there need to be clear and explicit requirements in the loan agreement that the second opinion provider considers appropriate (relevant, material and ambitious); consider the balance between objective criteria (e.g. achieving / maintaining a particular BREEAM or EPC rating) or more qualitative / evaluative)
    - Working practices – clear allocation of responsibilities among the parties involved, with the lender involved in appointing the second opinion provider to ensure suitability, credibility, etc. (but recognising that the lender should not dominate the proceedings thereafter)
- Next steps
  - Next discussion at sub-groups' 9 May meeting

ESG and valuation

- Progress to date
  - Background: desire among lenders (initially in Ireland) for greater consistency in how ESG matters are covered by valuers
  - Action: draft list of key ESG issues developed by lenders, to be considered when instructing and reviewing valuations (see Appendix)
  - RICS has since published a new guidance note on this subject (in Ireland, SCSI published guidance in June 2021)
  - Firms are currently updating internal guidelines to valuers for ESG
- Caveats
  - Collective dialogue between valuers and lenders to promote common understanding should be welcome
  - Recognise limitations of data availability and objectivity; degree to which ESG factors impact valuation
- Next steps
  - Ongoing engagement between lenders and valuers, monitoring of valuation reports, engagement with relevant industry and professional bodies
  - Next discussion at sub-groups’ 9 May meeting

Other updates

CREFC Europe

CRREM/PCAF webinar (etc.)

- Aim was to introduce our network to two important initiatives in our space
- Webinar was recorded, available on demand here
- We are keen to build on these relationships, especially CRREM, which is becoming the carbon risk modelling tool of choice among sophisticated real estate investors
- We also plan to revive our relationship with GRESB, which is integrating with CRREM and trying again to grow its relevance in the CRE debt market

EEFIG EE1st WG

- The Energy Efficiency Financial Institutions Group (formed by UNEP FI and the European Commission) formed a new working group at the beginning of 2022 to focus on operationalising the Energy Efficiency First principle in the lending and investment decisions of financial institutions
- First meeting was held on 20 January
  - CREFCE presented a “private sector viewpoint” (highlights reproduced in the **Appendix** below), alongside presentations by the EIB and EBRD
  - Angela Sheahan (Hermes) and Richard Craddock (LaSalle IM) are on the working group as well as Peter Cosmetatos (CREFCE)
- Second meeting was held on 5 April
  - A note setting out reactions from the real estate finance perspective, and attaching a few pages of relevant WG and European Commission materials, can be found here
  - A real estate finance sub-group is being convened to compare notes and provide coordinated feedback

Other initiatives / collaborations

- Green Property Alliance (formed by the Property Industry Alliance to include BBP, UKGBC, but also LMA as well as CREFC Europe from the lending side) – a work in progress

- Recent participation in an IIGCC webinar (alongside officials from the European Commission and UK BEIS, as well as industry) – webinar recording and full slide deck available here; CREFC Europe slide also reproduced below

- We joined a group submission to the UK FCA (cc TCFD and IFRS) on real estate ESG metrics – we are trying to coordinate further work to focus on real estate *finance* ESG metrics

- AIMA/ACC – ongoing dialogue

- CREFC (in the US) – ongoing dialogue

- INREV – ongoing dialogue

28 April IIGCC webinar: Real estate finance and climate/ESG

- CREFC Europe – trade body for real estate lenders and finance market, with very active ESG participation since late 2019

- **Debt matters in real estate, and for sustainability (but real estate sustainability leaders tend not to use much debt, so often forget)**
  - it provides a low-cost capital base for real estate investors/borrowers
  - a small number of lenders can reach a big number of less sustainability-savvy real estate owners with decarbonisation advice as well as finance

- **Banks**' climate-related disclosures and regulatory incentives are not designed with real estate lending in mind, and are not necessarily aligned with government policy for net zero buildings (there are signs of movement in the right direction, but financial regulation is lagging); focus remains primarily on:
  - climate-related risk to the institution (rather than the broader policy agenda around climate adaptation and decarbonization to reduce overall climate risk)
  - operating carbon (and financing new buildings with green credentials) rather than whole life, including embodied, carbon (which could drive financing the improvement of existing buildings – the real challenge)

- Policymakers and industry groups often forget **the role of non-banks** in real estate lending, even though they account for ~30% of the market in the UK (less in the EU, admittedly); and **policy silos** often separate policy relating to buildings from financial regulatory policy

- Above all, lenders need **an agreed sustainability assessment framework / standard** reflecting:
  - recognition that most buildings need to be (financed to be) improved – it's not a question of defining 'green' and supporting the buildings that 'pass'
  - an integrated approach to E (not just net zero carbon), S and G (not just climate)
  - clarity around the policy trajectory (so ESG considerations align with, rather than running counter to, financial assessment of risk and returns) – in the absence of a clear policy trajectory, the question will remain whether businesses and investors are "doing the right thing" at the expense of returns

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Appendices

CREFC Europe

ESG and valuation - ESG issues list (1)

The areas to be considered for impact on valuation / occupation may include:

Description of property:

- Age of construction / material capex; current condition; capex planned

E: Impact on Environment and Use of Resources

- Energy consumption
  - Energy consumption in design, construction and usage of building [supplied by building owner]
  - EPC or BER ratings [include expiry dates, review of EPC recommendations in certs, compliance with regulations and upcoming legislation / regulatory / policy changes]
  - Certification: NZEB / BREEAM / LEED / other regulatory or industry standards
- Energy efficiency – systems / impact
- Energy generation – investment in renewables to offset consumption / ability to feed the grid
- Water Efficiency – consumption levels, and systems/ storage/ technology to reduce consumption, improve efficiency
- Materials Waste Management / recycling capabilities
- Climate risk, event driven (e.g. flood, storm, fire) risks and barrier defences; historical cost of repair
- Biodiversity impact / strategies

ESG and valuation - ESG issues list (2)

S: Social impact of the built environment / owner / occupier

- Transport
- Health & wellbeing on-site: certification e.g. WELL certification
- Digital and communications: certification e.g. WiredScore
- Social impact, local community engagement, placemaking
- For developments, impact of section 106 (UK) or Part V (Ireland)

G: Measurement and Building intelligence, ESG planning [does not replace KYC activities of lenders]

- Green leases
- Ability to measure / monitor – intelligent buildings and tenant involvement / co-operation
- Tenant engagement and planning
    - Level of co-operation/integrated planning between landlord and tenant to measure and monitor, reduce usage of resources, capex planning and implementation
    - None, Ad hoc, planned, contracted
- Key business activities of owners, tenants and their ESG credentials
- Leases – impact of E, S and G above on income and valuation incl. lease expiries, break clauses, ability to renew/extend

A private sector real estate lending viewpoint

EEFIG EE1st Working Group meeting

20 January 2022

Peter Cosmetatos

CEO, CREFC Europe

EC EE1st guidelines for FIs (extract)

The areas to be considered by financial institutions include:

- Adapting and incorporating the EE1st principle into different processes to ensure due priority consideration is given to all energy efficiency measures.
- Ensuring technical capacity among project developers, banks and asset owners so that they could identify all energy savings potential and go beyond regulations or business-as-usual designs.
- Aligning project owners' interests in identifying energy performance improvements through technical and energy-related due diligence flags.
- Using the EE1st principle to flag the risk of stranded assets in installations, facilities and networks which are undergoing significant upgrades.
- Developing new financial products for the building sector, which already embed the EE1st principle and cover optimum energy efficiency investments.
- Promoting further integration of energy and carbon prices in the risk-assessment of assets, especially for greenfield asset projects.
- Considering the EU Taxonomy criteria, in particular regarding energy efficiency, to help project developers and owners as well as financial institutions to identify projects that contribute substantially to the climate and other environmental objectives.
- Transparency on energy efficiency benefits discount rates applied and implied in establishing the technical specification for upgrades and new build.

Session overview

- Intro to CREFC Europe and our membership
- Some observations about sustainable real estate finance
- CREFC Europe green lending / ESG working group
  - Background and activities so far
  - Current areas of focus
- Challenges and opportunities in sustainable real estate finance (and operationalizing EE1st for real estate lenders)

Introduction to CREFC Europe

- Non-profit membership body for European real estate finance markets with a focus on lending secured on buildings
  - Business-to-business (including ‘beds’ sectors, but not residential mortgages)
  - Established in institutional market, growing in mid-market
- ~140 member firms, including ~50 lenders (a diverse universe), ~15 borrowers, and many advisers and service providers
- Most individual contacts are in transactional/commercial roles
- Our activities span industry initiatives; learning, events and networking; and policy work
- We collaborate with many other national and international industry groups (including our sister organisation in the US)

Observations (1)

- Energy/carbon now a major focus (and one of the easier elements of a complex web of ESG considerations in the real estate context)

- Climate risk increasingly integrated into credit underwriting, under pressure from:

  - Transitional risk, as policymakers regulate buildings

  - Financial regulators demanding climate-related disclosures (but are they creating the right incentives?)

  - In some (but not all) parts of the market, capital providers, borrowers and occupiers/end-users

  - In certain cases, physical climate risk

- Lenders’ expertise is gradually catching up with their interest

Observations (2)

- Real estate is very **heterogeneous** (use, age of buildings); buildings have a **long life-cycle** with a lot of **embodied carbon**; and **separate ownership and occupation** can complicate the allocation of energy efficiency costs and benefits

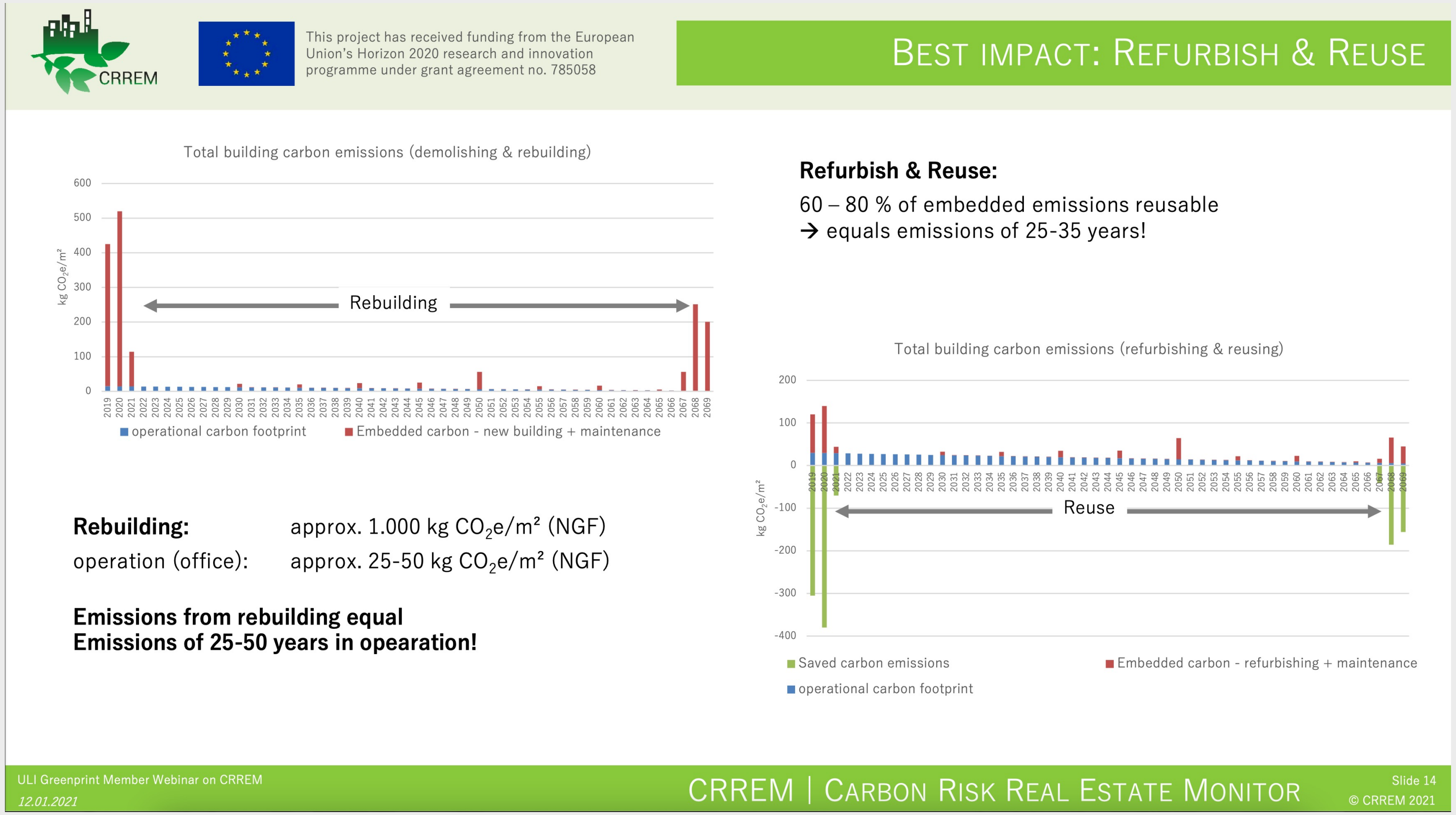
- The big challenge is (financing) **retrofit of existing buildings**, but it's easier to lend against a building with a 'green' label:

  - ignoring the embodied carbon cost of the demolition behind the construction

  - Side-stepping the lack of data and measurement standards for assessing building performance and improvements holistically

  - responding to (current) regulatory incentives focused on climate risk and financed emissions, rather than whole life carbon

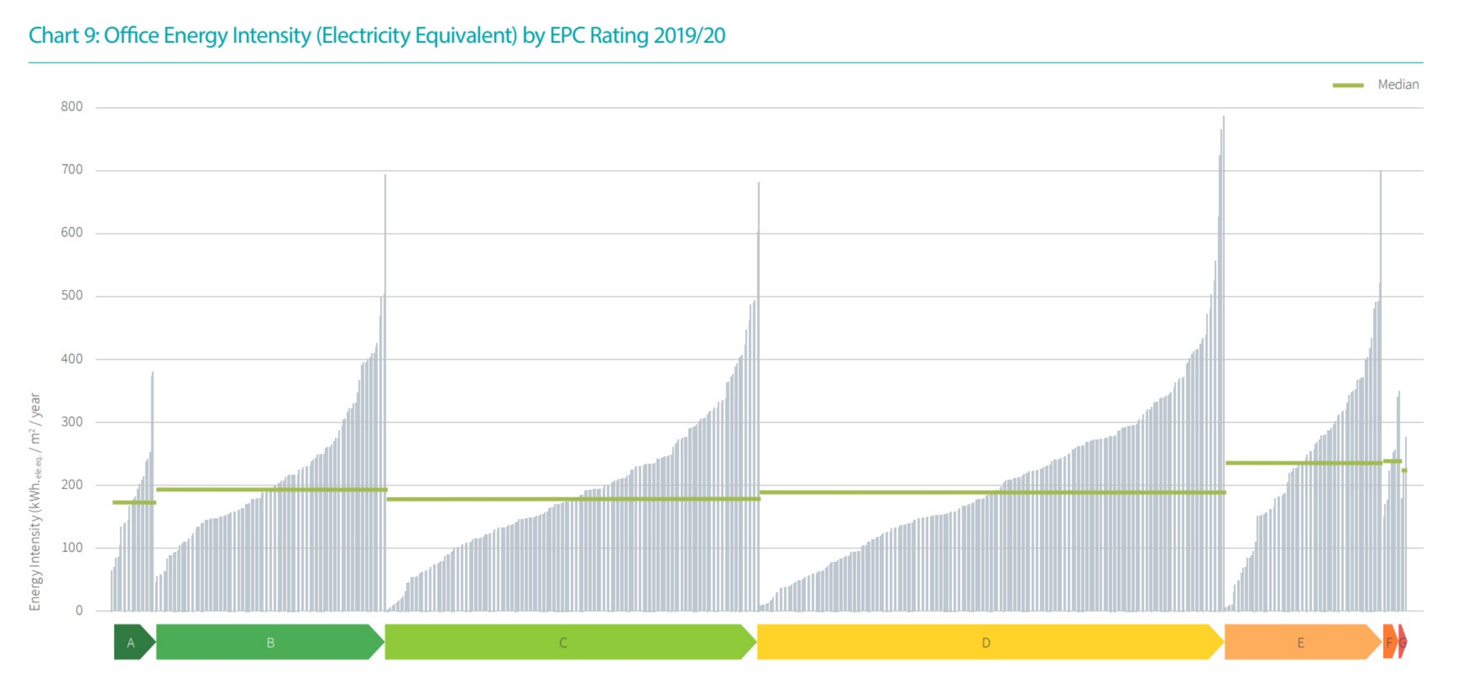
‘Green’, or just green*er*, buildings?



Observations (3)

- Some real estate owners, investors and managers with sustainability expertise are driving best practice and innovation – lenders are learning from them
- But there is a **'long brown tail'** of real estate owners who don't know (and may not care) much about sustainability – **lenders can be a source of advice, as well as finance, for them** (e.g. Dutch bank apps, as outlined here)
- Financing the green transition we need is **a huge opportunity for lenders** if investment goals and regulatory incentives align
    - Banks are the dominant source of credit in Europe, but are they well-suited to providing cap ex facilities to finance the retrofit of existing buildings? Don't forget other sources of credit

Pros and cons of policy levers



2019-20 UK Energy Performance Certificates (source: https://www.betterbuildingspartnership.co.uk/).

CREFC Europe green lending working group (2019-20)

- Established in late 2019 with ~15 lending firms
- Early 2020 survey asking working group member firms about:
  - Green lending policies, including what is covered, standards and certifications relied on, etc.
  - Approach to raising environmental considerations with borrowers, including requirements for specific reporting
  - Regular monitoring of environmental risks in CRE loan book
- Feedback collated, anonymised and shared

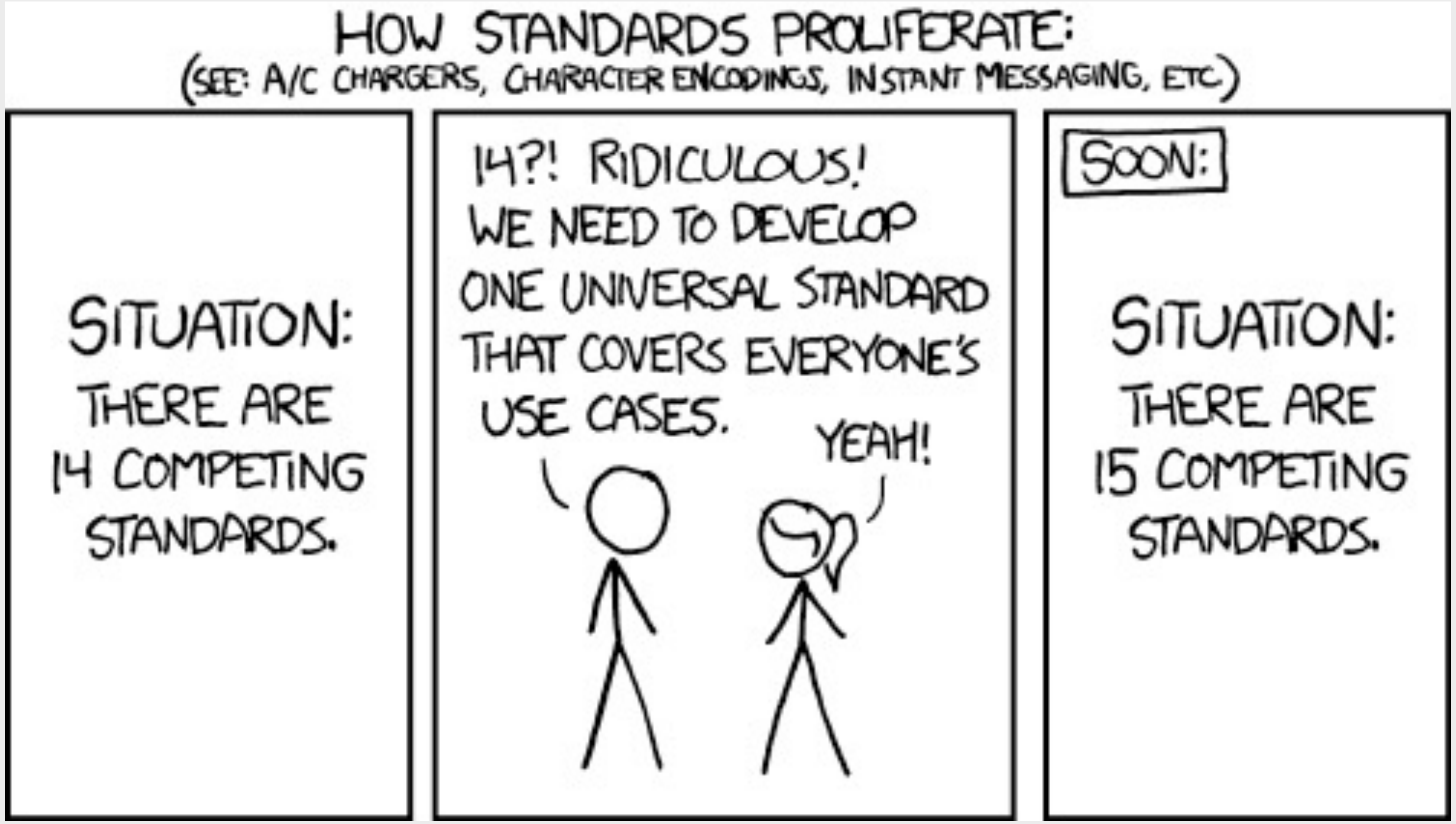
CREFC Europe ESG working group (2021-)

- Published a climate-related due diligence tool for real estate lenders in May 2021
- Group expanded to include advisers and representatives of other organisations, and scope widened to cover E, S and G
- Current work streams aim to create:
  - a suite of borrower ESG questionnaires
  - a document to ‘signpost’ lenders towards existing recommended resources across ESG
  - a framework for classifying real estate debt funds under SFDR
  - a guide about selecting and instructing second opinion providers
  - guidance for how lenders would like to see ESG covered in valuation reports (led by lenders active in Ireland)

EE1st challenges and opportunities

- **Diversity of sources of credit:** Real estate is financed by a diverse range of lenders with different regulatory and investment drivers – it's mainly loans not bonds, and it's not only banks
- **Don't try to define 'green' real estate investments:** Many old and/or energy intensive buildings should be made as efficient (and climate resilient) **as economically possible**, not demolished
- **Policy is key, but beware unintended consequences:** Climate should be a 'normal' element of credit analysis, but financial regulatory incentives may not align (especially for banks)
- **Sustainability 'alphabet soup':** There needs to be a single, generally-accepted standard for defining and measuring energy efficiency across construction and renovation as well as the operation of buildings (and alongside other ESG factors)

How (not) to develop standards



Source: https://xkcd.com/927/

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