Working Group: AREF/INREV/IPF

SFDR Real Estate Solutions Paper: Proposals for solving challenges arising from SFDR for real estate investments

7th June 2023

INTRODUCTION

Our working group (**Working Group**) comprises representatives of these industry associations:

- Association of Real Estate Funds (**AREF**);
- European Association for Investors in Non-Listed Real Estate (**INREV**); and
- Investment Property Forum (**IPF**)

(together, **the Associations**).

We, our Working Group, welcome the EU Action Plan on Sustainable Finance with its aim to redirect capital toward sustainable investment and drive the transition to a low- carbon, resource-efficient and just economy and society.

The Action Plan includes the Sustainable Finance Disclosure Regulation (**SFDR**) with the introduction of common reporting and disclosure standards. SFDR's objective is to promote transparency on environmental and social characteristics, and broader sustainability issues across financial markets.

We consider the overall aims of SFDR to be progressive and support its ambition to accelerate decarbonisation of financial market activities, including the built environment, and to inhibit greenwashing.

However, there are challenges. SFDR is difficult to apply to real estate. For instance, there are differences in the calculation methodologies between the TCFD's recommendations and the SFDR, as well as inconsistencies with energy performance certificate (**EPC**) ratings among EEA member states.

We also welcome:

- 12 April 2023: the European Supervisory Authorities (**ESAs**) published a consultation paper[1] proposing Regulatory Technical Standards (**RTS**) that would amend the SFDR Delegated Regulation (Commission Delegated Regulation (EU) 2022/1288) in response to a mandate[2] by the European Commission to review those disclosures.
- 14 April 2023: the European Commission published its responses to questions on the interpretation of SFDR submitted by the ESAs on 9 September 2022[3].
- European Commission's review of SFDR[4] which we understand is expected in Q4 2023.

In the context of responding to the ESAs' consultation and European Commission's review, we share our views - and hope the views assist the Associations and other respondents to the ESAs' consultation and European Commission's review - in:

- submissions to the consultation and review; and
- expressing solutions to address the challenges arising from SFDR, with a view to ensuring that SFDR:
    - (and associated legislation developed by the EU and implemented in EEA members states) is reformed so SFDR and the associated legislation can be appropriately applied to real estate;
    - has international coherence and compatibility with non-EEA jurisdictions (for instance with EPCs in the UK); and
    - enhances achieving its ambition for the built environment.

The proposals contained in this document represent the views of the Working Group: see details about the Working Group in page 7 below.

[1] https://www.esma.europa.eu/press-news/consultations/joint-consultation-review-sfdr-delegated-regulation
[2] https://www.esma.europa.eu/sites/default/files/library/mandate_to_esas_on_pai_product.pdf
[3] https://www.esma.europa.eu/sites/default/files/2023-04/Answers_to_questions_on_the_interpretation_of_Regulation_%28EU%29_20192088.PDF
[4] https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_22_7520

<u>PROPOSALS</u>

EPC Initial Condition

It is imperative, as a foundation for progress, that:

- the EPC methodology and ratings will be harmonised across the EEA as required under the recast European Energy Performance of Buildings Directive.
- an EPC methodology will be defined on actual in-use (as opposed to theoretical) operational emissions.

<u>Solution:</u> In the meantime, the real estate sector needs guidance as soon as practicable on how to apply:

- **the Energy Efficient Buildings PAI to the different methodologies / ratings of the EPC in each EEA member state.**
- **the PAI to countries outside of the EEA where the EPC does not exist and where NZEB is not in effect (see also comments below).**

Principal Adverse Impacts

<u>Exposure to Fossil Fuels</u>

There is considerable market confusion as to what should be included under the mandatory PAI "exposure to fossil fuels": for instance, what is defined as "the company" and the extent to which the exposure of occupiers or tenants should be considered.

<u>Solution:</u> The real estate sector needs more detailed clarification of SFDR in this regard. For example, there is confusion:

- **over the extent to which the supply chain in fossil fuels should be included. Is the storage of fossil fuels (not for use on the building) in a real estate asset sufficient to fall foul of this PAI – or does this only apply to the sale of fossil fuels?**
- **whether an entire real estate asset should be classed as exposed to fossil fuels (like a €250m Retail Park where there is a petrol station) or whether a proportion can be applied (i.e. this is unlikely to be valued separately and therefore is it appropriate to apply the floor area % to the value).**

<u>Exposure to Energy In Efficient Assets</u>

In its current form, the mandatory PAI "exposure to energy-inefficient assets" focuses on a snapshot of the operational sustainability characteristics of the underlying assets, rather than on the ambition for, and progress toward, the transition of such assets. As a result, SFDR does not promote investment capital toward this necessary transition. Indeed, it actively encourages investors to dispose of existing inefficient assets without improving them.

There needs to be an understanding in SFDR that investment in a real estate asset is actually an investment into a business plan of activity, which can include a costed plan to bring the environmental performance of an asset up to the level recognised as a sustainable investment under the SFDR. Typically, a building would be sold when this programme of activity is complete, and therefore the manager who undertakes this activity would not be recognised as engaging in sustainable activity. On account of the real estate investment lifecycle, this means that any core plus, value add or opportunistic real estate asset would not be likely to be categorised as a sustainable investment. The real estate investment lifecycle is more appropriately recognised in the EU Taxonomy which distinguishes between different activities: acquisition and ownership of buildings, development, refurbishment etc. This identifies a fundamental failure of SFDR, results in less sustainable activity and other negative unintended consequences.

<u>Solution:</u> Proposal to extend the definition of "energy inefficient" asset must not only be based on the "as-built" EPC but, in the case of refurbishment/re-development, allow disclosure of a "design" EPC, or having a costed business plan which results in a B or above EPC or submitting data derived from CRREM pathway alignment (see Applicable definition of "inefficient real estate assets" below).

The definition for inefficient real estate assets is overly complicated and unworkable with the separate methodology applied to buildings built after 31/12/2020, for instance:

- Not all parts of the EU have enacted NZEB, and similar to the EPC, NZEB is defined differently across Europe.
- The assumption would be that all buildings in the EU built after 31/12/2020 (assuming they were not designed before 31/12/2020) should have a PED below NZEB. Therefore, no new builds, in jurisdictions that abide with NZEB, should be included in the top of the energy in-efficient formula. If new builds in jurisdictions that do not abide with NZEB are excluded from the bottom of the energy in-efficient formula, then all new builds wouldn't be included in the formula.
- By saying that EPC are required for buildings built before 31/12/2020 and NZEB required for buildings built after 31/12/2020 implies NZEB would be replacing EPC over time. It was believed that EPC would be continuing so we do not understand why they are only used for buildings before 31/12/2020.

<u>Solution:</u> Proposal to remove the separate methodology applied to new buildings and have a single methodology for all buildings (see Applicable definition of "inefficient real estate assets" below).

Products disclosing as Article 8 or 9 are required to report on Level 2 RTS. The Level 2 RTS require operational emissions to be measured and reported. For many legacy products, the underlying assets may not yet have the systems in place to accurately measure emissions in line with SFDR. In addition, the assets are subject to existing lease terms that may not include reporting requirements on resource use, or indeed, include requirements for sustainable resource practices.

<u>Solution:</u> The real estate sector needs mandatory requirement for data disclosure: tenant to landlord, borrower to lender, for example as has been implemented in France with the Décret Tertiaire[5] i.e. from September 2021, landlords and tenants in France have been required to annually declare the energy performance achieved by their buildings via an online platform.

Applicable definition of "inefficient real estate assets"

The overriding aim of Level 2 is to clarify the content, methodology and presentation of ESG disclosures. The current RTS do not assist in achieving this ambition for a number of reasons including the absence of a standard definition for what constitutes a sustainable investment and the lack of symmetry between the EU Taxonomy and SFDR in respect of these definitions.

<u>Solution:</u> The real estate sector needs a redefinition of "energy inefficient" asset to be based on:

- **"as-built" or "design" EPC rating of D or below; and / or**
- **CRREM pathway stranding before 2035 (Version 2); and/or**
- **bottom 70% of local building stock;**
- **without a business plan to achieve one of the above standards within a reasonable timeframe (suggest 5 – 7 years) these assets would be categorised as sustainable transition assets. This could be verified by a combination of IC memos with costed underwriting to achieve these standards and reporting to investors.**

The use of EPC as proxy energy ratings are not a global standard and substitutes vary widely at country and city level.

<u>Solution:</u> The use of "top 30% of local building stock", alongside the EPC, can conservatively be translated to Energy Star in the US (which represents top 25%). In this respect:

- **CRREM is translatable internationally;**

[5] Owners and tenants of tertiary buildings of an area over or equal to 1000 m2 are compelled to reduce their energy consumption by – 40% by 2030, – 50% by 2040, and – 60% by 2050, and disclose relevant consumption data.

- **other proxies like NABERS in Australia could also be considered.**

Do No Significant Harm

It is vital that when comparing emissions between real estate assets, particularly between existing and newly constructed buildings, that new embodied emissions are considered with operational emissions to enable a valid comparison of total emissions. Focusing on operational emissions only has the potential to mis-signal to some investors that new buildings that are close to net zero are more beneficial and deter the rejuvenation of existing buildings.

Solution: Consideration of embodied carbon within the DNSH screen.

The PAIs are also used as the basis for disclosing to the DNSH principles of sustainable investment. There is considerable market confusion as to whether to disclose for both mandatory and all additional indicators relevant to real estate. For mandatory at least, there is an understanding of where DNSH sits, i.e. no investment in fossil fuels, EPC B or above, however for non-mandatory PAIs this is much more subjective. It effectively required entities to *"set and mark their own homework"*, which could engender (rather than inhibit) greenwashing. In addition, it has resulted in a wide range of definitions and standards being employed, making comparison ineffectual. Indeed, it was considered that it would be necessary to review the detailed data to enable useful comparable assessment of sustainable activity.

Solution: Limit the DNSH screen to mandatory PAI and/or set clear definitions for screening the non-mandatory PAI (to also include embodied carbon).

WORKING GROUP

Several have contributed to our Working Group in drafting and settling these proposals. These proposals would not have been possible without their support. We would like to acknowledge the support from key members:

Abigail Dean – Nuveen Real Estate, Head of Strategic Insights: Chair, INREV ESG Committee and BBP Board Member

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