Snapshot Professional Standards

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

> SFDR is not a good fit for real estate investments, even though buildings account for 39% of carbon emissions
> SFDR creates the impression that funds disclosing under article 9 are better than funds disclosing under article 8, which are better than Article 6
> Funds transitioning unsustainable real estate to sustainable must disclose under article 8 or 6, which disincentivises investment into urgently needed carbon reduction of buildings

Incentives for real estate transition critically needed

Real estate accounts for 3% of total financial capital, but buildings account for 39% of total carbon emissions and 36% of energy use. As a result, regulation supporting a net zero built environment has the potential to greatly accelerate decarbonisation, not only for real estate investment, but for the economy and society as a whole.

The Sustainable Finance Disclosure Regulation (SFDR) is one of the most significant parts of the EU Action Plan on Sustainable Finance. Adopted in November 2019, it aims to address a perceived lack of transparency and effectiveness on how institutional investors, investment managers and financial advisors consider sustainability in their investment strategies.Through the introduction of common reporting and disclosure standards, its main objective is to promote transparency on environmental and social aspects, and broader sustainability issues across the financial markets.

INREV's recently released Falling through the cracks paper evaluates the impacts SFDR has on real estate investment. It is based on interviews with representatives of institutional investors and managers from organisations that have demonstrated a long-term commitment to environmental, social and governance (ESG) and sustainability in both the core values of their organisations and their daily business in the non-listed real estate investment industry.

SFDR seen as a good initiative, but flawed

SFDR is not a good fit for real estate. It is designed for financial products invested in liquid assets, not in portfolios of real assets that need to be transitioned from unsustainable to sustainable. This is ironic, given that real estate accounts for 39% of total carbon emissions and its transition is therefore critical to helping meet net zero carbon goals and achieving Paris Agreement goals.

Categories tilt investment to funds disclosing under Article 9

SFDR's disclosure categories are not intended to act as labels, however they have been misinterpreted as such. Disclosures by numbers 6, 8 and 9, create an appearance that the higher number, the greater the contribution to sustainability goals. This perception can drive investment policies and therefore capital flows into funds disclosing under Article 9.

However, such funds must be invested in sustainable assets at all times and cannot engage in transitioning unsustainable real assets to sustainable. Real estate funds will mostly disclose under Article 8, which are considered 'light green funds' that contribute less to sustainability than Article 9 'dark green funds'. However, for existing real estate, the environmental impact should be measured after the transition, not at the acquisition of assets.

Incentives to invest in new buildings

SFDR is based on a static view of fund portfolios, which creates incentives to invest in new buildings and fails to promote the transformation and refurbishment of existing buildings. In addition, embodied carbon created in the building process is not considered by SFDR, which further incentivises construction rather than refurbishment.

Real estate investments are dynamic; investments are improved and refurbished following a business plan over the lifetime of a fund.

Regulatory uncertainty chills investment

Regulatory uncertainty of whatever kind creates a chilling effect on investment. SFDR is not yet complete and requires the use of certain metrics that are subject to change overtime. These include, among others, the use of Energy Performance Certificates (EPC) with ratings not being harmonised across all markets and countries and the Energy Performance of Buildings Directive (EPBD), which is currently under review. This creates an unlevel playing field for disclosure.

Missed opportunity

The regulation's flaws create a missed opportunity and result in a loss of precious time while global warming continues unabated. Click here to see the paper.