Falling through the cracks: SFDR's impact on real estate investment

> SFDR's ambitions are a push in the right direction to accelerate decarbonisation, but complying with it is difficult as it is not designed for dynamic, longer-term investments such as real estate

> Most real estate products with an impact or sustainable investment strategy disclose under Article 8 of SFDR alongside products with less ambitious ESG objectives

> Real estate has the capacity to reduce emissions and deliver a more sustainable economy - tailoring regulation to it could reap faster and higher dividends

Introduction

The EU Action Plan on Sustainable Finance aims to redirect capital toward sustainable investment to drive the transition to a low-carbon, resource-efficient and just economy and society. The action plan includes the introduction of several overlapping regulatory and policy initiatives developed in recent years that impact non-listed real estate.

The overriding aim is to increase transparency and introduce common standards, thereby impeding greenwashing. The ambition is to provide investors and advisors with the substantive information required to make effective allocations that support the growth of a more sustainable economy, society and environment.

The Sustainable Finance Disclosure Regulation (SFDR) is one of the most significant of these initiatives. Through the introduction of common reporting and disclosure standards, its objective is to promote transparency on environmental and social characteristics, and broader sustainability issues across financial markets.

The European Supervisory Authorities (ESAs), including the European Securities and Markets Authority (ESMA), initially framed SFDR regulation for public finance markets. These markets represent approximately 90% of all investment and ostensibly, it makes sense to make them the primary focus of regulation. However, although only representing approximately 3%[2] of total financial capital, the real estate market represents 39% of total CO_2 emissions[3] and 36% of energy use. Real estate punches considerably above its weight in terms of the potential to achieve a regulatory impact that greatly accelerates the path to a more sustainable Europe.

As such, the degree to which a regulation initially devised for public markets (that tend toward short-term trading horizons) remains apposite for private markets characterised by longer term dynamic strategies – especially real estate – is of significant consequence. INREV developed a range of resources to assist members and the wider industry in the interpretation and implementation of SFDR.

1 For more details, please see EU SFDR: Latest updates and implementation timeline paper published by INREV in December 2022; EU SFDR: Latest implications and implementation timeline paper published by INREV in February 2022; and INREV website

2 Derived from McKinsey (2022) Private Markets Annual Review; Blackrock (2023) Private Markets Outlook

3 Emissions data represents the wider real estate market and refers to assets held by public and private financial, non-financial, public and household sectors

These include publications, events and briefings as well as developing aligned industry responses to proposed regulatory initiatives and coordination of requests for clarification to the ESAs and ESMA. Where applicable, INREV also seeks to communicate the role, importance and specific characteristics of non-listed real estate to regulators.

This paper evaluates the application of SFDR to real estate products in practice and is derived from structured interviews with representatives of ten institutional investors and managers. All interviewees represent organisations that have demonstrated a long-term commitment to environmental, social and governance (ESG) and sustainability in both the mission values of their organisations and their actions in the real estate investment market.

The analysis identifies the opportunities and challenges that the application of SFDR to real estate generates and, where relevant, identifies practical and pragmatic solutions developed to assist in their approach to fulfilling regulatory requirements. The paper also evaluates how the application of SFDR to real estate in its current form relates to the overriding ambition of the regulation, which is to direct capital toward more sustainable investment and to support investors in their decision making by improving transparency and introducing common standards. To provide context, the SFDR framework is briefly reviewed followed by consideration of the opportunities and challenges arising from the application of SFDR to real estate identified by investors and managers. These are discussed in three subsequent segments.

First, overarching issues concerning the relevance of SFDR criteria to real estate are discussed followed by examination of concerns arising from the application of the specific requirements of Level 1 and Level 2 criteria comprising SFDR.

The SFDR regulatory framework

In its overriding ambition, SFDR represents a positive step in the promotion of sustainable and/or ESG investing within the EU. Many real estate investors and managers also support this objective.

SFDR was adopted in November 2019 following the 2018 EU Commission's Action Plan: Financing Sustainable Growth. It aims to address a perceived lack of transparency and objectivity on how institutional investors, investment managers and financial advisors consider sustainability aspects in their investment decision making (or advisory processes) and principal adverse impacts (PAI) of investments under management. It contains principles-based requirements (PBR) (Level 1) that are supplemented by Regulatory Technical Standards (RTS) (Level 2) to clarify the content, methodology and presentation of ESG disclosures.

SFDR applies to Financial Market Participants (FMPs) and Financial Market Advisors (FMAs) whose businesses are in Europe. In addition, non-EU firms may be within-scope of SFDR, depending on the nature of the products they market into the EU. The SFDR disclosure requirements apply at entity level and product level[4].

Background to regulatory implementation

As of 10 March 2021, the high level and principle-based requirements became applicable, as planned. The Level 1 text of the SFDR requires FMPs to make certain disclosures as to whether a financial product meets the requirements under SFDR and whether they disclose the PAI of their products. On 6 April 2022, the EC adopted the proposed RTS to be used by FMPs when disclosing sustainability-related information under SFDR and these apply from 1 January 2023.

4 For more details, please see EU SFDR: Latest implications and implementation timeline paper published by INREV in February 2022; The Impact of the EU Sustainable Finance Disclosure Regulation paper published in February 2021, published by INREV

The proposed RTS supersede draft RTSs and aim to create a “single rulebook” for sustainability-related disclosures for SFDR pre-contractual and periodic product disclosures, including taxonomy-related product disclosures. The SFDR RTS set out how firms should comply with aspects of the SFDR disclosure requirements, including by establishing template reporting requirements in relation to (i) entity level reporting of PAI of investment decisions on sustainability factors, and (ii) product level pre-contractual and website disclosures and periodic reports. It includes:

- Annex 1: Template of reporting PAIs on sustainability
- Annex 2 and Annex 3: Template of pre-contractual information for financial products referred to in Articles 8 and 9 of SFDR
- Annex 4 and Annex 5: Template of periodic information for financial products referred to in Articles 8 and 9 of SFDR

Consideration of application to real estate in practice

The EU and national governments have the capacity to strongly signal the direction and pace of sustainability programmes across financial markets, the wider economy and society, which has the potential to bring immense value. The research interviews sought to explore the relevance and suitability of the SFDR regulations for real estate. The interviewees consider the overarching objectives of SFDR to be progressive and are supportive of its ambition to accelerate decarbonisation of financial market activities, including the built environment, and to inhibit greenwashing.

SFDR is viewed as a good initiative that through a generic framework has the potential to add transparency and credibility to sustainability policies through reporting requirements, including substantive evidence. However, many interviewees consider SFDR to be difficult to easily apply to private markets, including real estate, corporate debt, infrastructure and private equity.

ESMA has indicated that SFDR has been designed primarily to improve reporting and transparency of sustainable finance activity in the public equities market, with its scope extended to the private markets. Interviewees consider this aspect to be a missed opportunity for the pace of decarbonisation in aggregate.

Although real estate represents a mere 3% of the total financial markets, it represents a massive 39% of total emissions of CO_2 and accounts for 36% of energy use. Greater consideration of how regulation might affect behaviour within the real estate market has the potential to have a major impact on the pace of decarbonisation. In short, by tailoring regulation to the sectors which make the largest contribution to total emissions, rather than to the sectors making the largest contribution to the financial markets, the overall impact on the pace of decarbonisation is likely to be much greater.

The interviewees recognise the merits of regulation that promotes transparency and requires all financial market participants to report, thereby compelling explicit decision-making on sustainability policies. In this regard, it is a push in the right direction for the industry as a whole. However, interviewees are finding it cumbersome to apply to real estate products. Many FMPs and FMAs with a long track record and commitment to a sustainability agenda for real estate report that complying with SFDR takes considerable mental agility.

Such stakeholders are eager to accelerate decarbonisation of the built environment and fear that SFDR in its current form will have a number of unintended and potentially detrimental consequences for real estate market behaviour and the pace of decarbonisation.

Interviewees discussed their approach to fulfilling SFDR requirements, the challenges encountered, and solutions developed. In addition, they also indicated what revisions to SFDR might result in greater transparency and better direct real estate market behaviour to address the just transition to a sustainable built environment.

These issues are discussed first, in the over-arching framework set out in the Level 1 Principles Based Requirements (PBR) and second, in the context of Level 2 Regulatory Technical Standards (RTS).

Level 1 Principles-based requirements

FMPs and FMAs must align their assets or assets under management in products – a fund or portfolio – to one of three categories that indicate their disclosure requirements (Figure 1).

Figure 1 PBR Disclosure categories

Article 6
Products must (a) integrate environmental, social and governance (ESG) risk considerations into the investment decision-making process, or (b) explain why sustainability risk is not relevant and (c) not meet the additional criteria of Article 8 or Article 9 strategies
Article 8
Products promote environmental/social characteristics, and may invest in sustainable investments, but do not have sustainable investing as a core objective
Article 9
Products have a sustainable investment objective. 100% of assets must meet sustainable criteria on day 1 and continuously demonstrate such criteria during the hold period

The categories are not intended to act as labels or as sustainability indicator shortcuts for investors seeking to allocate capital, however they are being misinterpreted as such. This is not aided by the proposed UK Sustainability Disclosure Requirements (SDR) which state that their categories – although different to those within SFDR – are intended to act as sustainability labels.

This is pertinent to real estate as the disclosure strategies are not a good fit for any of the wide range of ESG approaches underpinning investment strategies spanning from “do no harm” through to “sustainable”, “thematic” to “impact”.

Indeed, a number of institutional managers recognised within the industry as leaders in sustainability, commented that overlaying the framework to their range of products was “an exercise in fitting a square peg in a round hole”.

The issue lies in the mismatch of the nature of investments SFDR was devised for and the fundamental rational of real estate investments. ESMA has explained that the SFDR framework is designed to capture a snapshot of what are predominantly static investments in a pool of equities, that may be easily traded.

In contrast, real estate investments are dynamic, with investments representing an allocation to a business plan over the lifetime, or expected duration of an investment. This creates three overarching issues for the application of the SFDR framework to real estate.

First, SFDR regulation is not yet complete and requires the use of certain metrics that are subject to change overtime. These include, but are not limited to, the use of Energy Performance Certificates (EPC) as proxy ratings, which aside from not being a global standard are not even available in every European market, and are not consistent across markets where they are available. Indeed, the European Energy Performance of Buildings Directive is currently itself under review.

For public markets, this evolving regulatory environment is not a significant issue as holding periods are usually shorter-term with a greater emphasis on trading. For private markets including real estate, investments are medium- to long-term. The investment objectives are set and priced at the outset, with timelines for the implementation of the business plan of up to ten years and more. Incomplete regulation based on inconsistent proxy measures creates uncertainty for investors and managers. It is difficult to immediately adjust business plans covering medium- to long-term time horizons in response to unexpected regulatory changes.

As well as being difficult to adjust strategies operationally, especially for materials, building infrastructure and existing lease contracts, a more dynamic regulatory environment also creates a significant cost burden. Although this includes significant legal and management resource, it also extends to the acquisition and implementation of systems and technology, which can be made somewhat obsolete by fast moving regulatory requirements.

Second, the risk management of assets is represented by the business plan, with an overriding objective to protect and often, enhance the performance – including sustainability – of the asset through the hold period. The nature of business plans and the timing of returns on investment through income and growth vary by geography, sector, investment style and the level – if any – of development, refurbishment or tenant engineering required. As such, the investment represents a journey. A snapshot at departure, or at any point along the way, provides limited insight as to the destination.

Third, specifically as regards ESG, sustainability objectives are integrated with wider investment objectives from concept, through inception, execution and endurance post-exit. The “journey” is crucial for the transformation of the existing built environment to a near net zero “destination”. As it is based on a more static model of investment, the snapshot of the status quo of operational emissions captured by the current SFDR framework unintentionally signals investment toward new construction. This is because the embodied carbon created in the process is not considered by SFDR and therefore often not measured and not reported. Worse still, it fails to promote the transformation of existing real estate, which is crucial to the pathway to net zero and to a just transition in terms of reducing inequalities of both wealth and opportunity.

This mis-signalling stems from a lack of alignment between the issues most pertinent to the just transition of real estate and the criteria underlying the disclosure categories. This creates a number of inter-related challenges in the application of SFDR, with the potential to deliver unintended consequences that are detrimental to progressing decarbonisation.

The ambition of real estate sustainability and disclosure categories

The vast majority of real estate investment portfolios and funds comprise existing buildings constructed prior to 2010, which need to be retrofitted to lower their emissions as near to net zero as possible. This transition process is complex to manage due to existing lease agreements, costs of refurbishment and short-termism in valuation methodologies. In addition, without regulatory support, the capacity to implement systems and measure resource efficiency of not merely the asset, but of underlying occupiers is complex.

Much of this stock might merit an EPC rating C or less and be defined as inefficient real estate under SFDR. The sustainability ambition for real estate is to transition all real estate assets to be as resource efficient as possible through the design and implementation of a strategy that seeks to maximise resource efficiency and minimise emissions.

The strategy may include potential refurbishment of the physical fabric of the building, replacement of the plant and associated infrastructure, installation of renewable energy sources, introduction of sustainable energy, water and waste agreements, and use of green leasing contracts.The time required for each asset varies and, where an asset is subject to existing lease agreements, milestones requiring intrusive works are often aligned with lease terminations. The business plan will often aim to capitalise on the investment required for the successful execution of an asset's transition and sustainability improvements are therefore often designed to ensure disposal of assets after completion. As part of this approach, most sustainability focused asset owners/managers adopt a "cradle-to-cradle" approach, detailing and certifying materials for reuse or recycling in future refurbishments or redevelopments of an asset in accordance with an asset's anticipated lifespan.

In contrast, the SFDR disclosure categories are to a great extent determined through snapshots of the operational efficiency of assets. It fails to account for embodied carbon, which is an important component of total real estate emissions, and the reporting requirements, by default, emphasise current and future products owing to a lack of recognition of the characteristics of legacy portfolios. In doing so, the regulation fails to address the pivotal issue of transitioning the built environment. Worse still, it has the potential to steer activity toward new development, increasing rather than reducing total emissions.

Embodied and operational emissions in real estate

SFDR is focused on energy emissions generated by the operation of real estate, through Scopes 1 to 3, which account for 28% of total EU emissions. However, real estate generates a total of 39% of EU emissions with construction, including the process and materials employed, accounting for 11% of total emissions. Moreover, these emissions are generated in one big burst at the outset, as well as an emissions echo boom upon demolition. Hence, the cleanest, greenest asset, is the asset that is never built – or demolished.

Focusing solely on operational emissions, a newly constructed asset will likely outperform an existing asset, even if the existing asset undergoes a deep renovation in terms of energy efficiency involving the removal of fossil fuel fired systems, upgrading of heating/cooling systems and other facilities/systems that are part of the operational efficiency of the asset.

However, if the additional embodied carbon in the new asset is considered, the existing asset would likely outperform. And while deep renovations of existing assets – often involving the shell of the building with cladding, etc. – are not usually possible until lease expiry, with the agreement and cooperation of occupiers/tenants, it is possible to introduce light retrofits with tenants in place through staged investment and implementation that significantly improve operational efficiency.

By ignoring embodied carbon, SFDR creates an uneven playing field that encourages unnecessary new development, accelerates building obsolescence with a risk of urban decay and results in spiking embodied carbon in the short to medium term. This is exacerbated by the misinterpretation of the disclosure categories as a hierarchy rather than as a range of equivalent options.

The psychology of numeric disclosure categories

Although, the disclosure categories are not intended to act as labels, the numeric titles ascribed to Articles 6, 8 and 9 naturally suggest a build in the intensity of sustainability objectives. This is also supported by the description of each category.

For example, Article 6 includes products that may have marginal sustainability risk considerations. Within Article 8, sustainable investing is not a core objective while Article 9 requires sustainability to be an investment objective. Indeed, ESMA indicated that Article 9 is intended to capture impact funds. However, Article 9 also requires 100% of assets in the product to be aligned with the sustainability definition provided in SFDR at all times during the holding period.

In the wider investment market, Article 8 products are being dubbed “light green funds” and Article 9 “dark green funds”. However, for a real estate impact fund, the environmental impact occurs through the transformation of the energy performance of assets pursuant to the business plan and they are likely to meet this criterion near exit, not at acquisition.

With real estate impact objectives aligned with a dynamic longer-term investment horizon, they do not fulfil the pre-requisite of all assets being aligned with the criteria at all times, to be categorised as Article 9.

In contrast, a product consisting of newly constructed assets may meet the criteria for Article 9, if they are aligned with the SFDR sustainable investment definition. Of course, this ignores the embodied emissions generated through construction, including the process and materials employed. As this accounts for 11% of total emissions in the EU, a number of interviewees indicated that this should be considered to contradict the Do No Significant Harm (DNSH) principles.

As a result, most real estate products with either an impact or sustainable investment strategy are designated as Article 8 within SFDR. This places them in the same category as real estate products that have less ambitious ESG objectives.

As already noted, it is vital that when comparing emissions between 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, ultimately leading to a risk of urban decay. As for Article 9 funds, this designation requires the entity to report Level 2 Required Technical Standards. This creates an issue for products that may have strong sustainability strategies, including core objectives such as “stranded to green strategies” and for legacy real estate products that include ESG targets.

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SFDR and the legacy of real estate stock

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.

These terms may be difficult to amend during the lease term without the agreement of the leaseholder, and are particularly complex for multi-tenanted assets in the absence of a legal requirement. As a result, even where the investment strategy is otherwise “dark green”, these products are designated as Article 6, as reporting for Level 2 RTS is unachievable.

A number of interviewees commented that the introduction of legislation in certain markets that requires occupiers to provide and owners to collect energy use data, for example the Décret Tertiaire in France, has been helpful in accelerating the pace of sustainability initiatives. It also has the potential to facilitate reporting for Level 2 RTS.

However, interviewees also commented that there are myriad regulations that vary at the country and city level, as well as across real estate sectors. This creates significant inefficiencies for multi-country and multi-sector products that greater standardisation across markets would alleviate, as well as increase the pace of decarbonisation. Some interviewees expressed a concern that such legacy portfolios and funds within Article 6 represent the majority of existing stock and its transformation is the key to accelerating decarbonisation.

However, many institutional investors making new capital allocations regard Article 8 disclosure criteria as a baseline investment criteria. Worse still, the misuse of SFDR as labels is resulting in some FMPs and FMAs disposing of underlying assets, often to less sophisticated purchasers that either don’t care, or lack the knowledge, capital or longer-term investment horizon required to retrofit assets. To this end, an unintended consequence of SFDR is masking the central issue of decarbonisation: retrofitting existing stock. However, this issue also effects disclosure for some current and future products.

RTS and consumer protection for affordable and social housing

The application of the Level 1 PBRs to social and affordable rented housing assets have created a particular difficulty for a number of interviewees. Rapid urbanisation, changing demographics and household structures have led to an affordable housing supply shortage across many of Europe’s urban centres.

The activity of institutional real estate investors in providing innovative housing solutions through the build-to-rent sector is crucial to alleviating this issue. Given a scarcity of supply, much of this activity warranted construction and redevelopment, with leading institutions adopting sustainable construction practices in a cradle-to-cradle approach to both process and materials.

Although such assets usually offer passive construction, integrating renewable resources and offering high energy efficiency standards, occupiers control their own environment in regard to resource use, often including the energy provider and source of energy. Indeed, in many jurisdictions, the building owner is prohibited from being a resource provider to tenants. Equally, owners may be prohibited from collecting data on tenants, including requiring tenants to report on usage.

In contrast to the EU Taxonomy, which makes an exception for residential assets, SFDR RTS require periodic monitoring and reporting of operational energy use. As a result, products/assets must designate as Article 6 for reporting purposes even if they meet the sustainability threshold of EPC B or otherwise align with the EU Taxonomy, and have previously been marketed on the basis of their strong ESG criteria. Essentially, under Article 6 the energy reporting requirements are in line with the EU Taxonomy, but SFDR may create unintended consequences for the potential signalling to capital allocations.

As the Articles are stepped in terms of their wording of the intensity of sustainability objectives, many FMPs and FMAs are not considering new allocations to products with an SFDR disclosure less than Article 8. This may impede much-needed social and affordable housing solutions, or require additional, invasive regulation to permit household energy use to be controlled/ monitored.

RTS and non-EU products and investment assets

SFDR has the ambition to have extraterritorial influence as it extends to products marketed in the EU and to EU-domiciled products that have strategic reach to other jurisdictions in terms of scope. FMPs and FMAs consider SFDR presents two specific obstacles to achieving this ambition for real estate products.

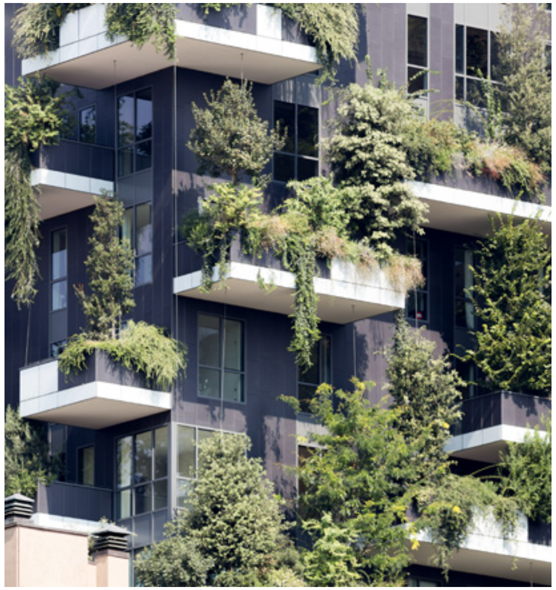
First, SFDR is a challenge at the entity level. SFDR is a stepped regulation, with stakeholders blind to the detail of subsequent regulatory phases. Substantive revisions are also anticipated. As a result, non-EU investors are reluctant to sign a contract that has blank pages to be completed later on for as yet unidentified issues and standards, regardless of the ESG objectives embedded in the strategy.

Similarly, non-EU joint venture partners for products and/or specific assets in jurisdictions outside the EU are reluctant to agree to be bound to the requirements of what is acknowledged as incomplete EU regulation that has the capacity to impact their wider organisation. The interviewees suggest that this persists even when the strategy and/or the joint venture partner have a sustainability purpose core to their objectives. The products disclose as Article 6.

Second, the Level 2 RTS for real estate is based on metrics that do not exist in most non-EU jurisdictions and substitutes vary widely at country and city level.

A number of interviewees are using emissions data derived and/or third parties to model equivalent EPCs or are using the Paris Agreement-aligned CRREM pathway.

Many countries are not yet advanced in the culture of sustainability and achieving measures of operational emissions can be delicate where it involves the agreement of occupiers/tenants and is not supported by regulation. Indeed, a broader issue is that in certain jurisdictions sustainability issues have become highly politicised and as a result, even where ESG criteria are firmly embedded in strategy, it is not prudent to market products as having ESG as a core objective.



> Non-EU joint venture partners for products and/ or assets in jurisdictions outside the EU are reluctant to agree to be bound to the requirements of what is acknowledged as incomplete EU regulation.

Social value and social impact in real estate

SFDR does not require real estate products to report on social value generation as there is no accepted metric. However, the social value dimension to real estate is considerable as it represents the built environment and services that touch the environment in which every citizen works, rests and plays.

As a result, many FMPs and FMAs seek to deliver measurable social value and/or impact through their products, often funded through the financial benefits of energy efficiency improvements. Again, such impact is measured from the baseline at acquisition, through implementation, execution and endurance post-exit. However, the SFDR framework does not enable the symbiosis of environmental and social impact goals to be captured or, as a result, encouraged.

SFDR Principle-based requirements and selection of disclosure category

Figure 2 summarises the general consensus among interviewees as to how to apply current SFDR Level 1 PBR to future, current and legacy products, with an indication of the risks they perceive for the pace of decarbonisation in the built environment.

Figure 2 Application of Level 1 Principle-based requirements for real estate disclosure

Article 6
• Products integrating ESG risks into investment decision-making but without access to required reporting metrics • Non-EU products • Can include very low to very high ESG ambition • Risk: New investors have a minimum of Article 8 as criteria; Disposal instead of transformation of legacy assets
Article 8
• Broad category encompassing bare minimum "do no harm" through to Impact ESG strategies, with access to metrics required for reporting • Risk: Institutional investors without real estate specialist knowledge and retail investors do not understand that for private market and dynamic investments, impact and sustainability rich strategies are Article 8 (and sometimes 6)
Article 9
• Sustainable real estate stratgies rarely meet the requirements of Article 9, with limited exceptions where new construction is warranted and securing metrics on operational energy use is permissible • Risk: Products comprising solely newly constructed, efficient real estate assets may be misconstrued by underlying investors without real estate knowledge as sustainable, regardlesss of embodied carbon involved or if new construction is warranted in context of supply of existing assets. In principle, this should conflict with the DNSH principle. Potential to impede decarbonisation progress, result in stranded assets and cause urban decay

In respect of disclosure, interviewees commented that during 2022, FMPs and FMAs have been on their own journey with SFDR. Initially, the descriptors pertaining to the Articles encouraged many managers and investors to seek a disclosure of Article 9, especially for impact-oriented products and investments. At the same time, concerns regarding the applicability of Level 2 disclosures to real estate led to many, especially legal and compliance officers, considering Article 6 as a prudent default disclosure option.

However, the interviewees all represent organisations that consider sustainability to be core to their over-riding mission and, as well as aligning with the requirements of SFDR, they are keen to align with the spirit of SFDR to increase transparency, impede greenwashing and accelerate decarbonisation. Where possible, products are aligned with a disclosure requiring Level 2 reporting.

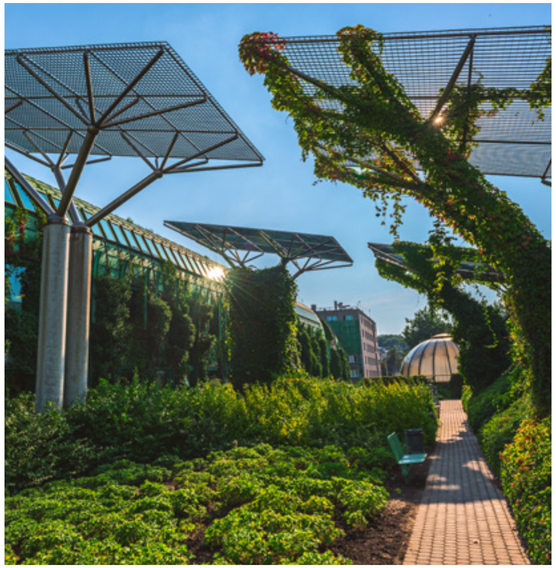
Clarification by ESMA that Article 9 funds require 100% of assets to be aligned with the definition of sustainability in SFDR led institutional real estate investors and managers to identify Article 8 as the appropriate disclosure standard for sustainable activity in real estate.

Indeed, a number of investors commented that they consider products being marketed as Article 9 as a risk, despite having trust in both the manager and the strategy. They consider the product's risk of re-rating to be high, which could destabilise the fund if co-investors used it as an opportunity to exit or change other terms in the future.

It is noteworthy that this issue is not limited to real estate and that from the second quarter of 2022, the number of European investment funds seeking to redesignate from Article 9 to Article 8 disclosure accelerated sharply following ESMA's clarification[5].

The risk of misinterpreting SFDR, or for aspects of the regulation that are considered vague and widely expected to be clarified or revised, is also present in the Level 2 RTS.

Again, this uncertainty is a greater issue for dynamic strategies characterising private market products that have a longer-term duration and are priced at the outset than for static, short-term investments in listed equities that can be more readily adjusted in time with evolving regulation.



> A number of investors commented that they consider products being marketed as Article 9 as a risk, despite having trust in both the manager and the strategy.

5 Webb, D (2022) SFDR Clarifications 'could cause huge burden' for asset managers, Responsible Investor, 15 November; Klasa, A (2022) European asset managers blame regulatory confusion for downgrade of ESG funds, Financial Times, 22 November

Level 2 Required Technical Standards

Products disclosing as Article 8 or 9 are required to report on Level 2 RTS. The overriding aim of Level 2 is to clarify the content, methodology and presentation of ESG disclosures. Interviewees are supportive of the over-arching aim to introduce greater standardisation and comparability within ESG reporting. However, it is suggested that 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.

The sustainable investment definitions set out in the EU Taxonomy and in the SFDR regulations are compared in Figure 3. SFDR is a much broader definition than the EU Taxonomy, which has more specific criteria. Each regulation comprises a specific range of environmental and social objectives, which although similar are bespoke for each regulation. FMPs and FMAs are required to indicate which objectives a specific product is targeting. Although a product does not have to target every objective, its activities must do no significant harm (DNSH) to any other objective in the scope of the regulation.

Figure 3 Comparison of selected criteria within SFDR and EU Taxonomy consideration of sustainable investment

EU Taxonomy Definition		
Substantial contribution to set environmental objective (Climate change mitigation or adaptation relevant)	DNSH to other objectives	Compliance with minimum safeguards
Detailed Technical Screening Criteria, including		
Construction of new buildings: EPC A and NNZE of 10% below mandatory thresholds in jurisdiction	Renovation: Existing buildings (pre 31/12/20) 30% reduction on PED	Acquistions/ Ownership: New assets post 31/12/21 EPC A. Exiting EPC A or within top 15% of assets for primary energy demand in jurisdiction

SFDR		
Contribute to an environmental or social objectives	DNSH harm any of those objectives, and	Companies follow good governance practices
Level 1 PBR and Level 2 RTS		
Select Article 6, 8 or 9 as relevant Level 1 disclosure category, determined by ESG criteria and in practice, by ability to report Level 2 RTS	RTS define guide as to metrics, but not required thresholds to be achieved	Driven by EPC data rather than underlying emissions data

At first glance, the EU Taxonomy appears to be a useful definition to apply within SFDR, as it considers the concept of the journey that the vast majority of stock requires by identifying a baseline that measures improvement in energy efficiency for renovation activity.

However, the second clause of the SFDR definition makes reference to DNSH to environmental and social objectives. Inefficient assets do not meet the DNSH criteria and in Annex 1 of the RTS, SFDR defines inefficient assets as having an EPC of C or less.

Notwithstanding that EPC rating thresholds vary considerably across jurisdictions, the great sustainability challenge for real estate is to improve the efficiency of assets with an EPC rating of C and lower. Counterintuitively, the SFDR framework discourages this activity by directing capital to invest in products acquiring assets that are already considered efficient.

Equally, although the interviewees are eager and making best efforts to comply with reporting requirements in Principal Adverse Impacts (PAI) and DNSH policies, many found that interpreting RTS designed for the public markets for investments in private real estate products required considerable mental agility. As a result, a range of approaches has been developed across organisations and for the specific context of certain products.

These are embedded in how FMPs and FMAs define and disclose for sustainable investment and in selection and disclosure of PAIs.

Defining and disclosing on sustainable investments

SFDR requires real estate FMPs and FMAs to disclose on the percentage of investments that have a sustainable objective and the percentage of assets that are aligned with the EU Taxonomy.

SFDR adopts a much broader definition than the EU Taxonomy, defining a sustainable investment as “an investment in an economic activity that contributes to an environmental or social objective, provided that the investment does not significantly harm any environmental or social objective and that the investee companies follow good governance practices”.

Although most interviewees consider that the threshold embedded in the EU Taxonomy is too high and too binary for real estate, they appreciate the clarity in comparison to SFDR. The interviewees stated that the broad scope of this definition effectively requires entities to set their own criteria for sustainable investment and report on the percentage of assets that meet that criteria. Many interviewees considered this to be a weakness of the regulation for a number of reasons.

First, one interviewee commented that it effectively required entities to “set and mark their own homework”, which could engender rather than inhibit greenwashing. Second, 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 any useful comparable assessment of sustainable activity.

Third, as the percentage is a snapshot, it may discourage investors from allocating to the transformation of real estate at the heart of sustainable activity and, instead, allocate to assets that are already sustainable. While not the aim of SFDR, it was considered that over time the change achieved in the percentage of assets meeting the criteria set might become a useful metric.

In terms of definitions employed, many interviewees commented that they had hoped that SFDR might act as a signal to assist in setting the future direction of their ESG objectives. However, as SFDR evolved they reverted to their ESG goals to ensure they remained focused on their sustainability ambitions and, instead, employed these to derive sustainability targets/thresholds for the purpose of SFDR. As a result, the definition of a sustainable investment for SFDR is often the minimum acceptable target for the product, rather than the target.

In the absence of an industry standard definition, three broad approaches are identifiable and summarised in Figure 4. As the baselines and thresholds are self-determined, it is necessary to deep dive into underlying data to make any meaningful comparison. Many interviewees suggested that having agreed industry standards for baselines and thresholds would be beneficial for comparison and improve transparency. However, it was also indicated that the baselines vary by real estate sector and by jurisdiction at a country and often city level.

Figure 4 Frameworks employed to determine sustainable investment for SFDR

Approach	Pros	Cons
Mandatory PAIs	Transparent, simplicity	Bare minimum that conflicts with the spirit of ESG commitments; EPC ratings flawed, inconsistent and too easily manipulated
Mandatory PAIs ++	EPC and selected metrics indicating emissions and resource use data; most valuable if industry wide and sector specific criteria agreed	Self-selection of metrics and thresholds could enable cherry picking/greenwashing and doesn't increase transparency/ comparability
CRREM Pathway	Detailed, audited, independent data; introduces transition timeline appropriate to real estate	Detailed data benchmarks not yet available for niche sectors or smaller countries, but can be estimated from emissions data

When disclosing a percentage figure, the interviewees are divided on their approach. All of the interviewees set and measure their thresholds for defining sustainability. However, although some organisations are willing to also disclose their current assessment, many are disclosing a zero percentage alignment, at least in their initial submissions.

This reticence is due to concern that they may be misinterpreting the existing regulation as well as a strong anticipation that the definition of sustainable investment will be revised and narrowed, and that greater standardisation will be introduced. A recent report representing over 17,000 equity investment funds including 7,169 Article 8 funds and 886 Article 9 funds indicates that this prudent approach is not restricted to real estate. The analysis reveals that 36% of Article 8 funds disclosed 0% alignment, and a further 30% disclosed a minimal 0 to 10% alignment[6]. A mere 6.1% indicate alignment greater than 50%.

The rates of disclosure are higher for Article 9 funds, reflecting their stronger qualifying criteria but some 43.4% are citing rates of less than 50%. As ESMA has clarified that Article 9 funds need to be aligned 100% at all times, this is surprising, as the finding that just 4.8% of these funds are disclosing rates between 90 and 100%.

Although the interviewees would welcome greater specificity and standardisation in the regulation, there is uncertainty as to whether such a threshold would be set appropriately for real estate, especially in regard to the transition of the stock of existing real estate. Given the longer-term investment horizons involved, some FMPs and FMAs are deferring disclosing a figure until there is more certainty, considering an upward revision on this specific datapoint to be a lower business risk than any potential for a downward revision.

Indeed, ESMA issued a consultation document in November 2022 proposing thresholds for the percentage of assets in a product that should align with the definition of sustainability in terms of SFDR[7].

The proposed thresholds are that if a fund has any ESG-related words in its name, at least 80% of a product's investments should be used to meet the environmental or social characteristics or sustainable investment objectives in accordance with the binding elements of the investment strategy, as disclosed in Annexes II and III of SFDR.
In addition, if the name of a fund references sustainable investment, at least 50% of the aligned investments should meet the criteria targeted.

Such a revision would likely intensify the challenge for sustainable real estate strategies seeking to transition inefficient assets.This decision on disclosure relates to the perceived business risk that any allegation of greenwashing might cause, especially when ESG and sustainability objectives are core to an organisation's mission and values. Although not ubiquitous, this concern is also more heightened for organisations most reliant on third-party capital. It also relates to how organisations have approached reporting for the PAIs.

6 Elliott, C (2022) SFDR is an IFA Headache, so How Are Advisers Getting on?, 2 November
7 ESMA (2022) Consultation paper on Guidelines on funds' names using ESG or sustainability-related terms, 18 November

Principal Adverse Impact and Do No Significant Harm

SFDR requires fund managers to disclose how they have integrated sustainability risk management into their processes and provide metrics and other supporting evidence to substantiate these claims. This forms the PAI disclosure (Annex 1), a template of twenty-five mandatory and twenty-two additional indicators applicable to all asset classes. Mandatory PAIs include indicators for climate and other environmental aspects, social and employee, respect for human rights, anti-corruption and anti-bribery.

There are seven PAIs applicable to investments in real estate, represented by fourteen indicators that concern investments in investee companies and two indicators relating to investments in real estate assets. Of these seven PAIs, two are mandatory and there are five additional indicators related to environmental aspects.

The mandatory PAIs for real estate are:

- Exposure to fossil fuels through real estate assets; and
- Exposure to energy-inefficient real estate assets

The aim of the PAI disclosure is to provide substantive evidence of ESG and sustainability claims being made in respect of products. It is also used as the basis for disclosing to the DNSH principles of sustainable investment. An investment may be considered sustainable if it contributes to an environmental or social objective and does not significantly harm any other environmental or social objective, as set out in the regulation. By requiring managers to provide PAI disclosures on various ESG-related matters, the process is intended to ensure that all relevant sustainability risks that might have a material impact are considered and accounted for.

There is strong support across the interviewees for the principle of increasing transparency and substantiating claims with objective evidence and data. The interviewees varied in their approach, to some extent reflecting their level of comfort in self-defining sustainable investment and associated thresholds. Many interviewees sought to disclose for both mandatory and all additional indicators relevant to real estate, explaining substitution of an indicator or metric with an alternative where necessary. Some interviewees only completed mandatory disclosures, while information related to non-mandatory disclosures was communicated as part of the DNSH principles disclosures.

The majority of interviewees consider reporting on exposure to energy inefficient real estate assets and to fossil fuels to be important, but not necessarily the most pertinent in respect of accelerating decarbonisation in real estate. In part, this is because exposure to inefficient real estate is driven by the EPC rating, which is not standardised across countries and can be easily manipulated. More direct metrics relating to emissions are preferred.

With some PAIs, including exposure to inefficient real estate using an EPC rating as a core component, it is difficult to apply to non-EU products/assets as EPC ratings are not used. A number of different approaches have been developed by interviewees to accommodate this:

- In addition to the EPC rating where available, interviewees disclose additional selected metrics. Such metrics are often core components of BRREAM or other standards on emissions. Baselines and thresholds are set and/or derived from modelling to align non-EU assets. For countries within the EU that do not have an EPC rating as their standard benchmark, GRESB has developed a model to convert environmental metrics to an EPC rating.
- Although attempting to submit on all PAIs as far as is possible, a number of interviewees have explained within their disclosure that the suggested data reporting is inappropriate or not the most suitable and substituted with more direct measures. One interviewee explained that they sought to disclose the most

transparent, objective and relevant approach to their alignment with the Paris Agreement. Submitting data derived from their CRREM pathway alignment, the timeframe of movement in a dynamic investment is explained.

A number of interviewees are also concerned about what should be included within exposure to fossil fuels, what is defined as “the company” and the extent to which the exposure of occupiers or tenants should be considered. Although it is possible to exclude fossil fuel companies and where possible provide power purchase agreements (PPA) for new leases, the owner/occupier relationships are complex.

The degree to which an investor can – or should – try to influence an occupier/tenant’s behaviour is problematic. For example, multi-national retailers may have thousands of individual landlords and a centralised energy procurement system, many industrial/logistics/technology occupants lease a building as shell and core, and there are legal requirements mandating third-party energy provisions for residential leases in many jurisdictions.

A number of interviewees adopted a more holistic approach to the process. Although adopting their best efforts to report on all PAIs, they considered the benefit of the approach to be in identifying the most relevant data and metrics, reporting on those and tracking their improvement over time.

This shifts the focus toward monitoring the achievement of milestones for the transition of the portfolio over the business plan time horizon.

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Conclusion

At first glance, real estate is relatively insignificant in terms of its mere 3% share of the total finance market. However, with all real estate accounting for two fifths of carbon emissions, regulation supporting a near-net zero built environment has the capacity to greatly accelerate decarbonisation not merely of real estate investment, but of the total economy and society.

SFDR represents a major opportunity to effect meaningful change. Many institutional investors and investment managers, already aligned to the Paris Agreement, require the support of regulation to assist in effecting change in what is a complex, longer-term, multi-stakeholder asset class.

The overriding aim of SFDR is to redirect capital toward more sustainable investment and to assist investor decision-making through improving transparency and introducing common standards. It has a wide remit, covering all financial asset classes. Its lack of discrimination between static and more dynamic asset classes is a weakness when applied to real estate, impeding the capacity for SFDR to deliver on its objectives for real estate for four inter-related reasons.

First, investment in real estate represents an investment in a business plan executed over a medium- to long-term investment horizon. This is intensified for sustainable real estate investment products, which commonly represent transition strategies that involve the acquisition of inefficient real estate, that through asset management expertise and capital expenditure is repositioned to better meet the requirements of occupiers.

Resource efficiency and ensuring social value generation is net positive are central components of risk management implemented over a medium- to long-term investment horizon. This just transition of the built environment is pivotal to achieving the overriding ambitions of the Paris Agreement.

In its current form, SFDR 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 risks encouraging investors to dispose of existing inefficient assets.

This is exacerbated by SFDR ignoring the 28% of total real estate emissions, representing 11% of total EU emissions generated from embodied carbon associated with construction. This stimulates unnecessary new development.

Second, real estate investors and managers advancing sustainability rich investment strategies, share the ambition to impede greenwashing through greater transparency.

> With real estate accounting for two fifths of carbon emissions, regulation supporting a near-net zero built environment has the capacity to greatly accelerate decarbonisation.

Disclosure is considered a necessary requirement. However, as the categories are designed for static investments, the application of the Level 1 disclosure categories to real estate does not add transparency or assist investment decision-making, and may actually lead to greenwashing.

It is accepted that the disclosure categories are not intended to be labels; however, it is an issue for real estate if they are being even partially interpreted that way, or used as signals of the intensity of sustainability within strategies. In short, across all asset classes, Article 9 is being interpreted as deep green and Article 8 as light green.

For real estate, deep green activity is transforming inefficient real estate – in SFDR terms assets with an EPC of C or less – to be efficient. In real estate products, this activity is concentrated in Article 8 products. It is also the basis of some Article 6 products where existing lease contracts or legislation limit access to data on operational energy use/emissions.

Legacy real estate products, usually representing assets requiring transition are also often categorised as Article 6. Many investors and managers are implementing ESG strategies to improve these assets, however, they risk being starved of capital with many investors and debt providers using Article 8 as a baseline for new allocations. With perhaps the exception of new development of social and deeply affordable housing, Article 9 funds are likely to represent the least sustainable activity for real estate. Although investors with real estate expertise recognise that sustainable real estate products align to the Level 1 categories in a different way to the majority of public market products, investors and many debt providers without this expertise are misconstruing the signals from real estate disclosure categories. To this end, while SFDR is demonstrating its capacity to influence the allocation of capital, it may misdirect it within real estate, with significant consequences for reducing emissions.

Third, Level 2 RTS are heavily based on operational real estate emissions using EPC ratings. Such ratings are not standardised across markets, which creates an uneven playing field for disclosure at both Level 1 and Level 2. They are also not available – or many of the metrics underpinning them – in most non-European countries as well as in certain European markets. Interviewees also considered that they can be easily manipulated to deliver a higher rating without any improvement to energy efficiency. It is suggested that the use of metrics based on derived data might be more robust and more transparent.

Fourth, SFDR is fulfilling its ambition to direct capital, with many interviewees reporting that institutional investors consider Article 8 to be a pre-requisite for new investment. Although this is positive in respect of many current and new strategies, it creates an issue for the majority of existing stock. However, it does demonstrate the power of regulatory support in the promotion of a more sustainable investment market.

Real estate is a major linchpin in fulfilling the EU's objective to reach the ambitions of the Paris Agreement. Regulation has the capacity to greatly accelerate the necessary transition of the built environment. The over-riding objectives of SFDR to increase transparency, create standards and inhibit greenwashing are well matched to the needs of the real estate investment market.

However, as SFDR has been tailored to the public markets, which dominate financial markets – although not emissions – efficacy is lost in their application to real estate. While not their intended purpose, periodic disclosures are likely to prove useful in tracking the strategic objectives of investment products against investment milestones within longer-term business plans. Equally, any revisions that seek to tailor SFDR to private markets and in particular to real estate, have the potential to increase its potency and further increase the pace of decarbonisation.

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