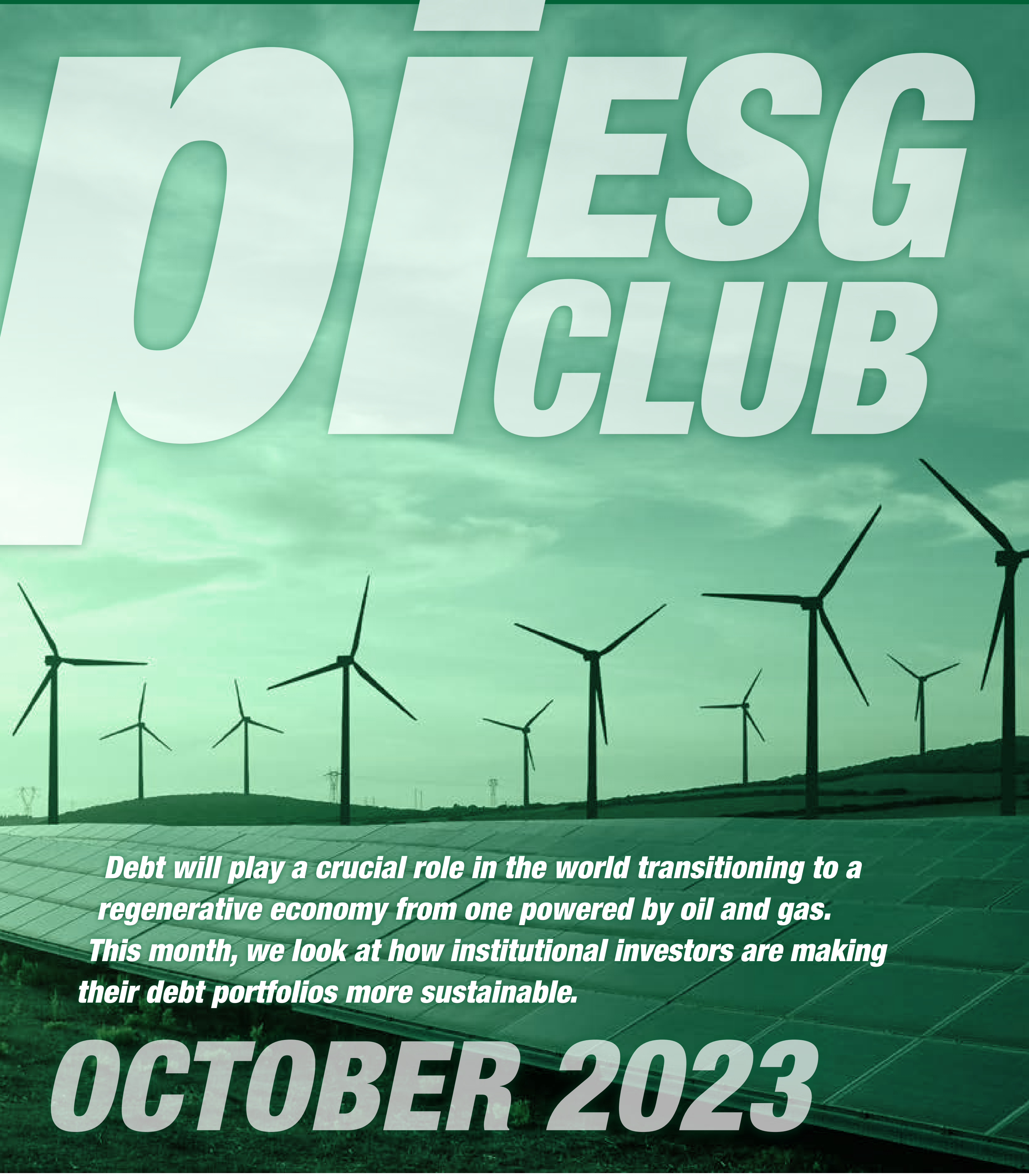


pi ESG CLUB

Debt will play a crucial role in the world transitioning to a regenerative economy from one powered by oil and gas. This month, we look at how institutional investors are making their debt portfolios more sustainable.

OCTOBER 2023

Members

AON · BlackRock · BNP PARIBAS ASSET MANAGEMENT · JUPITER ASSET MANAGEMENT · LGIM · M&G Investments · NEWTON Investment Management · PENSIONS AND LIFETIME SAVINGS ASSOCIATION

NEW FRAMEWORK AIMS TO PUSH FINANCE AND BIODIVERSITY CLOSER TOGETHER

The TNFD wants to shift the dial on nature-related risk through improving reporting and boosting financial flows, finds *Andrew Holt*.

After two years of discussion, The Taskforce on Nature-related Financial Disclosures (TNFD) has published its final recommendations for a nature-related disclosures framework – a move which is likely to have big implications for institutional investors.

The TNFD has two aims: to inform better decision making by companies and investors; and contribute to a shift in global financial flows toward nature-positive outcomes.

The initiative has strong support. It is led by 40 members which collectively have more than $20trn (£16trn) of assets under management. It also has the support of stakeholders from almost 60 countries.

The introduction of the TNFD's 14 disclosures, along with its implementation guidance, comes at a time of rapidly growing global interest in nature and biodiversity issues.

Policymakers, regulators, asset owners, investment managers and corporates are, as witnessed at events hosted by *portfolio institutional*, particularly our ESG Club Conference in September, increasing their focus on nature-related risks.

A big and vitally important factor within that is the necessity of mobilising finance to tackle nature loss and scale-up nature-based strategies.

The costs of inaction

The TFND's recommendations build on those of the Task Force on Climate-related Financial Disclosures (TCFD). They are also "consistent with the global sustainability standards of the International Sustainability Standards Board" and the "impact materiality" approach used by the Global Reporting Initiative and incorporated into the European Sustainability Reporting Standards.

This, says the TNFD, provides organisations with nature-related guidance that enables their reporting requirements across jurisdictions with the different approaches to materiality now in use.

On the impetus behind the disclosures and framework, David Craig, co-chair of the TNFD, said: "Nature loss is accelerating, and businesses today are inadequately accounting for nature-related dependencies, impacts, risks and opportunities.

"Nature-risk is sitting in company cashflows and capital portfolios today," he adds. "The costs of inaction are mounting quickly. Businesses and financial institutions now have the tools they need to take action."

Emma Latham-Jones, senior manager at responsible investment campaigner Share Action, applauded the initiative. "The new TNFD framework is a crucial step in the right direction towards protecting our planet's nature and biodiversity."

She does, though, have some concerns. "Chief among them is the lack of data standardisation that would allow information about biodiversity to be compared effectively between financial institutions," Latham-Jones said.

"We urge the business and finance sectors to incorporate the new framework into their decision-making process," she added.

Aligned reporting

The TNFD recommendations align with the requirement of Target 15 of the Global Biodiversity Framework for corporate reporting, which calls for assessment and disclosure of nature-related risks, impacts and dependencies. This would enable companies to align their corporate reporting with global policy goals, as they are doing on climate-related issues.

Following the example of the TCFD, the TNFD will track voluntary market adoption annually through a status update report beginning next year.

David Willans, sustainability director at corporate communications consultancy Bladonmore, has been following the issue with interest and believes the outcome is positive. "The guidelines do the herculean task of setting out how to understand the relationship between nature and a business. This gives communicators the facts to communicate in engaging ways, over and above ticking the disclosure boxes," he said.

Echoing a similar point, Elizabeth Mrema, co-chair of the TNFD, highlighted how nature-related risk management has risen up the ladder of importance for investors. "Business as usual is no longer an option and business and finance can no longer consider nature and biodiversity as just a corporate social responsibility issue. It is now squarely a central and strategic risk management issue," she said.

Fast evolving

But Willans added that challenges remain. "Corporates and investors alike have to recognise that this is an entirely new, fast-evolving field. Smart investors will. And they will expect companies to be transparent about what's not yet been done as much as what has. For some companies that's going to be hard because they're worried about the optics, but not doing it carries much greater risks," he said.

Pharmaceutical behemoth GSK has been first to rise to the challenge. It is to publish its first TNFD disclosures from 2026, based on 2025 data. TNFD expects other companies to follow its lead. The TNFD also plans to announce an inaugural list of its adopters – companies that have indicated their intention to start adopting the recommendations – at the World Economic Forum at Davos in January.

INTERVIEW – DAN NEALE

"Investors should not see themselves as separate from society."

The responsible investment social themes lead at the Church Commissioners for England sits down with *Andrew Holt* to discuss the challenges of promoting the social aspects of ESG, waving goodbye to oil and gas, pushing human rights and the importance of having a plan.

What does the role of social themes lead entail?

Within the investment division, I look at social issues in the Church Commissioners' portfolio. I look at human rights, slavery, ethics, the just transition and ethical screening – and that covers all asset classes.

The role of social themes lead is a new position: why was it created?

I joined in April last year when the Church Commissioners decided to bring in more thematic specialists. This reflected a strategy change within the organisation away from having generalists to a focus on specialists in particular areas.

Why is the social aspect so important to the Church Commissioners?

At the highest level, the Church of England's Marks of Mission include addressing social structures and social issues. Our role as an ethical investor is plugged into those social structures.

The social aspect should be equally important to all investors because fundamentally, investors are part of society. They are impacted by it; they are not separate from it.

That is an important part of the ESG debate: investors should not see themselves as separate from society. And our belief is that socially responsible conduct underpins value creation and supports long-term returns.

A good point. Do you think, therefore, that the S in ESG gets neglected by investors in favour of the E?

Neglected is a little strong, but the S has been a poor cousin to the E. Although if we go back to when responsible investment and ethical investing was new, a lot of it was people focused. It was about avoiding products that were inherently harmful, like tobacco. We don't invest in those because they harm people. So there was a starting point with a heavy S as a focus in investment.

The rise of sustainability led to a heavy focus on the E, particularly climate issues. That then received a lot of traction.

In part, it reflects that many investors got behind the idea of climate change as a systemic risk. The setting up of frameworks – like the Task Force on Climate-related Financial Disclosures – came with all that and it was driven forward.

There is also an argument that the numbers within the E are easier to wrap your head around, such as the targets. Whereas the S can mean different things to different people.

Is that why the social part doesn't get the focus it should?

There are always going to be trade-offs in terms of resources and what to focus on. Seeing what has happened in the past few years, particularly between Covid and social movements in North America, has helped push the S higher up the agenda.

But it is steeped in inclusion in some cases. And that doesn't necessarily trans-

late into all parts of the world having the same point of focus. There is a certain element of being conceptual with the different topics.

Like with net zero in the E, there isn't that identifiable equivalent that everyone can pile into and push forward on within the S. So it isn't, coming back to the initial point, that the S hasn't been neglected as such, it is in fact more disparate across a lot of different topics.

So, therefore, does a net zero equivalent need to be created on the social front?

We want companies to respect human rights and we recognise social inequalities as a systemic risk. We want companies to address social inequality or at least not become entrenched within it.

And on those two things, it is unfortunately something that companies don't coalesce around. There is no net positive on the social side because you cannot offset human harms here by doing good stuff over there.

How does your responsible investment approach work overall?

We are quite open about our responsible investment approach, which is set out by our RI and ethical policies. Our framework is to respect people and the planet. It is big and, as it is not either/or, relates to our increased positives and negatives in dealing with those risks.

The systemic risks we have focused on will guide our stewardship work on three levels: climate change, nature loss and social inequality. They also feed into the practical work as to where we should invest.

And then there is the micro level, where we actually engage with assets and individual companies. And also on the manager level, where we integrate responsible investment into our manager selection so they improve and go higher up that level of responsible practices.

Then there is the macro level, where we look at the big picture stuff – the environment in which businesses operate in. So that is how we translate the policy into a practical approach.

You are guided by the Charity Commission's rules: do they hamper your ESG ambitions?

We are not an impact-first investor. The Charity Commission's rules set out quite clearly that our charitable objectives are to supply sustainable returns to the Church. So that gives us nice clear parameters.

Just because we cannot do concessionary investing it doesn't mean we cannot have a positive impact at the same time.

They hamper us in that respect – because it comes down to the objectives of the organisation. There is a box we are in within the rules and it is how do we do the best within that box to achieve what we want to achieve. For example, we had a green bond launch, which fed into the sustainability investments. So there is plenty like that we can do. There is a vast amount of impact that charity investors can have.

The Church Commissioners have committed to divesting from fossil fuel companies which are not aligned with the Paris Agreement goals. Where are you with these plans?

Back in 2021, we excluded 20 oil and gas majors from our investment portfolio. We are now excluding BP, Ecopetrol, Eni, Equinor, Exxon Mobil, Occidental Petroleum, Pemex, Repsol, Sasol, Shell and Total, after concluding that none of them are aligned with the goals of the Paris Climate Agreement, as assessed by the Transition Pathway Initiative.

The broader exclusion of all oil and gas exploration, production and refining companies will follow by the end of 2023. The decision to disinvest was not taken lightly. Alan Smith [First Church Estates Commissioner] has said on the issue that the energy majors have not listened to the voices in society or markets they serve and they are not moving quickly enough on the transition.

Last year you made a commitment to vote against companies that do not meet expectations on human rights. Why is this important?

It comes back to having respect for the people. On a human rights policy, we expect all companies to respect human rights. That is a fundamental expectation. And it underpins other social themes like decent work, just transition and artificial intelligence ethics.

We also recognise, as I have said, social inequality is a systemic risk, which can create a risk to investors like us. The Business Commission attacked inequality, and we agree with their view that at the heart of that risk is how companies respect human rights.

So it brings together our ethical thinking and our long-term systemic risk thinking. It is about how we take that systematic approach.

Would you divest from a company over this issue as a result?

What we are looking at is whether they have policy commitments to respect human rights and whether they implement due diligence. These topics are well aligned to the legislative requirements. It is a good hook to engage with companies.

It is not really a disinvestment conversation. But if there are breaches of human rights, that is then a different conversation.

The Church Commissioners list the themes as Respect for People and Respect for the Planet. What do they mean?

As I mentioned, it is big and we look at where both come together: like a just transition for workers towards net zero, or respect for land and rights in addressing nature loss.

It gives us a focus area of the things we want to see. We have set out net-zero targets. It gives us the ability to say why we are talking about these topics and gives us a framework in which to bring all the things together. We are recruiting for a planet lead at the moment.

The S has been a poor cousin to the E.

Your experience is leading social and human rights rankings and impact at the World Benchmarking Alliance. Has your time as a social performance consultant and an officer in the Royal Navy served you well in your current role?

I hope so. I have had a wiggly career path. It is good to have a diverse experience coming into a role like this.

And there are some unrealistic expectations placed on the ESG stuff – to be experts across all of its issues. One of the Navy's defined traits is to be cheerful in adversity. That's useful when we have emerging dramas. Worse things have happened at sea. I bring that with me when it comes to emergencies or problems.

From the civil society piece, it is engaging with companies and understanding what engagement looks like. That has been useful.

What have been your biggest challenges in this role?

Moving into a different space. It has been learning about the Church Commissioners, as it is a complex organisation. It has a long and distinguished history and is a diverse investor. There has been a lot to learn. So the biggest challenge has been wrapping my head around it all.

What are your main priorities going forward and why?

One of them is the human rights voting approach. We are looking to publish a round up on this towards the end of the year. But we also recognise the lack of data on this. So we are in the grip of something for investors to engage with data providers on this topic. That is something we want to carry forward. We want to take systemic action, but we recognise the data is not yet available.

A broader priority is to bring all these disparate elements into an overarching social plan. This is so that we can have a social action plan close to that of a climate action plan.

Christophe Montcerisier is head of real estate debt at BNP Paribas Asset Management

EUROZONE COMMERCIAL REAL ESTATE RESET CREATES OPPORTUNITIES FOR DEBT INVESTORS

The sharp rise in interest rates over the last year has lowered valuations and led buyers to demand higher yields when acquiring commercial property. Banks have increased their scrutiny and caution, reducing loan-to-value funding ratios. While there is still demand from borrowers, especially for refinancing maturing debt, the amount of debt offered by banks per square metre is lower. We believe this environment presents an attractive opportunity for investors.

Real estate pricing

Currently, real estate prices are being reset. Property markets, including those for commercial real estate, are adjusting in the face of two opposing forces:

– On one hand, the significant rise in interest rates in the eurozone since the summer of 2022 has increased borrowing costs and is weighing on property valuations

– On the other hand, higher inflation is expected to boost rental revenues over time as rents are typically partly or fully indexed to the rate of inflation.

As a result, the amount of money you can now borrow from a lender has decreased (the maximum is circa 10 points less than a year ago), while returns have increased along with market interest rates (the coupon rate on the bonds is typically floating).

Vulnerable segments Interest rate rises have pushed up costs for property owners. Leveraged lenders may be vulnerable when asset price resets occur. Pessimists point to the lingering effects of the Covid-19 pandemic: consumers have not fully returned to shops and many workers are still working from home. These trends are undermining the value of shopping centres and offices, though more so in the US than in the eurozone. This is because the eurozone has not seen the property market excesses that will likely create problems in the US market in coming months. In the European CRE market, lower-grade office properties face both weakening demand and higher construction and maintenance costs. Potential buyers are retreating; lenders are imposing punitive lending rates; and occupiers are upgrading, leaving lower-grade properties and moving into buildings that meet the latest environmental standards.

WFH – less impact in the eurozone

The shift to working from home (WFH) during the pandemic triggered discussions about the impact on demand for office space and the damage it could do to the performance of office markets. News that financial firms are encouraging, or even requiring, staff to return full time to the office suggests the trend may have peaked, but we have not yet reached a new equilibrium. If working from home expands, it could significantly reduce demand for office space, resulting in higher vacancy rates, obsolescence and falling rents.

Anecdotal reports suggest offices in Europe have seen a much sharper post-Covid rebound in usage than in the US. The Wall Street Journal recently noted US office occupancy was at 40% to 60% of pre-Covid levels compared to 70% to 90% in Europe. Longer commutes, poorer public transport networks and larger suburban dwellings kept US commuters working from home. Tighter labour markets may also have led US firms to hire more remote workers in recent years.

While the commercial real estate market will undoubtedly face challenges in the years ahead, we believe the office sector remains a viable opportunity, particularly when considering the regional differences.

Risk of stranded assets due to ESG requirements

According to the World Green Building Council, buildings account for 39% of global energy- related CO_2 emissions. Around three-quarters of these emissions come from operating buildings, the rest from construction. New environmental regulations to address these issues have added significantly to the costs of upgrading a building from today's standards to 2030 requirements.

Owners of buildings outside city centres or in smaller towns may struggle to meet these obligations and these buildings may become stranded assets. This factor is already being integrated into the market's assessment of buildings and contributing to lower valuations.

While the requirement to upgrade or refurbish buildings to a higher standard is a challenge for property owners, it creates opportunities for those financing it.

SUSTAINABLE DEBT: CLEAN MONEY

With the energy transition needing debt to succeed, how are institutional investors ensuring that their capital is being used to create a sustainable future? *Mark Dunne* reports.

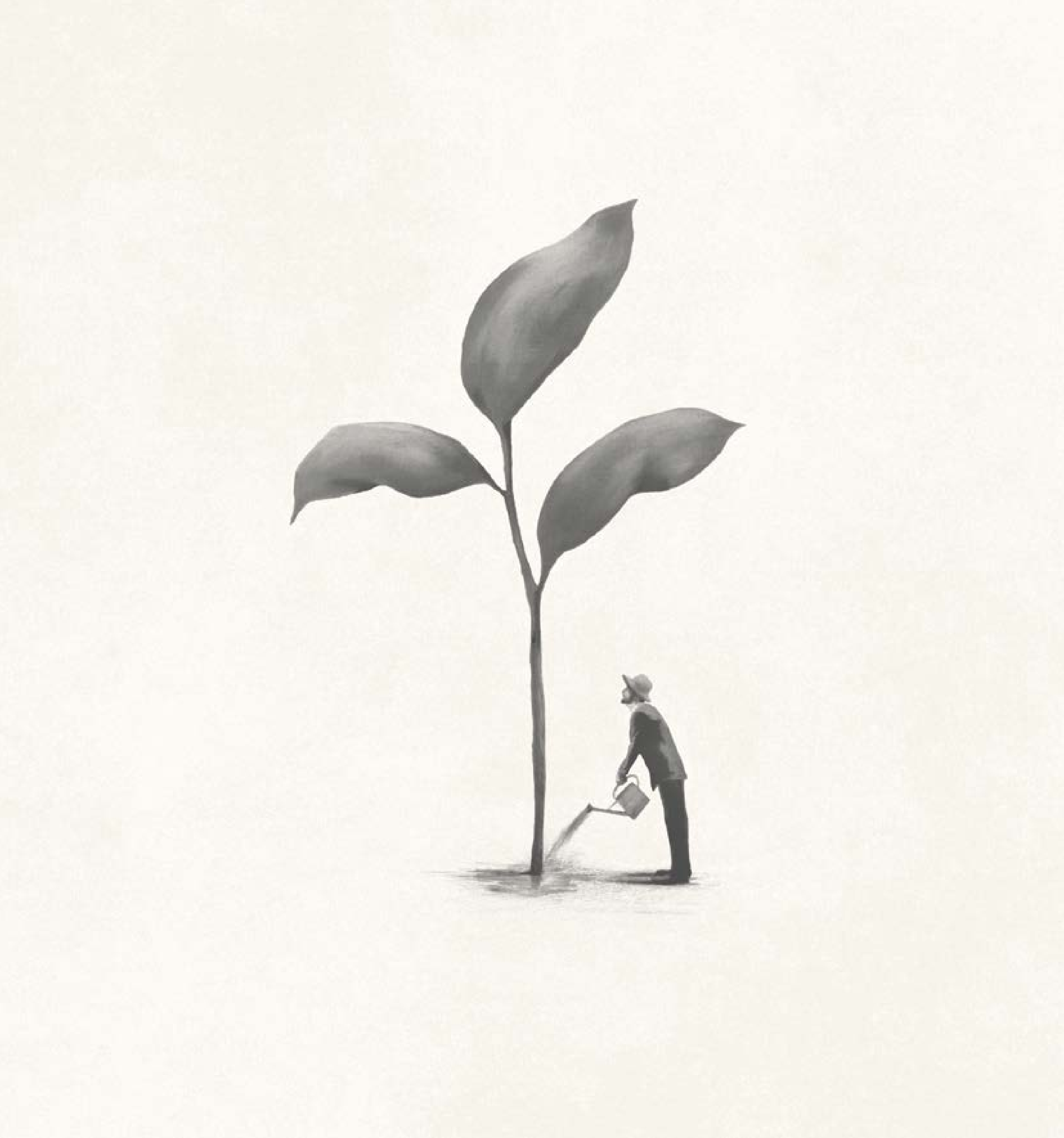
Debt makes the world go round. It has built civilisations, funded technological and medical breakthroughs and kept armies stocked with the armaments that have changed the course of history.

Indeed, today the world's debt pile stands at $307trn (£251trn), a figure which jumped by $10trn in the first half of this year.

Lending money to corporates and governments has for centuries been used to change the world. And it is needed once again, but this time to fund the most ambitious project we have ever faced – shifting the world off oil and gas and into cleaner alternatives, while trying to make the world fairer.

It's not an easy task. Especially, when you read headlines claiming that it is too hot for solar panels to work or there's not enough wind in the North Sea to drive the turbines.

"Fixed-income markets are critical to funding the transition, as most of the funding will come from the debt markets, both



sovereign and corporate," says Scott Freedman, a fixed income portfolio manager at Newton Investment Management.

"This provides a growing number of opportunities for bond investors to help further the drive to achieve positive environmental and social objectives, even in an environment of several ESG headwinds," he adds.

Historically, sustainability has been promoted in equity portfolios. However, this is changing as investors and their stakeholders believe that such a policy should stretch to all the assets they have exposure to. And different asset classes need different approaches.

"Although a lot of focus has been on the equity side, there are a number of tools on the debt side to do this. And those tools are becoming more sophisticated," says Jonathan Lawrence, senior responsible investment analyst, active fixed income at Legal & General Investment Management (LGIM).

These include promoting decarbonisation and temperature-alignment pathways, while exclusions form a big part of how asset managers approach climate risk on the debt side.

"The other big tool, which is less appreciated, is engagement," Lawrence says. "It's important that we are engaging with companies in our debt portfolios to understand if they have a meaningful climate transition strategy in place."

Not what it says on the tin

But debt which is labelled sustainable is not an end in itself. "We shouldn't just look at a portfolio of sustainable debt and believe it is robust from a climate transition perspective," Lawrence says.

"What it does is signpost that issuers are potentially moving in a certain direction, but we need to look at issuers in their entirety and not just their labelled debt," he adds.

A portfolio of labelled debt cannot achieve net zero, Freedman says. "Labelled bonds, while an important and growing part of sustainable finance, must be considered on a case-by-case basis given greenwashing risks," he adds. "They may not always provide credible and robust initiatives and targets."

Many labelled bonds make furthering environmental objectives part of their framework, but other targets exist too, such as healthcare provision. "There is much more that needs to be done in order to try and achieve net zero, and shorter-term targets will be an important part of that," Freedman says.

Yet just because a company has not issued any green bonds does not mean it isn't mobilising capital into green projects. "That would be more important to consider than a brown issuer who uses a green bond to fund a small amount of capex," Lawrence says.

In the conventional debt market, engagement sets the expectations for companies in terms of their strategy and making sure robust governance and accountability is in place. "That's more important than the label on the bond," Lawrence says.

Different shades of green

But could a portfolio of sustainably labelled debt make an investor appear to be greener than they actually are?

"That's definitely a risk," Lawrence says. "The tension in the market has always been around governance and whether or not the barriers to entry should be higher to issue sustainably labelled debt without hindering efforts to mobilise capital towards green activities.

"LGIM's position has always been to focus the analysis at the issuer, not just the instrument, to make sure the bond, and the portfolio, reflect a genuine move towards the transition and not just a chance for greenwashing," he adds.

Freedman says that it is "likely" sustainable labels make portfolios appear greener than they truly are, and warns: "You need to analyse issuers on a case-by-case basis," he adds. "We need to be careful about label chasing."

> **We need to be careful about label chasing.**
>
> Scott Freedman, Newton Investment Management

With a limited supply of green bonds, the main option for institutional investors is to make mainstream debt more sustainable. "Issuers, both sovereign and corporate, are under much greater scrutiny in terms of behaving as responsible citizens," Freedman says. "This raises the level of granularity around sustainability initiatives that a broad range of stakeholders, including bond investors, expect to see.

"This introduces a greater level of accountability, a type of trust or covenant in place between issuers and investors. In turn, this leads to greater bondholder engagement, ESG analysis, tracking of ESG performance and will increasingly impact issuers' cost of capital, especially for 'sin' sectors," he adds.

A test of quality

Transparency on non-financial factors by issuers varies, Freedman says. "As you would expect, there is a greater level of disclosure by listed companies and those in jurisdictions with stricter regulatory regimes.

"We also see pressure on asset managers to make disclosures that are not always being provided by underlying issuers in portfolios," he adds.

Transparency on ESG performance is improving thanks to a "huge wave" of regulation, Lawrence says. "But we still have an issue with the consistency of reporting and the end-use case for the investor.

"Again, I would tie that back into the case for engagement where we need to understand the nuance and context of the business model and how a company plans to become more sustainable.

"Disclosure is necessary, but being an end in itself is not sufficient," he adds.

An independent view

With the standard of disclosure needing to improve, it was disappointing to hear in August that S&P would no longer report

ESG scores alongside its credit ratings. Could this be a sign of how hard it remains to prove that investors cash is making a positive difference? "I don't think so," Lawrence says. "That probably represents more of a misunderstanding of what ESG ratings are there to do.

"In the case of S&P, they are a credit rating agency and their decision to remove the ratings reflects their ability to translate ESG data into a material credit rating impact.

"What they have done is kept their qualitative analysis in terms of explaining where ESG risks could potentially impact the rating."

The bigger challenge is people's understanding of what ESG ratings are, how they're constructed and how to use them. For Lawrence, ESG ratings are a subjective analysis of how companies are managing sustainability risks and opportunities. "But where these ratings become hardwired into portfolios, then we need to take care with how the rating has been constructed, what is the methodology."

While such data can be useful, perhaps this is a positive move, in that the lack of consensus among providers could be confusing. Freedman says that such divergence among ESG rating providers mean that you cannot take such ratings seriously. "It is just part of the mosaic of information.

"We do not rely on data providers' methodology but on raw data, and then draw our own conclusions," he adds.

"The unfortunate thing about a conventional credit rating agency no longer reporting ESG scores alongside its debt ratings is the message this gives to issuers," Freedman says.

"Having that data published increases the level of scrutiny and accountability on issuers – and having a more explicit link between ESG factors and a conventional-credit rating does impact market pricing, thereby encouraging issuers to strive to be an ESG leader if it results in a possible lower cost of capital."

Disclosure is necessary, but being an end in itself is not sufficient.

Jonathan Lawrence, Legal & General Investment Management

Different worlds

For investors with sustainable goals, their debt portfolios must reflect them, matter who they are lending to. This includes corporates or sovereigns, which have similarities but offer investors different exposures.

First of all, the number of sovereigns is fixed, unlike in the corporate world, which is constantly changing. "We have a lot more information about the world's sovereigns and there's lots of ESG data that has existed for a long time. In a sense, measuring ESG risk for sovereigns is easier than for corporates," Lawrence says.

"Where it gets trickier for investors is on the engagement side. As a significant holder of sovereign debt, we are an important stakeholder to governments. We can therefore use this leverage to influence policymakers to address ESG risks and opportunities. However, there are challenges which can limit our influence, including structural features of the sovereign debt market."

And investors need to have influence over governments if they are using their money. "There are challenges and barriers that we need to overcome in the sovereign market with respect to what sovereigns are doing on the ESG side," Lawrence says.

Behind the rate

Have rising interest rates had an impact on the sustainable terms of debt? "Not really. Issuance looks quite robust," Lawrence says.

In September, labelled debt on the active side of LGIM's investment universe was about 8% of the index. In 2020, it was around 2% to 3%. "When issuers come to market, we are seeing a lot of momentum behind the labels. So, the macro conditions could play through in terms of issuance trends in general," Lawrence says. "But we are seeing a lot of appetite to use the labels on bonds, and increasingly, a greater breadth of issuers are coming to market with this form of debt."

However, Freedman says the volatility in the bond market resulting from the fast pace of rate hikes by central banks has led to a slower pace of sustainable and broader bond issuance. "As we have seen lately, there is a gradual realisation amongst companies and governments that decarbonisation ambitions are important but not at any cost," Freedman says. "We are seeing timeframes therefore extend and policy-backtrack from governments. The cost of achieving the transition has been increasing not only due to higher funding costs from higher rates, but also from persistently higher inflation. Within this is more acceptance of the need for climate adaptation as well as mitigation."

When it comes to lending your capital to corporates or governments, the important point is that it is not about where they are today, but where the capital they receive will take them.

Duncan Batty and Dan Riches are directors of real estate finance at M&G Investments.

ESG IN REAL ESTATE DEBT: FUNDING THE TRANSITION TO NET ZERO?

Recent turmoil in the banking sector has further highlighted the role real estate lenders can play by stepping in to provide capital for borrowers as banks retreat, while potentially delivering a stable, long-term source of income. With many lenders now gravitating towards high quality assets with strong ESG credentials, we consider what role real estate debt can play in funding the transition to net zero.

The built environment is responsible for around a third of global emissions, the majority of which stem from building operations[1]. As momentum behind sustainability in real estate continues to gain pace, lenders can play a key role in how the sector evolves as it strives to meet net zero goals.

In the EU, where almost 75% of building stock is energy inefficient, real estate is the single largest energy consumer, with heating, cooling and domestic hot water accounting for 80% of the energy consumed by citizens[2]. The European Parliament adopted measures earlier this year to reduce real estate energy consumption and greenhouse gas emissions, while increasing the rate of renovations to improve existing standards[3]. Currently only 1% of existing buildings in Europe are renovated each year. New developments will have to be carbon neutral from 2028 onwards.

> **Substantial renovations are necessary across geographies to improve existing real estate stock and reduce energy loss.**

In the UK, real estate accounts for 40% of total energy use and around a third of emissions[4]. The government has laid down ambitious plans designed to spur a 'green revolution' in real estate, requiring all homes and businesses to meet rigorous targets in order to lower energy consumption. Indeed, policies are already obliging developers, landlords and occupiers to focus on the environmental performance of buildings.

Addressing energy efficiency in real estate

Regulations setting out Minimum Energy Efficiency Standards (MEES) are making it increasingly unlawful to rent properties that do not meet the Minimum Energy Performance Certificate (EPC) requirements, bar some exemptions, with landlords facing serious sanctions for non-compliance. This means lenders will also have to navigate the changing regulatory landscape and consider ESG criteria when deploying capital.

Currently, non-domestic buildings in England and Wales need an EPC rating of E or higher to be viable for lease. From April 2030, rented properties will be required to have at least a B rating. This poses a significant challenge for the real estate sector given that the vast majority of existing commercial stock in England and Wales – around 64% – falls below the B threshold for energy performance[5]. In real terms, over half a million individual assets need to be compliant with MEES within the next seven years[6].

In Europe, a set of standards and accompanying technical reports have been established to support the energy performance of buildings standards, with the European Commission aiming to reach the target of at least a 60% reduction in emissions in the building sector by 2030 compared to 2015, and achieve climate neutrality by 2050.

Although there is little guidance on the level of capital required to decarbonise non-domestic assets, it will be a costly endeavour. Substantial renovations are necessary across geographies to improve existing real estate stock and reduce energy loss, while new developments would have to consider smart solutions and energy efficient materials to ensure buildings are compliant with net zero goals and regulation.

Funding the transition

Real estate debt investors could be crucial in helping fund the transition to net zero in real estate due to the levels of investment called for, but it is essential for lenders to have a solid understanding of how energy is used in buildings and what measures can be taken to reduce emissions and energy consumption in line with science-based targets. There are challenges, particularly where there is a lack of consistent data and reporting among borrowers, as well as a disconnect between some sustainability metrics and a lack of definition regarding what net zero actually means across the industry.

To play a role in the transition to net zero, lenders may want to consider improving the environmental performance of real assets over time, while also excluding investments which are considered harmful to the environment or society, such as assets which are involved in the extraction and storage of fossil fuels.

For sustainability-conscious lenders, opportunity may be found in new green buildings with strong ESG credentials, amenities and accessibility, but there is also a significant opportunity to fund the transition by improving the environmental performance of existing buildings, rather than just knocking down and developing new ESG buildings.

When financing or refinancing new or existing commercial and residential buildings lenders would need to ascertain certain criteria are met. We believe EPC and green building certification are the most readily available and consistent metrics for measuring environmental performance. These can be assessed from day one and over the term of the investment to show measurable improvement while also holding borrowers accountable.

Although lenders may consider excluding inefficient real estate assets as defined by the Sustainable Finance Disclosure Regulation – such as those with an EPC of C or below if built before 2021 – where proceeds of the loan are used to improve energy efficiency and the asset is expected to meet the relevant criteria upon completion of the renovations funded by the loan, then these assets will no longer be deemed inefficient. Once the relevant works are complete, they may even qualify as "green buildings" should they meet specific eligibility criteria.

When funding existing buildings that do not meet energy requirements, lenders can hold borrowers accountable by ensuring loan documentation includes specific clauses on energy performance obligations. This will typically require the borrower to improve overall energy efficiency and/or aggregate green building certification as well as meet specific thresholds such as EPC B or above, LEED Gold or above or BREEAM "excellent or above".

Working together

It is important for the industry to work together with key stakeholders in order to decarbonise the built environment. In our view, EPCs and green building certificates are an important step to improving the transparency of ESG data being shared with the investment community. Using this data, we believe it is possible to improve the energy performance of real estate through a combination of green and sustainability-linked loans (as defined by a third party consultant), occupier and tenant exclusions and key sustainability indicators, designed to measure improvement in a building's green credentials.

As the case for decarbonisation in real estate grows, ESG-focused assets are becoming increasingly desirable. For lenders, this is a potential opportunity to improve environmental credentials whilst also enhancing investment performance.

1) IEA, "Buildings – Tracking report", (iea.org), September 2022.
2) European Commission, "Energy performance of buildings directive", (energy.ec.europa.eu), December 2021.
3) European Parliament, "Energy performance of buildings: climate neutrality by 2050", (europarl.europa.eu), 9 February 2023.
4) UK Government, "Rigorous new targets for green building revolution", (gov.uk), 19 January 2021.
5) UK Government, "Energy Performance of Buildings Certificates Statistical Release: January to March 2023 England and Wales", (gov.uk), 27 April 2023.
6) Gerald Eve, "Energy Performance in Non-Domestic Buildings", (geraldeve.com), July 2021.

M&G Investments


LGIM
Inaction is NOT an option
LGIM is committed to creating a better future through responsible investing
LGIM
Find out how:
lgim.com/responsible-investing
Proud partner of Lewis Pugh, UN Patron of the Oceans
For investment professionals only. Capital at risk.
Issued by Legal & General Investment Management Limited. Registered in England and Wales No. 02091894.
Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority.