The Bartlett School of
Sustainable Construction

ESG in the real estate finance industry
Current developments and call to action

Dr. Armando Castro and Dr. Kell Jones

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1. Introduction and Purpose

With a growing global policy focus[1] on delivering sustainable investments[2] and on avoiding greenwashing[3], there is increasing attention on the environmental, social and governance (ESG) performance of companies in all sectors.

Real estate companies, in particular, have a significant impact on the environment and society, and their good governance plays a major part in most countries' social and legal development. Real estate Investors and developers have the power to finance and develop sustainable buildings and businesses that contribute to achieving energy and environmental objectives, improving the quality of life of citizens, and reducing the negative impacts from the built environment.

There is a demand from institutional investors and consumers to further develop these kinds of practices. By March 2022, nearly 4,400 investors, managing over USD121 trillion have adopted the Principles for Responsible Investment (Castro & Gradillas 2022). A study from Merril Lynch Wealth Management showed that this drive towards ESG investing was driven by investors' moral concerns, while BNP found that around half of the surveyed investors were looking at ESG for improved longer-term returns alongside an improved brand image[4].

Beyond reputation and credibility, transparency in ESG also has financial implications. First, an organisation's ESG disclosure and performance can impact its ability to raise capital in the financial markets as well as the price at which it is able to raise money (Clarkson, et al., 2008). Second, the valuation of companies without adequate ESG reporting activities will be discounted as regulation in this area increases (Serafim, 2020). It is little wonder then, that some organisations are promoting positive ESG credentials to capture this market without changing their underlying impactful activities.

Governments around the world are introducing policies to influence investor behaviours and mitigate against 'ESG washing', most typically using sustainable finance reporting regulations and taxonomies. However, organisations are facing increased regulatory and social pressures to disclose ESG-related information to address risks of greenwashing and green hushing (Box 1). Coupled with a host of local initiatives developed to fill the regulatory and definitional void, we are witness to a highly dynamic ESG reporting and information landscape.

BOX 1

Green-hushing is when companies take steps to stay quiet about their climate strategies. They do this through avoidance or refusal. If somebody asks about their climate goals, they decline to answer. If nobody asks, they don't do anything.

There are two main reasons for 'green-hushing':

- Companies don't want to be called out if they fall short of their stated targets
- Companies don't want to be called out for 'greenwashing'.

Source **thecorporategovernanceinstitute.com**

The pressure to implement regulations are driven by the need to protect consumers, and an understanding that ESG factors present material risks that can affect an organisation's ability to generate financial returns (Sharma and Aragon-Correa, 2005). Due to its downstream influence on the activities of borrowing and investee companies, the finance sector is receiving particularly intense scrutiny and needs to be alert to these changes in their license to operate.

[1] https://www.globalpolicywatch.com/2023/05/the-green-claims-global-drive-developments-in-the-uk-us-and-eu/

[2] https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en

[3] https://www.gov.uk/government/collections/misleading-environmental-claims; https://environment.ec.europa.eu/publications/proposal-directive-green-claims_en

[4] Boffo, R., and R. Patalano (2020), "ESG Investing: Practices, Progress and Challenges", OECD Paris, https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf

We are already seeing larger organisations (i.e., banks[5] and pension funds[6]) respond to this increased focus on ESG by diverting capital to impact funds and increasing the granularity of their internal and external reporting. Smaller organisations – those in the 'long brown tail' of real estate owners and investors – may struggle to shift their organisations to a new, lower-impact footing. Studies suggest that these smaller organisations often lack the skills, knowledge, funding, and time to understand and adapt to the new operating and reporting environment[7].

Notwithstanding the clear market and regulatory signals to change[8], the absence of any global ESG standard and conflicting definitions and reporting requirements are creating hesitancy and uncertainty in the market[9].

In the face of this changing landscape, organisations of all sizes need to consider some fundamental questions:

1. **Should we introduce an ESG strategy and practices?**
2. **If yes, how should we go about it? and**
3. **When should we start?**

Given the uncertainty, and dynamic landscape, the temptation is to wait and see, or to do the minimum and react to changes in the regulatory landscape when they arise. While ignoring this changing landscape is certainly an option, it is one that comes with significant risks to both the organisation and the context in which that business operates. Indeed, we are already seeing risk premiums being attached to investments that fail to address some of these ESG challenges[10].

Staying ahead of the regulatory curve, however, will ensure that transition costs can be managed and there is a potential for a competitive advantage in comparison with laggard funds.

This report has been developed for and with the property finance sector to help real estate funds address these challenging questions. To inform the report we have built on our ESG related academic research and experience, changing regulatory demands and our professional experience advising the industry. Further, we engaged with institutional investors and pension funds with hundreds of billion pounds under management, attended real estate industry events and consulted legal experts on the theme.

This report begins by exploring the changing regulatory landscape, before considering the types of response we have seen in the property finance sector in the face of this new imperative, and finally makes recommendations for property funds to reflect upon as they consider their longer-term positioning in the market and internal practices.

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5 https://www.eib.org/en/stories/15-years-green-bond

6 https://www.lgim.com/uk/en/real-assets/responsible-investing/responsible-investing-in-real-estate/

7 https://smeclimatehub.org/new-survey-reveals-small-business-barriers-climate-action/

8 https://www.sciencedirect.com/science/article/pii/S104244312200018X

9 The coming crackdown on the ESG rating industry https://www.ft.com/content/2284893d-dc6d-4681-8a12-fc08f9f94c1a

10 https://www.bis.org/publ/qtrpdf/r_qt2112f.htm

2. Context – The changing ESG regulatory marketplace

This section explores the emerging and evolving regulatory landscape with a focus on the EU's sustainable finance reporting framework which exemplifies the approach to regulation being taken across the world. Other jurisdictions' responses – often informed by the EU's approach – will be slightly different, reflecting their contextual needs, but we have seen an overall similar pattern through many jurisdictions.

The EU's Sustainable Finance Disclosure Regulations

The EU's Sustainability-related disclosure in the financial services sector (SFDR) regulation lays down *direct mandatory reporting obligations* that guide how financial product providers describe the sustainability attributes of their products. The regulations envisage **3 levels for products**, depending on the degree to which the product or fund is aimed at advancing ESG.

- *Article 6* products integrate ESG risk considerations into investment decision-making or explain why sustainability risk is not relevant.
- *Article 8* products promote good ESG practices, and may invest in sustainable investments, but do not have sustainable investing as a core objective.
- *Article 9* products have an (environmental or social) sustainable investment objective. All assets must continue to meet these objectives from the outset.

While these categories of products are not labels, the market is increasingly treating them as such, with Article 9 products being described as 'impact' products[11]. These regulations also require asset-level disclosure of:

- Assets that have environmental and/or social characteristics
- Assets that can be considered sustainable, and
- Other assets that do not meet either of these criteria.

An increasingly granular, asset-level analysis is also being driven by the requirements of the EU's Taxonomy regulations that define what is 'sustainable' in relation to certain asset classes – including new buildings – and impact categories. The existence of these regulations means that financing companies will need to gather data from the asset level in accordance with the regulatory requirements of the jurisdiction of the funding organisations at each level of the value chain. This data will need to be communicated through the funding chain to the ultimate source of funds.

Even without a regulatory requirement to have a certain proportion of assets invested in sustainable assets, we are already seeing a market movement towards those products and funds that can be included under Articles 8 and 9.

Similarly, in the US, the SEC distinguishes between Integration funds (where ESG metrics are integrated within a whole suite); ESG Focused funds, in which ESG factors are a main or significant factor; and impact funds that seek to achieve a particular ESG impact.

The UK's FCA has also issued a consultation on equivalent UK regulations. The proposed labelling scheme in the UK is stricter than in the EU or US and distinguishes between

- investments with a **sustainable focus** that meet a credible standard of environmental and/or social sustainability or are aligned with a specified environmental or social sustainability theme.
- Sustainable **improvers**: these are effective investments that are in the process of transition, with clear objectives to meet environmental/social sustainable targets for the future.
- Sustainable **impact** investments: these are products that are intended to have a positive, measurable sustainable outcome.

However, there are some challenges with reporting under the SFDR[12,13], that means that even larger companies

[11] Product labelling regulations are also currently being consulted in many jurisdictions.

[12] https://finance.ec.europa.eu/system/files/2022-10/221011-sustainable-finance-platform-finance-report-usability_en_1.pdf

[13] https://www.aref.org.uk/uploads/assets/9e2362c2-fd25-4382-9a7839be89ec3046/SFDR-Real-Estate-Solutions-Paper7-June-2023.pdf

are struggling to report taxonomy alignment. Anecdotal evidence suggests that reporting entities are making simplifying assumptions in their application of the reporting requirements, undermining the aims of the regulations.

Other non-financial reporting regulations

There are many other frameworks that can be adopted to report on non-financial impacts for companies[14,15]. The abundance of frameworks and their differing data requirements means that complying with them all is a resource intensive task. There is ongoing work that attempts to harmonise these frameworks. The sections below consider regulations relevant to the EU and UK.

Acknowledging that organisations have impacts beyond the narrow confines of profitability, the EU introduced the non-financial reporting directive (NFRD) in 2014[16]. This required large companies to publish information on their ESG performance. In the UK, this was implemented in the Companies Act for accounting periods ending after 1 January 2017.

The EU's NFRD has since been replaced by the Corporate Sustainable Reporting Directive[17] (2022) (CSRD), extending the scope of the reporting requirements to more companies. The CSRD now applies to all companies in the EU apart from micro-enterprises. Companies will have to apply the new rules for annual reports published in 2025, in line with reporting standards developed by EFRAG, the European Financial Reporting Advisory Group.

The CSRD also now incorporates the concept of 'double materiality', meaning that companies must report on both how sustainability issues might create financial risks for the company (financial materiality), and on the company's own impacts on people and the environment (impact materiality)[18].

On July 31, 2023, the European Commission also adopted a Delegated Act that contains the first set of EU-wide European Sustainability Reporting Standards (ESRS). These are applicable to all companies covered by the CSRD. The ESRS package includes 12 standards covering general requirements (2), environmental standards (4), social standards (4), and one governance standard. The standards will come into law on 1 January 2024, and will apply to some entities for accounting periods that begin on or after this date.

TCFD

The Task Force on Climate-related Financial Disclosures (TCFD) is an industry-led task force that aims to provide a clear and efficient voluntary disclosure framework for climate related risks and opportunities.

Although concerned with financial disclosures, the TCFD provides a framework for making disclosures of environmental data. The TCFD framework aims to encourage companies to look at the risks and opportunities present in climate change and the transition to a low-carbon economy. The framework uses scenario modelling to explore the potential impact of climate-related change on business strategy and financial planning.

The US and UK have also incorporated the recommendations of the TCFD[19] for listed companies to report on the risks and opportunities presented by climate change.

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14 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/935097/frameworks-for-standards-for-non-financial-reporting.pdf

15 https://www.unpri.org/real-estate/mapping-esg-a-landscape-review-of-certifications-reporting-frameworks-and-practices/11348.article

16 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0095

17 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022L2464

18 https://ec.europa.eu/newsroom/fisma/items/754701/en

19 See also TNFD for nature related disclosures at tnfd global

Changes to international accounting standards & the TCFD

In addition to the evolving regulatory framework, international accounting standards are also being introduced to address ESG questions[20]. These changes build on the work of the TCFD, the Climate Disclosure Project (CDP), and the Global Reporting Initiative (GRI) and supplement the non-financial reporting disclosure requirements already in place. These new standards are intended to have a high degree of alignment with the EU's ESRS.

The first two standards from the International Sustainability Standards Board (ISSB) have just been released. These standards are: IFRS S1 (General disclosures) which covers the disclosure of material information about sustainability-related risks and opportunities; and IFRS S2 on Climate-related disclosures, requiring disclosure of physical and transition risks from climate change, and climate related opportunities. This standard also sets out the disclosure requirements for transition planning, climate resilience, and the reporting of scope 1, 2 and 3 emissions. The ISSB is also consulting on their plans for looking at biodiversity, ecosystems, ecosystem services; human capital; and human rights. These will, in time, translate into additional reporting requirements for organisations.

Voluntary or non-regulated reporting frameworks

As well as these mandatory indicators, there is a range of voluntary SFDR disclosures which reporting companies can choose to adopt (Gallo and Christensen, 2011). This creates a *direct voluntary reporting obligation* for them. These SFDR voluntary disclosures can be supplemented by the adoption in an organisation of any number of voluntary codes and frameworks, with their own specific focus (e.g., PRI, BREEAM, GRESB, Fitwel, Well, NABERS). Certification under these frameworks simply shows an alignment with their requirements.

The built environment is faced with an oversupply of such standards, many of which distil multiple ESG-related metrics into an overarching score. This abstraction tends to obscure specific ESG performance attributes of the building or organisation, and the direction of travel of regulation is to increase the granularity of reporting.

The ESG Tightrope – Independent verification

There are still concerns about greenwashing and data verification of ESG policies. In the UK, for example, the FCA is concerned that some loans and products that are badged as sustainable may not be delivering the intended outcomes[21]. This reinforces the fact that there is a lack of trust in ESG data being published by some companies and supports the argument for an interim form of independent verification, through companies such as Sustainalytics, or your regular audit organisation.

The FCA is looking to develop a code of practice in this area, and there is an increased focus on reducing greenwashing, or green hushing[22] (i.e., increasing transparency). Given this focus and the fact that it will take some time to establish many SME funds' granular and robust ESG reporting framework, a pragmatic approach to the question of independent verification might be to adopt a position of wait and see, while developing that framework.

Implications for property finance organisations

Together, these regulations impose a series of *direct reporting obligations* on larger, usually listed organisations (Gallo and Christensen, 2011). However, with the extension of the EU's CSDR scope, these are expected to impact on medium and small sized property finance organizations shortly.

Irrespective of this extension, the reporting needs of these larger companies will, in time, trickle down to smaller investee companies: Direct funders' reporting obligations mean that they will need to get granular data on their investments and will be looking to smaller private equity and property funds for information to help them to meet their obligations.

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20 https://www.ifrs.org/issued-standards/ifrs-sustainability-standards-navigator/

21 https://www.ft.com/content/f368121a-8de9-490c-98a5-1635a8a6b81b

22 https://www.weforum.org/agenda/2022/11/what-is-greenhushing-and-is-it-really-a-cause-for-concern/

These *indirect reporting obligations* for investee companies mean that smaller funds are likely to be exposed shortly to the requirement to gather and report ESG performance data for their organisations and the buildings they fund.

Therefore, all funds will eventually be required, directly or indirectly, to report on the performance of their portfolio against regulated and/or voluntary schemes beyond those schemes that the board have already signed up to. Understanding and aligning with the scope of the regulatory demands on current and future funders is a key part of market positioning.

As a minimum, this suggests that for reporting under the SFDR, a minimum early step for all organisations should be to identify the principal adverse impacts[23] (PAI) of their operations and lending under the mandatory indicators (Figure 2).

However, will this be enough?

In summary

- The external regulatory pressure on companies to report and integrate ESG is growing.
- The reporting landscape is complex and dynamic.
- However, we are seeing a slow process of harmonisation and consolidation in the requirements on 'sustainability reporting'.
- General rating schemes do not have stakeholders' full confidence: there is discontent and confusion about the ratings and how they work (transparency).
- The granularity of information requested is expected to increase as a result.
- Therefore, organisations that want to be ahead of the curve need to start developing, implementing and collecting their own data now (meaningful, granular ESG) data that might be used for potentially different reporting frameworks, investor requests, voluntary standards and future regulations.

SFDR mandatory adverse sustainability indicators

Climate and other environmental indicators

- GHG emissions (scope 1,2,3 & Total)
- Carbon footprint
- GHG intensity
- Fossil fuel sector
- Non-renewable energy consumption and production
- Energy consumption intensity per high impact climate sector
- Biodiversity sensitive areas
- Emissions to water
- Hazardous waste ratio

Social and governance indicators

- Violations of UN Global Compact principles and OECD Guidelines
- Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines
- Gender pay gap
- Board gender diversity
- Exposure to controversial weapons

Figure 2: Source greenomy.io

[23] For an example PAI statement see https://www.refinitiv.com/content/dam/marketing/en_us/documents/fact-sheets/sfdr-principle-adverse-impact-indicator-coverage.pdf

3. ESG Adoption – Market reaction

We have reviewed the positioning of financial sector organisations, spoken with different funds, and other industry participants, and observed the related press[24]. This section provides an overview of our findings.

Companies of all sizes are establishing and publicly reporting their positions on ESG issues.

A combination of the shifting regulatory landscape and the increased market expectations on the delivery of ESG aligned investments is encouraging organisations to take a position on ESG issues. Sometimes these are quite robust, with specific exclusions policies, KPIs, full transparency and independent validation. Others have been early adopters of impending regulations, and yet others comply with regulations, but beyond that do little, describing their routine practice very carefully (e.g., 'we *consider* ESG issues in each investment decision'). Paying lip service to the ESG agenda in this way can be considered a form of green hushing. Deciding on where to position an organisation in this disclosure continuum is a strategic decision for each organisation.

Reporting on ESG is becoming routine, and increasingly granular.

In discussions with some of the larger organisations, this conversation was seen as old news. We were told that "everyone will be there in 2 years".

As well as wanting to be seen to be doing the right thing, these companies are being asked by their global funders to provide highly granular data related to ESG performance. As highlighted above, international reporting is seeing a shift away from the use of abstract building sustainability ratings towards much more specific and granular data points, for example, on carbon in use and embodied carbon.

It is also becoming routine to gather and report this carbon-related data. In our conversations, there was an acknowledgment that there would be costs to smaller organisations in meeting this reporting requirement, but these are costs that will need to be incurred and absorbed somewhere in the value chain. Two of our interviewees described that biodiversity and natural resources are also fast rising on their funders' agenda.

A large fund also described to us how on carbon, they expect their borrowers to be 'Paris-aligned', but that SMEs really struggle with validation. To address this, the fund offers no discount on the completion of the deal but ratchets down when they get a sign-off from the Science-Based Targets Initiative[25]. However, the ratchet is removed if the company fails to meet its annual decarbonisation obligation. They recognise that they might lose some margin on this lending, but they have funders who are willing to accept that reduction for impact. If the fund fails to meet its target, they return some of its carried interest to its funders. Other organisations give such windfalls to a non-profit organisation.

Companies are developing parallel funding streams to align with Article 9.

The EU's introduction of three investment classifications is driving behaviour in the market. Where possible, finance houses are presenting their offer as aligned with Article 8 (promoting sustainability). However, this is often a halfway house to creating Article 9 (impact) funds.

Depending on the position of the ultimate funder, these sustainable and impact funds might be able to offer cheaper sustainable loans, but this is not always the case. The likely direction of travel instead is for non-sustainable assets to attract a risk premium due to early asset stranding risks.

Anecdotal evidence suggests that some lenders are washing their portfolios to identify assets that might qualify under Article 9 and separately badging them. This approach may generate good press but is not going to help achieve the benefits that robust ESG policy seeks to deliver and could also be considered a form of greenwashing.

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24 E.g. New Private Markets 2023

25 https://sciencebasedtargets.org/

Funds that are creating ambitious ESG related product lines have a parallel interest in transparency and organisation-wide sustainability policies.

Changes promoting ESG credentials are being made in part in the pursuit of greater returns or access to new (patient) investment funds, but otherwise, they are driven by the ethical positioning of the leadership team. The latter organisations are frequently more transparent and provide detailed information on their position and decision-making.

Transparency in ESG information that truly reflects an organisation's long-term commitment to considering the environmental and social impact of its business activities is becoming imperative. Cosmetic fixes can easily be considered greenwashing, which, beyond being unethical and risking reputational damage, is increasingly being considered illegal. Authentic ESG goals, policies, and initiatives need to be transparently shared with internal and external stakeholders, so they understand how the organisation is considering and addressing their ESG challenges. Again, transparency is very much the direction of travel for the regulatory context, so these organisations are ahead of the regulatory wave.

Lenders are extending their offer

Several property funds have extended their engagement with the real estate's lifecycle by creating an interest in the longer-term performance of buildings. Typically, this is through joint ventures with[26] or investments in[27],[28] rental focused builders (Registered Providers or Build to Rent). In committing their funds to this longer-term perspective, lenders are incentivised to build resilient and energy efficient homes and can align their interests with those of those pension funds who seem reluctant to invest in just development[29].

Elsewhere, pension funds have invested in property finance companies or appointed investment consultants to align their investment strategy with 'ultra-long-term growth objectives[30]'. Notably, large sections of the market consider that new buildings should be developed so that they are already climate aligned, and not in need of significant further remediation.

ESG metrics and executive pay

Another recent trend that has received considerable media attention is linking senior management pay to ESG metrics, to both incentivize and make senior management accountable for the organisation's ESG goals[31]. Theoretically, if ESG metrics are relevant for long-term value, then tying pay to long-term value should be sufficient to encourage executives to bolster them (Flammer and Bansal, 2017). Yet, some nudging for change might still be needed since senior executives might want to focus on traditional managerial practices and performance metrics/priorities. Hence, in recent years, activist funds have pushed companies to tie c-suite/decision makers' compensation to ESG metrics (Hill, 2021) to speed up adoption. In fact, there have been some developments in this regard, with 58% of FTSE 100 companies in the U.K. having included an ESG measure within their executive incentive plans by 2021 (PWC, 2021). This has also led to a positive public relations boost for companies that adopt this practice (Castro, Gradillas, 2022).

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[26] https://www.redevco.com/redevco-announces-uk-build-to-rent-joint-venture-with-sfp/

[27] https://www.showhouse.co.uk/news/apache-capital-launches-platform-to-build-family-rental-homes/

[28] https://octopusgroup.com/newsroom/latest-news/octopus-investments-launches-uk-affordable-housing-strategy/

[29] L&G is one of the largest investors in BTR and has already invested c£2.5 billion into twenty BTR schemes around the UK and is looking to invest £500m in the sector this year https://www.egi.co.uk/news/lg-poised-to-pump-500m-of-retirement-funds-into-btr/

[30] https://www.funds-europe.com/news/redington-appointed-as-strategic-investment-adviser-for-cambridge-university-pension-scheme

[31] https://www.ft.com/content/36e3143b-6c6f-4991-b310-46c07e7c3e02

In Summary

- Organisations are already taking positions on ESG reporting issues
- Sometimes these are quite robust, with specific exclusions policies, KPIs, full transparency and independent validation
- Others have adopted of impending regulations early
- Yet others comply with regulations, but beyond that do little, describing their routine practice very carefully (e.g., ‘we consider ESG issues in each investment decision’)
- Deciding where to position an organisation in this disclosure continuum is a strategic decision.

4. Should Property Finance Organisations introduce a proactive ESG strategy?

Soon all organisations will have to answer the following questions:

- *Will we treat ESG as a compliance issue?*
- *How will we consider and manage both risks and opportunities strategically, integrating ESG with the business?*
- *Should we take an ESG-leading position, integrating ESG into your business operations, and driving strategy?*

Achieving long-term value creation through ESG initiatives that are core to the organisation's activities involves strategic decisions that cannot be made by a sustainability team but require the attention of the CEO and senior management. However, not doing so can expose organisations to risks.

In our review, we have identified two broad responses that organisation might take in response to this changing landscape (Graph 1, opposite).

- An organisation might choose to strategically integrate ESG strategies and practices into their business. This engagement considers the adoption and changes in the ESG sphere as an opportunity for the organisation. To avoid accusations of greenwashing, organisations will need to make their adoption authentic.
- A second option is to adopt a compliance and risk-focused approach. This path focuses on responding to new legislation, and following what competitors are adopting. This reactive strategy carries the risk of the organisation becoming a laggard as the market changes.

With government actions currently falling short of ambition in the pursuit of nationally declared contributions to deliver on the Paris Agreement, an aggressive, and inevitable policy response[32] is needed. Companies maintaining a reactive compliance position to ESG reporting could leave funds exposed to significant and sudden transition risk[33].

Cosmetic fixes – while easy – can be considered as greenwashing, which can lead to reputational damages, and is increasingly being regulated against. Doing nothing or staying silent about ESG performance is green hushing.

Ultimately the decision as to whether, how quickly, and how far to move from a strictly compliance position is one for an organisation's executive committee.

The Benefits of adopting a proactive ESG position

The journey towards robust and integrated ESG reporting comes with several benefits making an investment in ESG reporting potentially a no-regrets option:

- Staying ahead of the regulatory curve will ensure that transition costs and risks can be managed.
- It focuses attention on material risks and opportunities for the organisation & their market.
- There is a potential of a competitive advantage vs laggard funds.
- ESG commitments, if publicised, send a market signal that could attract new funders looking to 'green' their portfolio.

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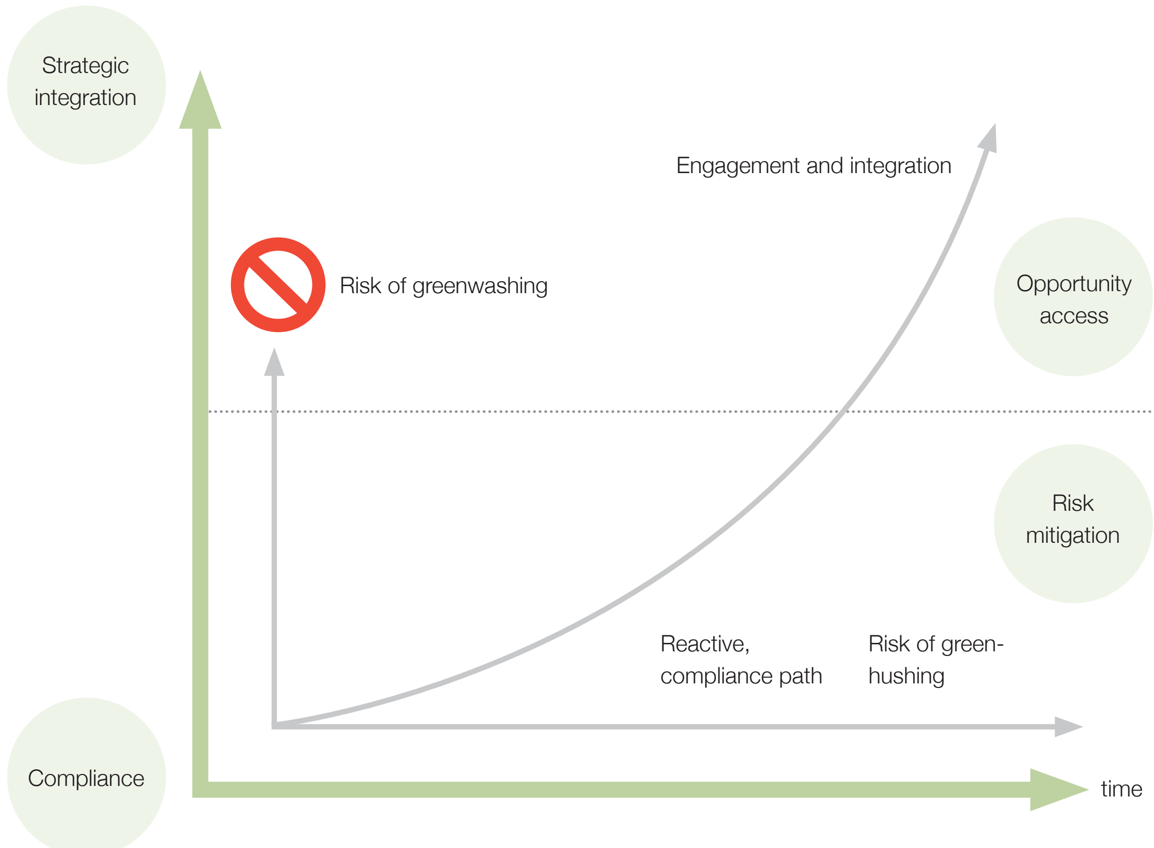
[32] https://www.unpri.org/inevitable-policy-response/what-is-the-inevitable-policy-response/4787.article

[33] https://www.bankofengland.co.uk/explainers/climate-change-what-are-the-risks-to-financial-stability



Graph 1: Degree of ESG engagement

5. How should funds go about developing an ESG strategy and practice?

To create value, an organisation's ESG initiatives need to be part of a long-term strategy that is aligned and coherent with the organisation's vision, identity, and core activities. As we have set out, there is currently confusion of reporting standards & certification schemes, and the market is highly dynamic. It will take some time to settle down, and for the regulatory framework to expand to encompass SMEs.

As a result, it does not necessarily make sense for smaller organisations to start their detailed ESG journey immediately, let alone select just one standard with which to align. Given the anticipated trickle-down of regulations from funders who will be requesting increasingly granular and transparent information, however it may be appropriate to begin on the ESG reporting journey sooner rather than later.

The question then becomes what should property finances do?

How to Change

We set out below some points that need to be considered by an organisation in order to enable their funds to develop and communicate their ESG position. We have included some of the key strategic questions and actions that need to be considered by the funds (refer to table 1)..

- **Identify** the organisation's principal adverse impacts and priorities in environmental, social and governance spheres[34]. This is part of good governance and will help funds better understand the risks of (in)action. For a more robust review, the TCFD framework and associated scenario analysis could be used.
- **Strategic decision**. Decide where you want to stand on material ESG issues. Do you want to:
  - Treat ESG as a compliance issue?
  - Manage the impacts as risks to avoid the downside?
  - Consider both risks and opportunities strategically (e.g., a way to access funds), integrating ESG with the business?
- **Get granular** – the reporting direction of travel is granular as broad sustainability rating schemes are increasingly seen as obscuring important underlying performance indicators. By getting a better understanding of the detailed lifecycle performance of the buildings you are funding, you will be better prepared to meet the indirect reporting requirements of your funders.
- **Establish** your baselines – this is essential to understand where you are now and your exposure[35].
  - Where is your fund now on the key ESG issues, and their principal adverse impacts?
  - Consider the scope. e.g., for carbon reporting, is the focus on scopes 1 & 2 only, or does it also include scope 3?
  - Which aspects of the buildings' lifecycle should the property fund consider?
- **Commit** to mitigation targets and a timeline for action – some of these actions will be no-regrets actions, and others will require funds to take a position and invest. To withstand scrutiny, climate change targets should be 'Paris-aligned'.
- **Communicate** action to the market – Not just once, but keep the market updated with honest assessments of the challenges you are facing.
- **Implement** according to your commitments.
- **Integrate** – Consider the extent to which you want to integrate ESG into decision-making in the organisation: Is ESG to be reflected in your loan-making decisions, through exclusions or thresholds, or by making ESG performance an aspect of individuals' bonuses?

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34 Suggest using GRI as a framework to support this process, but it could / should be bottom up.

35 XTonnes is an organisation that might be able to help them on carbon

A. Agree on a Strategic direction
Mission statement
Vision and values
B. Develop KPIs & transition pathways
Identify principle adverse impacts (granular), assess risks and opportunities
Develop Baselines for PAI
KPIs & targets (funded assets)
KPIs & targets (organisational)
C. Integration
Market positioning
Market reporting
Remuneration strategy

Table 1: Illustrative steps for a fund to deliver strategic ESG goals in the short, medium and long term

BOX 2

Example: Implementing a risk-based approach to pricing loans.

We have heard how discussions being held today could lead to buildings being completed by the end of this decade. As a result, the market is already responding to the expected landscape in 8 years. By this time, new buildings will be expected to operate at nearly net zero carbon in consumption. Is this enough?

Any buildings that are not designed *and delivered* to meet these strict operational carbon emissions standards may require retrofitting in a short number of years. CRREM[36] have developed a 'stranding line' for buildings by country. Assessing a building's anticipated performance against this stranding line provides an indication of the depth and timing of future renovations of buildings. The CRREM line is gaining traction in the industry as a tool to assess portfolio assets. One could foresee a metric for new buildings including an 'estimated years to stranding.' Incorporating this adaptation thinking into decision-making may encourage developers to build resilience into their buildings, making their assets a longer-term investment proposition, and providing an insight for funds into the risks to the ultimate realisation of the sale of the building.

Further, the expected reduction in the operational carbon emissions from buildings focuses attention more closely on the embodied impacts of the buildings being developed. The focus on the delivery phase is beginning to manifest in the regulatory space: For example, the EU Taxonomy calls for information on new buildings' whole lifecycle carbon for larger developments, and in the UK, the Government have announced that they will be consulting on embodied carbon regulation in 2023 or 2024[37]. The Science Based Targets Initiative is also working towards a new set of criteria for new buildings which include consideration of embodied carbon. Green building councils and sustainability rating schemes around the world are also intensifying their focus on this lifecycle stage.

[36] https://www.crrem.eu/

[37] https://www.building.co.uk/comment/why-our-part-z-proposals-must-be-a-milestone-on-the-road-to-net-zero/5120998.article

6. Conclusion – Call to Action

During this review, we have felt a sense of inevitability in ESG reporting that will introduce significant *direct* or *indirect* reporting obligations on property finance organisations across the world. As reporting requirements will trickle down, companies of all sizes need to decide how to respond to this change in their license to operate.

The key points from the study, and our call to action are summarized below.

- New legislation and accounting changes to the regulatory and reporting environments are moving forward at pace across the globe. ESG reporting will not be a voluntary adoption issue for much longer. It is no longer a case of ‘if’, but ‘when’ you will need to respond.
- ESG reporting is becoming more granular and routine. The **data** you collect **needs to be improved and expanded**.
- **This means that it is time for organisations to take a position**. Senior leadership teams must decide now where they stand on material environmental, social and governance spheres affecting the real estate and property finance industry.
- Senior management teams need to decide how **ESG will** be part of the **organisation’s strategy**.
- A **clear plan is needed to** implement change.

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Contributors

Dr Armando Castro is the director of the Centre for Sustainable Governance and Law in the Built Environment and an associate professor at the Bartlett School of Sustainable Construction (UCL).

Dr Castro's research is interdisciplinary with an emphasis on Management, Finance and Law. More specifically, his research interests are in Environmental, Social and Governance (ESG) topics.

He has conducted studies and published articles and reports focusing on the voluntary adoption of ESG standards and sustainable governance.

Additionally, he has provided advisory services to the financial sector and different governments.

Dr Kell Jones is the deputy Director of the Centre for Sustainable Governance and Law in the Built Environment, and a lecturer at the Bartlett School of Sustainable Construction (UCL).

His research is located at the intersection of buildings, finance and sustainability, with a focus on ESG reporting and regulation.

His work builds on his industry experience as Chartered Accountant (ACA), architectural designer (ACIAT) and BREEAM Accredited Professional. Prior to taking up his role as lecturer, Kell was the Building Standards Manager at the Climate Bonds Initiative.

“This report has been developed for and with the property finance sector to help funds address these challenging questions. To inform this we have built on our ESG related academic research, changing regulatory demands and our professional experience advising the industry. Further, we engaged with institutional investors and pension funds with hundreds of billion pounds under management, attended real estate industry events and consulted legal experts on the theme.”

University College London, Gower Street, London, WC1E 6BT Tel: +44 (0) 20 7679 2000