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SUSTAINABLE LENDING IN REAL ESTATE FINANCE

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Legal Briefings

With green loans and sustainability-linked lending going mainstream, we assess the prospects for real estate finance.

Sustainability is now firmly at the top of the agenda, but the term has an enormously wide scope. Mirroring the approach of the bond market, two categories of sustainable loan are developing:

- sustainability-linked loans, where key performance indicators are used to set sustainability performance targets (SPTs) and there is an incremental pricing benefit for meeting those SPTs; and
- green loans, to finance green improvements or developments or to finance a green asset.

In this briefing we look at their use in the real estate finance market.

IMPETUS FOR CHANGE

The drive to create a green economy has accelerated, powered by a confluence of environmental and societal forces. ESG is now a core strategic focus of many businesses, and of their investors and lenders. There is a pressure and a desire to do something meaningful. The green and sustainable bond markets are relatively well developed compared with the equivalent loan markets, however. Further, central banks and financial institutions are recognising that the risks from climate change, and also from lack of biodiversity and nature-based risks more widely, are financial risks like any other, and this is likely to affect credit decisions.

The real estate sector will be absolutely key in the move to net zero and in real estate finance this means there will be a need to finance (and re-finance) green buildings and also to fund the development and improvement of existing buildings. However, the relatively nascent sustainable lending market means that there is a lack of consistency in the terms and the language used to describe the products, and also a variation in lenders' eligibility criteria for the products that they offer.

The built environment accounts for 30- 40% of carbon emissions in Europe

THE SCAFFOLDING

Around 80% of the buildings which will be standing in 2050 already exist

The term sustainable lending encompasses both sustainability-linked loans and green loans. The loan market trade bodies globally have developed high-level market standards for each of these; for more detail on this please see **BOX 1**. These are not legally binding but are intended to provide some consistency across the market.

Inter-linked is the developing legislation and regulation, which can be used to answer the two key questions in sustainable lending:

1. Is it "green": How do you determine, in an objective way, whether the asset or development being financed is environmentally sustainable?

2. What if it isn't? How do you ensure that there is some accountability for borrowers and financial institutions, and counter sustainability-or green-washing?

The EU Taxonomy Regulation sets out how a decision is made as to which economic activities are environmentally sustainable. It is intended to be a tool to assess whether a financial product or business is environmentally sustainable, and to enable comparison of the "greenness" of different activities. See **BOX 2** for more details. The UK is working on a similar taxonomy as part of its wide-ranging Green Finance Strategy: the Green Technical Advisory Group, chaired by the Green Finance Institute, will make the recommendations. It is expected to be broadly similar to the EU Taxonomy but there may be some differences in approach (for example a principles-based approach, rather than a prescriptive one, would have the potential to be more flexible).

Both the UK and the EU have already expressed an intention to impose ESG reporting requirements under their respective sustainable finance strategies. In the EU so far this focusses on the financial sector, but the UK has gone further by publishing a roadmap to mandatory Taskforce on Climate-Related Financial Disclosures (TCFD)-aligned disclosures across financial and non-financial sectors. This is coupled with increasing investor demand for enhanced disclosure of sustainability-related information.

BOX 1: SUSTAINABILITY-LINKED LOANS

Sustainability-linked loans have a small incremental pricing benefit to the borrower for meeting certain sustainability targets in its business. The Sustainability-Linked Loans Principles (SLLPs) developed by the Loan Market Association, the Asia Pacific Loan Market Association and the US Loan Syndication and Trading Association broadly fall into two categories:

- the requirement for the borrower and its lenders to identify sustainability key performance indicators (KPIs) which are "material to the borrower's core sustainability and business strategy, and address relevant environmental, social and/or governance (ESG) challenges of the industry sector", and from those, set and calibrate ambitious and meaningful sustainability performance targets (SPTs); and

- the need for transparency in determining whether those SPTs have been met, through both the borrower's reporting obligations and an external review or audit to verify the borrower's performance against the SPTs.

Green loans

Green loans are usually taken as those intended to fund green projects, or to finance green assets.

In the Green Loan Principles (GLPs), also published by the LMA, the APLMA and the LSTA, the use and management of proceeds is key. Green and non-green tranches can be mixed, in which case the proceeds of the two tranches will need to be treated differently.

The selection and on-going evaluation of the relevant asset or project as "green" is key to categorisation as a green loan under the GLPs, and where many lenders' eligibility criteria are likely to focus. The funded asset or project may also sit in a wider, corporate sustainability strategy, which again may be subject to eligibility analysis by lenders. The GLPs suggest that green projects should have a clear environmental benefit, where the loans will address key areas of environmental concern such as climate change, natural resources depletion, loss of biodiversity, and air, water and soil pollution. They further suggest that green loans should focus on the environmental: social and governance benefits may also be involved, but there needs to be an environmental impact. Specifically, the GLPs mention as indicative categories of eligibility energy efficiency such as in new and refurbished buildings, energy storage, district heating, smart grids, appliances and products and green buildings meeting certain regional, national or internationally recognised standards or certifications.

There are also reporting requirements, with external review or verification, set out in the GLPs.

The LMA, APLMA and LSTA have developed separate guidance for the application of the GLPs to real estate finance, both in financing green buildings or funding retrofit projects.

BOX 2: EU TAXONOMY REGULATION

This came into force in July 2020. It sets out how a decision is made as to which economic activities are environmentally sustainable. The activity will be assessed as to whether it substantially contributes to at least one of six environmental objectives, being:

- climate change mitigation;
- climate change adaptation;
- protection of water and marine resources;
- transition to a circular economy;
- protection and restoration of biodiversity and ecosystems; and
- pollution prevention and control.

Further, that activity must do no significant harm to any of the other five environmental objectives mentioned, and must comply with minimum safeguards, for example the UN Guiding Principles on Business and Human Rights in order to qualify as environmentally sustainable.

Determining these points is a very technical exercise, and performance standards, or technical screening criteria, will set out the detailed criteria to determine if an activity is really sustainable, and therefore "taxonomy-aligned".

The focus in the EU so far has been on climate change: further developments focussing on environmental sustainability outside climate change and on social objectives are expected to follow, which will raise similar issues.

SUSTAINABLE LENDING IN REAL ESTATE

- Sustainability-linked loans have the advantage of flexibility because of the wide scope of the SPTs, the targets which must be met for the margin to decrease.
    - The SPTs can be set by reference to sustainability goals which relate to the borrower's business as a whole, aligning with its own ESG strategy; this is often the approach in corporate facilities. Typically 3 or 4 SPTs will be set, for example relating to improving the energy efficiency of an aspect of the business, using more renewable energy or reducing emissions of greenhouse gases.
    - Increasingly in real estate finance, the SPTs are more narrowly defined and linked to a particular asset or development being financed. For example, the margin decrease in a development financing could be contingent on certification as a Net Zero Carbon development in accordance with the UK Green Building Council framework at various stages.
    - A sustainability coordinator, or sustainability structuring agent, may be appointed from the lender group to assist in the process of setting the SPTs. In some cases, further external input may be needed to confirm that the KPIs and SPTs are appropriate.
- While there have been relatively few green loans to date, there is scope for these to be used more widely in real estate finance since tight controls over use of proceeds and

rigorous reporting are already features of the market. For example, a loan could be made to finance or refinance a green building, or to fund capital expenditure for improving energy performance or water consumption in a building or portfolio.

- The sophisticated standards of measurement in use in the real estate sector can help in demonstrating satisfaction with lenders' eligibility criteria, whether in setting SPTs in sustainability-linked loans, demonstrating that an asset or development is green, or reporting on compliance with sustainability or green-requirements. See **BOX 3** for more details.

BOX 3: REAL ESTATE ACTIVITIES

Perhaps surprisingly there was significant controversy in determining the technical criteria by which a building will be judged as environmentally sustainable for the purposes of the EU Taxonomy (initially only those with an Energy Performance Certificate (EPC) Rating of A would have qualified, though this has since been changed to buildings whose primary energy demand is within the top 15% of the national or regional building stock, following consultation with the market).

As well as EPC ratings, there are other commonly used standards which include BREAM and LEED, though these measure only theoretical performance based on design intent.

Perhaps most interesting in the UK is the NABERS Design for Performance, which is a new model, recently used on 1 Broadgate in the City. This provides a framework by which a developer can verify the performance of the building in-use over its life cycle, which will be vital for such long-lived assets and for longer term loans which require green projects to be certified as such over a period of time.

Green leases may also form part of the eligibility criteria for green loans. A green lease has additional clauses which provide for the management of, and improvement of, the environmental performance of a building by both owner and occupier(s). It is legally binding, and its provisions remain in place for the duration of the term of the lease. There is scope for green leases to be made much more robust than they currently are, and thereby allocate responsibility for in-use energy performance between landlords and tenants.

CHALLENGES

- Lack of consistency across the market in terminology, in products and in eligibility criteria. There is no universal standard of what a green building is, for example, or what retrofit projects should qualify as a green project for the purposes of designating a green

loan.

- Lack of a standard methodology for reporting: there is, so far, no accepted methodology for reporting on SPTs, in particular. Lenders will almost always require a level of verification, audit or third party review of the borrower's reports, which will add to the cost and time burden on the borrower of servicing the loan. In the real estate finance market, lenders usually want to have at least a contractual right to require external review, but the market has not yet agreed on who will fund this. It is possible that if borrowers see tangible pricing benefits from their loans being sustainable, they will be happier to bear this cost.

- The over-arching concern of lenders and also of regulators and investors, is avoiding green- or sustainability-washing in making sustainable loans. Individual lenders have their own eligibility criteria, and a fear of reputational damage may mean that these are more stringent than the Green Loan Principles or Sustainability-Linked Loan Principles (see Box 1) in some respects. This will affect the setting of SPTs, the eligibility criteria for green assets and developments, analysis of the overall impact of the financing, and also the reporting requirements.

CONSEQUENCES OF FAILURE TO MEET SPTS OR TO BE GREEN

- In sustainability-linked loans, if the SPTs are not met, the margin may increase. One question is whether it will increase above the original level as a further incentive. If so, it is possible that the additional cost of servicing the facility could be diverted into improving the borrower's ESG performance, for example, since many lenders may not think it appropriate to benefit from a borrower's failure to meet its sustainability targets.

- It would be very unusual for the failure to meet an SPT to constitute a default in a sustainability-linked loan, although the provision of inaccurate information or a breach of a general reporting obligation may be a standard breach of covenant leading to an event of default.

- What will constitute a "green breach" under a green loan may also vary from loan to loan: the key message in the Green Loan Principles is that any breach of the use of proceeds provisions should be taken seriously and the loan should not be considered green from the date of occurrence of such event. What that actually means in practice is less clear.

- It is possible that a failure to apply the proceeds of a green loan towards a green project or asset could be deemed sufficiently serious to constitute an event of default however, in contrast with the consequences of failure to meet SPTs in a sustainability-linked loan.

- Alternatively, if a green asset fails to meet the relevant criteria in a periodic assessment, the lenders could require that the relevant loan is no longer referred to as "green" in any publicity materials issued by the borrower, and it is removed from any relevant lists which refer to it as such.

THE FUTURE

Given the intense focus of investors, society, governments and regulators on sustainability, the direction of travel in this area seems clear. There may be further developments in greening the financial services sector, for example differentiating the capital treatment of green and sustainable loans, which would provide an added incentive for lenders. The development of the UK taxonomy, and the technical standards associated with the EU taxonomy will help a market position on eligibility criteria develop, and hopefully market practice around reporting standards and requirements will also coalesce.

Please do speak to one of our team to discuss this in more detail, and to see how sustainability-linked loans, green loans or other ESG requirements, may be relevant for your business. We have also issued a podcast on this topic, which is available here.

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If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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