Review of recent ESG-related regulatory and policy initiatives

Snapshot Public Affairs

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Pursuant to the European Commission's Capital Markets Union and Sustainable Finance programme, several regulatory and policy initiatives were developed in recent months that impact non-listed real estate investing. These initiatives focus on setting standards related to investments labelled as "green" and adopting requirements related to the accurate assessment and disclosure of climate change risk and sustainability measures to investors. A brief description and status update of the most important recent initiatives follows.

Commission draft delegated act on the introduction of ESG considerations into AIFMD

On 8 June 2020, the European Commission published the draft delegated act incorporating sustainability issues and considerations into EU financial services, including AIFMD, based on technical advice submitted by ESMA in 2019. The draft delegated act is open for stakeholders' feedback until 6 July 2020.

The draft delegated act is important for the industry because, if endorsed by the Parliament and the Council, AIFMs will be required to consider sustainability risks when complying with AIFMD organisational requirements and retain the necessary resources and expertise for the effective integration of sustainability risks.

Proposed requirements:

- including definitions of 'sustainability preferences', 'sustainability risks' and 'sustainability factors' into AIFMD level 2 measures, as well as the concept of 'material adverse impact' on the value of investments;
- due diligence requirements would also need to include consideration of sustainability risks;
- AIFMs will need to consider sustainability risks when complying with the organisational requirements and retain the necessary resources and expertise for their effective integration.
- senior management of the management company or AIFM will be responsible for the integration of sustainability risks, and conflicts of interest will need to include those that may arise as a result of sustainability risks; and
- risk management policy will need include procedures to enable the AIFM to assess the exposure of each AIF it manages to, inter alia, sustainability risk and managers must assess this risk.

Disclosure Regulation

The Disclosure Regulation was adopted in April 2019 to address a perceived lack of transparency on how institutional investors, asset managers and financial advisors consider sustainability risks in their investment decision-making or advisory processes.

The regulation aims to enable financial intermediaries to use a coherent disclosure framework on the integration of ESG risks, which will facilitate investments in sustainable projects and assets across the EU.

The regulation includes entity and product-level disclosures, with the entity-level requirements coming into force from 10 March 2021 and product-level requirements coming into force from 30 December 2022.

On 23 April 2020, the joint committee of the three European Supervisory Authorities (EBA, EIOPA and ESMA together, the 'ESAs') have issued a consultation paper seeking input on proposed ESG disclosure standards for financial market participants, advisers and products with deadline for responses on 1 September 2020. The consultation paper includes draft Regulatory Technical Standards (RTS). Following the close of the consultation, the draft RTS will be finalised and submitted to the European Commission.

Taxonomy Regulation

The Taxonomy Regulation was adopted on 18 June 2020 to establish a framework to facilitate sustainable investment to pursue the EU's environmental neutrality objective by 2050.

The Regulation is designed to identify economic activities that are considered environmentally sustainable to enable investors to focus their investments on sustainable technologies and businesses based on six EU environmental objectives:

1. climate change mitigation;
2. climate change adaptation;
3. sustainable use and protection of water and marine resources;
4. transition to a circular economy;
5. pollution prevention and control;
6. protection and restauration of biodiversity and ecosystems.

Most relevant for real estate investment, the criteria for construction of new buildings is focused on the near-zero energy building concept using a transitional approach so that thresholds for assets that are not necessarily low carbon today will be tightened until they reach zero emissions.

The Taxonomy Regulation also adds new reporting requirements for Large Public Interest Entities, which includes some asset managers. They will need to provide information on how, and to what extent their activities support environmentally sustainable economic activities referenced in the Taxonomy.

EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks Regulation

On 9 December 2019, the [EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks Regulation] (known also as Low Carbon Benchmarks and positive carbon impact benchmark Regulation), amending the existing Benchmarks Regulation, was published to address a perceived lack of EU harmonised rules for low-carbon benchmarks and transparency, which lead to confusion among investors when measuring the performance of low-carbon funds and products.

This regulation will require consistent ESG considerations in the decision-making process of investors and asset managers, which should facilitate investments in sustainable projects and assets across the EU.

The Regulation includes minimum standards for:

- EU Climate Transition Benchmarks', where the underlying assets of a benchmark are selected, weighted or excluded in such a manner that the resulting benchmark portfolio is on a decarbonisation trajectory;
- EU Paris-aligned Benchmarks', where the underlying assets of a benchmark are selected in such a manner that the resulting benchmark portfolio's carbon emissions are aligned with the long-term global warming target of the Paris Climate Agreement (2% temperature reduction); and
- new transparency obligations, requiring administrators of benchmarks or families of benchmarks that pursue or take into account ESG objectives to provide an explanation of how the ESG factors are represented by the methodology used to structure the benchmark.

By 31 December 2021, all benchmarks or families of benchmarks should include an explanation of how their methodology aligns with the target of carbon emission reductions or attains the long-term global warming target of the Paris Climate Agreement. A benchmark administrator providing an EU Climate Transition or an EU Paris-aligned Benchmark must also comply with the requirements set out in the regulation by 30 April 2020.

Summary

All the above mentioned ESG-related regulatory and policy initiatives reflect a clear policy goal of encouraging the transition to a low-carbon, more resource-efficient and sustainable economy.

Investors have become more environmentally conscious and are taking a far more holistic approach to their investments, while asset managers have a clear duty to report and integrate ESG factors into their management decisions.