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Sustainable Finance Disclosure Regulation (SFDR) in the Real Estate Industry

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Discover the key steps and challenges for real estate asset managers to comply with the SFDR by March 10, 2021.

With buildings being responsible for approximately 40% of energy consumption and 36% of CO_2 emissions in the EU[1], the relevance of SFDR to the real estate sector is indisputable.

Regulators, investors, stakeholders and the public in general are increasingly holding businesses accountable for sustainable practices. The growing relevance of sustainability issues is also driven by recent legislative developments which reflect the urgency to mitigate environmental risks related to climate change.

The scope of the regulatory framework

The publication of the EU Action Plan on Sustainable Finance in March 2018 has significantly raised awareness on sustainability issues in the real estate industry. As part of the EU Action Plan on Sustainable Finance, two key EU regulations were published with the aim to provide transparency and harmonization to sustainability within financial markets:

1. The EU Sustainable Finance Disclosure Regulation (SFDR) – also known as the Disclosure Regulation – requires the disclosure of sustainability-related data and policies at entity and product level.

Certain real estate asset managers and other investment products and/ or product manufacturers of real estate investments are included in the scope of this regulation.

The SFDR applies to certain financial products and extends to their product manufacturers and their financial advisers who are located in the EU:

- Alternative investment funds (AIFs) and UCITs
- Portfolios managed by credit institutions or investment firms
- Managers of a qualifying venture capital fund
- Insurance-based investment products (IBIPs)
- Pension products, workplace pensions products regulated under the IORP directive and PEPPs

Questions have been raised to the European Commission (EC) by the European Supervisory Authorities (ESAs) as a result of consultation process with major stakeholders regarding the applicability of the SFDR to non-EU AIFMs and registered (also referred to as sub-threshold) AIFMs. These questions are still unanswered as of the date of this article. It is, however, the market's view that sub-threshold AIFMs are excluded from the scope of SFDR and that non-EU AIFMs that market AIFs in the EU must comply with product-level disclosure requirements.

The SFDR consists of the following measures:

- Regulation (EU) 2019/2088 (SFDR) (also referred to as "Level 1")– sets out the framework principles to establish harmonized transparency rules on sustainability risks and adverse impact on sustainability factors. These principles are applicable from March 10, 2021.
- The newly published Regulatory Technical Standards (RTS) (also referred to as "Level 2") – supplement level 1 with greater details, clarifications and structure. The RTS specify the content, methodologies and presentation of information in relation to sustainability indicators and the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, websites and periodic reports. The RTS will come into force from January 1, 2022 (see previous regulatory news).

This means that, until the more detailed RTS will apply on January 1, 2022, the SFDR compliance will be more qualitative and "principle-based", leaving managers some time to adapt and build up their sustainability strategy for the more stringent requirements coming in 2022.

2. The Taxonomy Regulation 2020/852 has already entered into force, with most of the requirements being applicable starting from January 1, 2022, and requires that economic activities considered environmentally sustainable are to be defined and classified so that the degree of environmental sustainability of an investment can be determined. This Taxonomy thus provides investors with guidance on which activities are environmentally sustainable and which are not. It is aimed at preventing "greenwashing" and ensures a systematic and comparable approach to environmentally sustainable investments.

[1] European Commission: New rules for greener and smarter buildings will increase quality of life for all Europeans, April 2019.

The SFDR disclosure requirements by March 10, 2021 in a nutshell

The respective disclosures that should be made on the website of the entities in scope and the pre-contractual documentation of the products they manage can be summarized as follows:

Website disclosures: Corporate level (Articles 3–5)

- Describe how sustainability risks are integrated into the investment decision-making process and remuneration policies.
- Either:
  - publish a statement on the due-diligence policy relating to the "principal adverse impacts" (PAIs) – deleterious effects of investment decisions on environmental and social criteria,
  - or publish clear information on why it is not doing so. (Referred to as the "comply or explain" approach)

However, from June 30, 2021, firms with more than 500 employees will not have a "comply or explain" option anymore and must disclose their PAIs on sustainability factors and summary of engagement policies on their websites. Of the 18 mandatory principal adverse sustainability impact indicators, two are specific to real estate.

Pre-contractual and website disclosures: Fund level (Articles 6–11)

- Describe how sustainability risks are integrated into the investment decision-making of the product funds.
- Either:
  - articulate the impact of these risks on the return of all of their products, including those funds that do not promote any sustainability factor,
  - or explain why the sustainability risks are not relevant to the fund.
- For products that promote environmental and/or social characteristics ("Art. 8 products") and those which have sustainable investment as their objective ("Art. 9 products"), disclose how these characteristics or objectives are met and provide information on any index designated as a reference benchmark.

Further disclosures are required in the annual report and website from January 1, 2022 relating to the extent to which the environmental and/or social characteristics of the fund are met (for Art. 8 products), information on the overall sustainability impact of the fund (for Art. 9 products) and environmental objectives and other supplemental disclosures under the Taxonomy Regulation.

From December 2022, managers must also disclose in the fund prospectus whether and, if so, how, they consider principal adverse impacts for each of their funds. If the managers do not do so, they must explain for each fund the reasons why they do not consider principal adverse impacts to apply.

SFDR opportunities and challenges in the real estate industry

These regulations create both opportunities and challenges for real estate asset managers: Opportunities for product differentiation, not only in relation to the environmental aspect but also with respect to the social impact of real estate projects on people, particularly low-income and vulnerable populations in need of support and stability; and challenges, when it comes to real estate asset data gathering to meet these disclosure requirements and in identifying the necessary resources and expertise for effective integration of sustainability risks in their due diligence policies and processes.

Along with the real estate asset managers there is an ecosystem of investors, financiers, partners such as property and facility managers, as well as external providers of real estate products such as project developers and suppliers of building materials that constitute the real estate value chain. Although the SFDR directly impacts the real estate asset managers, reporting and transparency in relation to sustainability must be achieved along the entire length of the value chain.

The impact of sustainability risks is determined not only by operating real estate properties, but also by the investment strategies and fund management activities. Fund and asset managers must interact closely with the operating participants of the value chain in order to face the challenges of data gathering and sustainability impact measurement and meet the new disclosure requirements. The SFDR creates expectation from every player in the real estate value chain to support the funds' product differentiation and sustainability strategies in their own policies and operating practices.

As noted earlier, two of the 18 principal adverse sustainability impact indicators to measure the PAIs are specific to real estate. One indicator is the exposure to fossil fuels through real estate assets, measured as the share of investments in real estate assets involved in the extraction, storage, transport, or manufacture of fossil fuels. The second indicator measures the exposure to energy-inefficient real estate assets. Real estate asset managers will have to look for the appropriate resources and expertise to be able to measure these indicators and comply with the regulation. The lack of consistent and comparable data across countries for benchmarking building performance and setting suitable thresholds for the top performing buildings represent a challenge for the required measurements.

Disclosing the due-diligence policies relating to PAIs will be mandatory for firms with more than 500 employees starting from June 30, 2021. Another challenge resides in the interpretation of this aspect of the regulation and what criteria will have to be used to determine whether a real estate asset manager falls within the 500 employees threshold.

As highlighted in a survey conducted by Deloitte at the end of 2020, in the coming months, real estate asset managers will have to redefine their internal processes and governance to effectively transform mere compliance to regulation into strategic management. Examples of the transformations include the fact that they will have to strategically choose their product categorization with respect to sustainability by drawing a "SFDR roadmap" in both the short and the long term. The SFDR roadmap and monitoring of the product categorization will become part of the new operating model of real estate asset managers.

They will also need to identify the data stream they will use and determine the appropriate scoping, analysis and reporting. The data gathering process for financial data is already a challenge considering the diversification of the real estate asset locations and numerous data sources inherent to the data flow – and an efficient data gathering process will surely remain a challenge for non-financial data as well.

It is therefore essential that real estate asset managers react quickly to face the challenges raised by the SFDR.

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