ESG Requirements Forcing Change

Volume 46, Number 12 - August 31, 2022 • Written by: Ms. Deborah Cloutier, CRE

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ESG Requirements Forcing Change was listed as the #10 issue in the [2022-23 Top Ten Issues Affecting Real Estate®] by The Counselors of Real Estate®.

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Government regulators around the world are increasingly passing laws, rules, and ordinances regarding the performance and disclosure of real estate assets according to environmental, social, and governance (ESG) criteria. These requirements are forcing real estate investors to measure and report – and in some cases publicly disclose – their assets' energy and water use, waste, carbon emissions, and climate change risks. It is these fast-paced developments in the regulatory landscape that will likely support the adoption of policies and practices toward low-carbon economy change over the next few years. These requirements are also instigating much innovation in the design, development, and construction of new buildings as well as renovation of existing stock with long lifespans ahead of them.   Regulators are taking this stance because they are being demanded by the marketplace and the next generation of consumers and politicians to address climate change.

In the real estate industry, ESG risk assessment and mitigation initiatives are becoming essential components of real estate investment. In 2021, the U.S. Securities and Exchange Commission (SEC) acknowledged the growing demand by investors for ESG and climate-related disclosures. In March 2021, the SEC launched an ESG Enforcement Task Force to identify material omissions or inaccuracies in issuers' disclosure of climate risks[1] and in April issued a risk warning to caution investment advisers, registered investment companies, and private funds that their ESG statements will be more heavily scrutinized.[2]

The SEC proposed sweeping requirements in March 2022 that would require public U.S. companies to begin disclosing greenhouse gas (GHG) emissions and climate-related risks as early as 2024 for calendar year 2023 operations. If adopted, public companies would need to disclose both *physical* climate-related risks, such as sea level rise, and *transition* risks, such as increased insurance costs or decreased asset values. For example, if determined to be material real estate investors would be required to provide a list of any properties by zip code with identified physical risks and the percentage of buildings or properties located in flood hazard areas. All effected companies would be required to report Scope 1 and Scope 2 GHG emissions from owned operations and purchased electricity. One of the most controversial proposed requirements include larger portfolios to report material Scope 3 emissions, such as tenant electricity consumption. If not satisfied with the disclosures, investors and the SEC would be able to challenge what a company deems material.[3]

More extensive requirements are in place and being expanded in Europe and the UK. The UK government's Green Finance Strategy set an expectation that all listed issuers and asset managers will begin reporting emissions and climate risks in alignment with the Task Force on Climate-Related Financial Disclosures (TCFD) by 2022.[4] On the continent, European Climate Law has codified the EU's commitment to reaching climate neutrality by 2050 and the intermediate target of reducing net greenhouse gas emissions at least 55% by 2030 compared to 1990 levels.[5] Two of the largest regulatory bodies governing ESG initiatives and reporting in Europe are the Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy.[6] SFDR introduced new ESG transparency and disclosure requirements for European financial market participants, mandating that all Financial Market Participants (FMPs) evaluate and disclose ESG data at entity, service, and product level. Likewise, the EU Taxonomy requires financial participants in scope for SFDR to back up claims on environmental characteristics associated with their products, and report the percentage of their turnover, capital expenditures, and operational expenditures aligned with the EU Taxonomy.

In addition, cities and municipalities around the world are implementing local ordinances requiring the benchmarking and reporting of commercial buildings' energy use, including over 30 cities and four states in the U.S.[7] Several cities have also passed laws mandating GHG emissions reductions from large commercial buildings within their borders, such as New York City's Local Law 97 and similar laws in Denver, Boston, and Washington D.C. Building owners who do not comply face significant fines in the coming years.

While the "E" in ESG gets the most attention, we must remember that ESG stands for environmental, social, and governance. Increased stakeholder recognition of the importance of social factors like diversity, as well as health and wellness, in commercial real estate are setting new expectations from investors, employees, and the communities in which real estate operates. Both the SDFR and the SEC have expressed interest in disclosures on social topics, and they may be added to ESG disclosure regulations within the next few years. The "G," Governance, comes into play by holding companies accountable for their actions. ESG is hardly a new concept, and it may be number Ten in this survey, but one could say that it is embedded in or greatly impacts each of the other issues. Like all the Top Ten Issues, it is very present and will continue to make its mark on the real estate industry.

Endnotes

[1] "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues," U.S. Securities and Exchange Commission (March 4, 2021). https://www.sec.gov/news/press-release/2021-42

[2] "The Division of Examinations' Review of ESG Investing," U.S. Securities and Exchange Commission (April 9, 2021). https://www.sec.gov/files/esg-risk-alert.pdf

[3] "Proposed Rule: The Enhancement and Standardization of Climate-Related Disclosures for Investors," U.S. Securities and Exchange Commission (2022). https://www.sec.gov/rules/proposed/2022/33-11042.pdf

[4] "A Roadmap towards mandatory climate-related disclosures," HM Treasury (2020). https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROADMAP.pdf

[5] "European Union: European Climate Law on Achieving Climate Neutrality by 2050 Enters into Force," Library of Congress (August 31, 2022). https://www.loc.gov/item/global-legal-monitor/2021-08-31/european-union-european-climate-law-on-achieving-climate-neutrality-by-2050-enters-into-force/

[6] Maia Godemer, "The relationships between SFDR, NFRD and EU Taxonomy," Bloomberg Professional Services (Mar. 31, 2021), available at https://www.bloomberg.com/professional/blog/the-relationships-between-sfdr-nfrd-and-eu-taxonomy/.

[7] "Map: U.S. City, County, and State Policies for Existing Buildings: Benchmarking, Transparency and Beyond," Institute for Market Transformation. https://www.imt.org/resources/map-u-s-building-benchmarking-policies/