INDUSTRY INSIGHT

BBP BETTER BUILDINGS PARTNERSHIP

SUSTAINABILITY BITES?

The impact of Minimum Energy Efficiency Standards for commercial real estate lending

NOVEMBER 2015

Introduction

In recent years sustainability risks and drivers have had a transformational impact on the way in which equity investors approach direct real estate investment and management. One of the greatest drivers we're now seeing in the UK is the introduction of regulatory Minimum Energy Efficiency Standards.

Major REITs and fund managers are starting to get to grips with the impacts these regulations will have on the property portfolios they own. However, with many institutional and private equity investors increasingly focused on lending as an additional form of real estate exposure, such sustainability considerations have to be considered from a new angle.

This is particularly important because of the way the real estate lending market has been evolving since the 2008 financial crisis. To begin with, lending activity has recovered strongly in the last year or two in the UK and much of Europe, and now represents approximately one third of the total commercial real estate investment market. While levels remain well below previous cycle peaks (CBRE estimate 2014 absolute levels are still less than half of their 2007 peak) 2014 saw a 55% increase in lending origination across Europe and 45% of that secured on properties in the UK[1].

Just as importantly, an unprecedented proportion of real estate lending is now taking place outside the UK and European banking systems, both in terms of where the capital deployed is coming from, and in terms of what kind of entities are managing that capital. De Montfort University's Commercial Property Lending Report suggests that around a quarter of new lending is coming from insurance firms (and their investment management arms) and other non-bank lenders (such as private equity debt funds).

Why is sustainability relevant to commercial real estate lending?

Understanding emerging real estate sustainability risks and opportunities will help lenders to:

- Incorporate sustainability considerations into due diligence, underwriting, deal structuring and loan documentation as part of their risk management strategy;
- Better monitor the direct impacts on their existing loan portfolio, not least to ensure that the value implications of operational or regulatory obsolescence risks are understood and managed;
- Prepare for the possibility of regulators choosing to request sustainability risk data in future years;
- Explore opportunities for growth through the development of new products and business models driven by the sustainability agenda;
- Demonstrate responsibility and leadership through engagement with borrowers to help them understand sustainability risks and opportunities.

Banks and non-bank lenders alike need to get to grips with the implications of both the changing regulatory landscape for sustainability, and growing investor interest in firms' sustainability policies.

This paper sets out the current thinking from the Better Buildings Partnership regarding the risks associated with Minimum Energy Efficiency Standards for commercial real estate lenders and the practical steps lenders can take to mitigate such risks. We also touch on some of the wider sustainability considerations lenders may wish to take into account and the value creation opportunities they offer.

Minimum Energy Efficiency Standards

The Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015, more commonly known as Minimum Energy Efficiency Standards (MEES), make it unlawful to rent out residential or business premises that do not reach a minimum energy performance standard, with that standard currently set at Energy Performance Certificate (EPC) rating "E". This applies to all new leases from 1 April 2018 and all privately rented property (existing leases) within the scope of the regulations by 1 April 2023.

Risk

The regulations pose a significant new risk for lenders as any property that falls below this minimum standard may potentially be subject to:

- A negative impact on collateral value[2] and a consequent increase in the loan to value ratio (perhaps threatening financial covenants);
- Increased void rates, impacting the ability of the borrower to pay back the loan;
- Requiring additional capital expenditure to raise the property above the minimum standard.

What are Energy Performance Certificates?

Energy Performance Certificates (EPCs) advise owners, occupiers, buyers and lenders of the potential energy efficiency of a building and are required by law to be displayed in marketing literature when a building is built, sold or let. The EPC displays a grade from A (best) to G (worst) and numerical score and is valid for a period of 10 years.

Challenges

- The quality and reliability of EPCs can be highly variable dependent on the number of default values used within an assessment and the quality of the assessor. In addition, there is no easy way of assessing the quality (i.e. what is a 'good' or 'bad' EPC) based on the certificate itself.
- EPC ratings are likely to change over time as the assessment methodology is linked to the Building Regulations in force at the time of assessment. It is therefore important to know the EPC certification date and how the expiry of certificates may overlap with tenancy agreements and loan repayment schedules.
- EPC assessments can be undertaken per tenanted demise, meaning properties securing a loan may have more than one EPC – and a later EPC always 'trumps' an older one relating to the same property. Therefore a lender needs the capability to add EPC data at the individual tenancy level as part of its on-going loan book monitoring.

Mitigation strategy

A lender has a number of options to reduce its risk exposure for:

- **New lending decisions:** through due diligence, underwriting and loan documentation;
- **Existing loan books:** through loan book monitoring and borrower engagement.

New lending decisions

REVIEW EPCS AS PART OF DUE DILIGENCE

Request a copy of the EPC from the borrower (or seller in case of acquiring an existing loan portfolio) and review the EPC letter rating (A to G) and number rating, as well as the EPC expiry date. This should sit alongside the valuation report, technical due diligence and environmental (Phase I) due diligence. The quality and reliability of EPC certificates can vary considerably (see box – What are Energy Performance Certificates). It has been known for a property's EPC rating to improve or diminish simply through a new EPC assessment. A lender may therefore wish to consider instructing its own EPC assessment.

ASSESS AND UNDERWRITE MEES RISK

EPC ratings at or below an E (or absence of any EPC rating at all) should sound an alarm bell and require a more detailed review in the context of the lending decision (loan term, property lease lengths, planned capex etc.). It should be noted that a property with an EPC rating below an E need not be fundamentally problematic. It is something that needs to be considered as part of the wider due diligence and underwriting process. In this instance, the lender should seek to understand the borrower's business plan around leases and upgrading the building (thereby improving the EPC rating) and any associated planned capex.

CONSIDER RISK MITIGATION THROUGH STRUCTURING AND LOAN DOCUMENTATION

Where a material MEES risk is identified it can often be mitigated if the borrower is encouraged or obliged to take practical steps to address it. Any costs or commercial impacts should be underwritten and a lender may want the loan structure and documentation to provide some means of monitoring and enforcement to protect itself.

As a start, the LMA real estate finance template facility agreement for multi-property investment transactions[3] recommends the use of clause 23.4 (maintenance) to provide some protection in relation to MEES for lenders:

Each Borrower must ensure that all buildings, plant, machinery, fixtures and fittings on its Property are in and maintained in:

(a) Good and substantial repair and condition and, as appropriate, in good working order; and

(b) Such repair, condition and order as to enable them to be let in accordance with all applicable laws and regulations; for this purpose, a law or regulation will be regarded as applicable if it is either:

> *(i) In force; or*
>
> *(ii) It is expected to come into force and a prudent property owner in the same business as the Borrower would ensure that its buildings, plant, machinery, fixtures and fittings were in such condition, repair and order in anticipation of that law or regulation coming into force.*

However, where due diligence and underwriting indicate a significant MEES risk this wording may not be considered sufficient and lenders may consider bespoke obligations on the borrower with regard to MEES related information reporting and compliance in order to protect the lender's position.

What EPC data to collect?

A lender will need to consider what information is material to its risk management strategy and therefore what should be included as part of its loan book monitoring system. However, the following should provide a useful starting point:

- EPC letter rating
- EPC number rating
- Date of certification
- EPC Assessor (company)
- EPC Certificate Reference Number (24-digit number)

Existing loan book

START COLLECTING AND MONITORING EPC DATA

In comparison to new loans, where EPC data should be collected at due diligence stage, it is recognised that for existing loans the lender may not hold any EPC data.

To obtain an EPC in relation to a property securing an existing loan a lender has the following options:

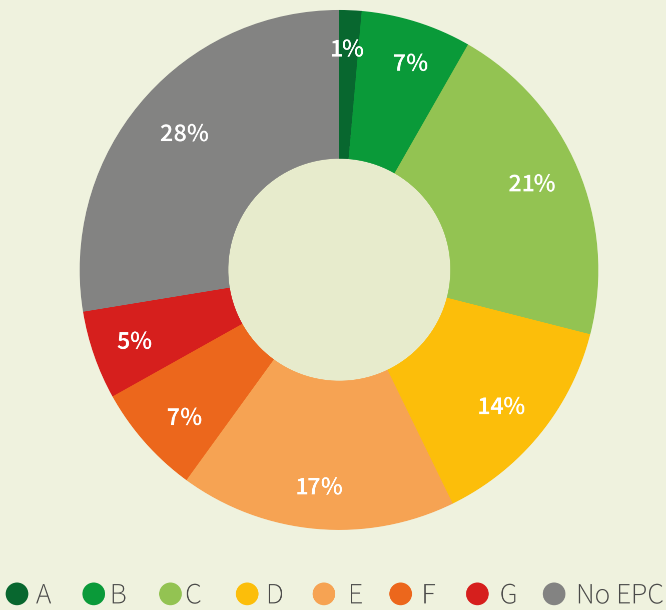
- Request it from the borrower (as part of standard borrower engagement procedures);
- Require it from the borrower, either pursuant to loan documentation (though this may not be covered) or in the context of considering a request for consent (such as to a new letting);
- Obtain it at the point of next valuation by making sure that the valuer reports on it. Another possibility is to look through old valuation reports to see if it has previously been covered;
- Search the Government register using the property's address (www.ndepcregister.com).

INCORPORATE EPC DATA AND MEES RISK INTO EXISTING LOAN BOOK PORTFOLIO MONITORING

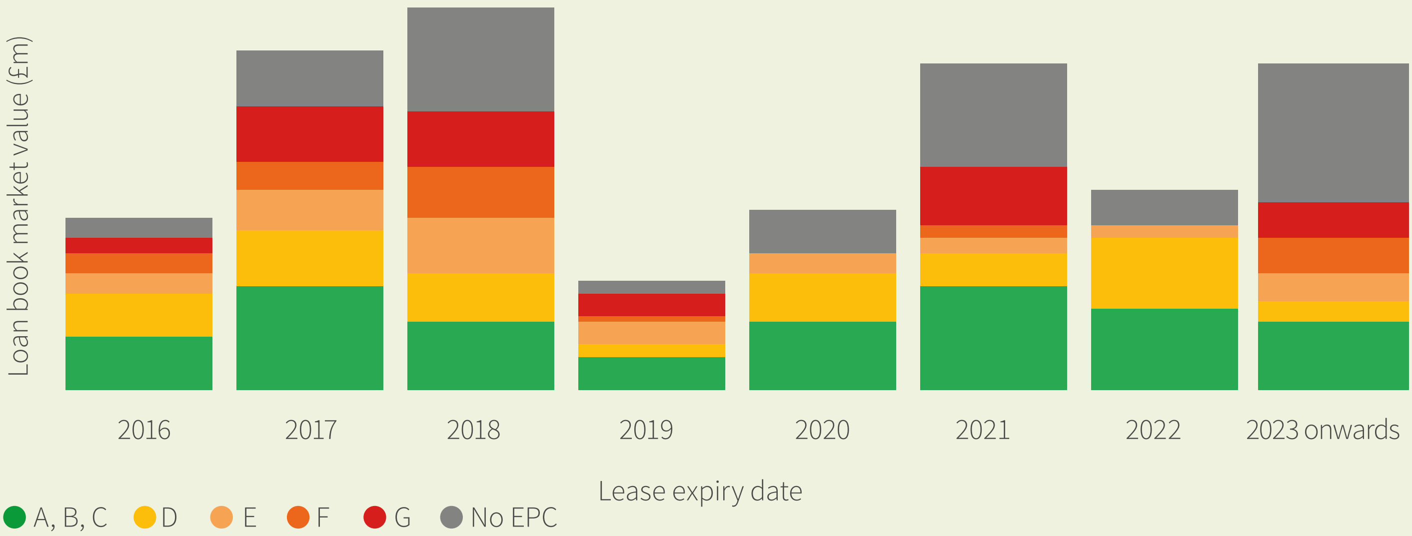
Consider metrics such as:

- Proportion that does not have an EPC (i.e. unknown risk);
- Proportion at risk of failing to meet MEES (i.e. at or below an E rating);
- Overlay of the above metrics ordered by lease expiry or EPC expiry date.

Example loan book market value (%) by EPC rating



Example loan book market value by EPC rating ordered by lease expiry



If a material MEES risk is identified a lender may consider implementing the following steps to manage that risk:

REVIEW LOAN DOCUMENTATION

Assess whether the loan documentation places adequate responsibility upon the borrower to meet MEES requirements if the property becomes non-compliant. Potentially also consider lease-level due diligence to determine if upgrade costs can be passed on to occupiers or whether they will form part of any (hopefully planned) borrower refurbishment costs.

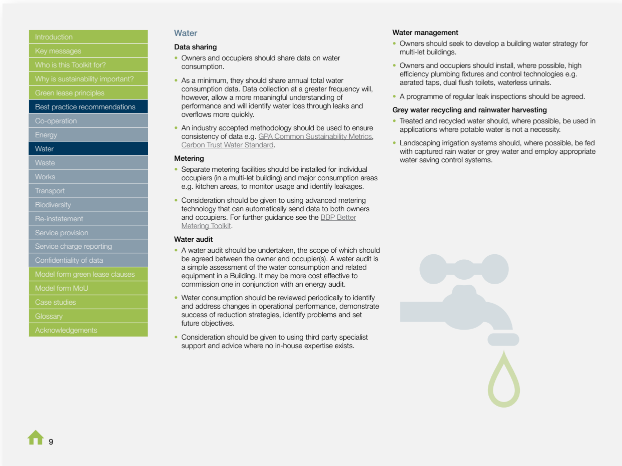
ESTABLISH A PROACTIVE BORROWER ENGAGEMENT STRATEGY

Lenders have the opportunity to go beyond the simple provision of capital by engaging with the borrower and providing advice and support. Early engagement and communication can help foster relations that in turn should help identify and manage risks sooner in the process.

In relation to MEES, lenders should seek to understand whether the borrower is aware of associated risks and whether they have a business plan setting out the required improvement works (thereby improving the EPC rating) and any associated planned capex. A lender could also use this opportunity to discuss how sufficient funding can be allocated, as well as take the opportunity to assess other value creation opportunities that may exist for the property.

What sustainability information can lenders provide to their borrowers?

The BBP has created many resources, available at www.betterbuildingspartnership.co.uk, which will be of use to borrowers and that any lender can use as part of any borrower engagement strategy.



Wider sustainability considerations

Beyond the MEES legislation, there are many other sustainability considerations that impact commercial real estate investment. Though beyond the scope of this paper, we set out below the key considerations and initial thoughts on how a lender may wish to consider them in order to mitigate risk or identify value creation opportunities[4].

Risk mitigation

Flood risk is one obvious area of growing significance to investors, insurers and lenders. Flooding (surface water, ground water or coastal/river) can have a significant impact on the value of a property. It can cause damage requiring refurbishment works; result in the loss of rent if the building becomes incapable of being occupied or if access is restricted; increase the risk of insurance cover being withdrawn and even cause resale to become difficult/impossible. Arguably, the lending community is fairly adept in assessing and managing flood risk, but due to climate change its physical and commercial impacts are becoming more severe.

Building ratings and certifications that rate the sustainability characteristics of a property, such as BREEAM, LEED and WELLBuilding Standard, are increasingly seen within the real estate industry as a mark of quality and attractiveness. There's a growing body of research suggesting such sustainability characteristics can have a positive impact on value through higher rental premiums, higher occupancy rates and reduced obsolescence[5]. Therefore, lending against such properties should reduce the risk of the borrower's inability to make the repayments over the term of the loan. This is highlighted in a recent study from the University of Arizona that demonstrates a link between transport hubs, accessibility and sustainability ratings and reduced default risks of borrowers[6].

Additionally, the **sustainability credentials of the borrower** (as opposed to the properties) may be another aspect for consideration. A recent study by the University of Cambridge suggests a positive correlation between how well a REIT incorporates sustainability policies and management practices into its business operations (measured by its GRESB score[7]) and its financial performance in terms of returns on assets and returns on equity[8]. This would indicate that a property company that successfully embeds sustainability policies and practices into its business operations may be a lower risk customer for lenders.

Whilst the above two paragraphs (and the somewhat theoretical conclusions put forward) may be met with healthy scepticism, it helps to consider them from a different angle. The lack of sustainability credentials or ratings (at property or borrower level) may be an indication of higher risk and should therefore be reflected in rating models and risk premium. This is part of a shift from backward-looking to forward-looking risk perception.

Example international building rating and certification schemes

Beyond risk management

Understanding how sustainability risks, such as those highlighted in this paper, impact existing business models is essential for real estate lenders. However, we are now starting to see lenders move beyond a pure risk management perspective to explore opportunities to create value through:

- Securing new sources of funding from a more diversified investor pool;
- The development of new products and business models.

Investors are becoming increasingly conscious of the environmental performance of the asset classes into which their capital is invested. This is demonstrated by the growth over time of initiatives such as such as the Asset Owners Disclosure Project, CDP, Dow Jones Sustainability Index, FTSE4Good, GRESB etc. While much of the initial attention fell on equity investments, it is notable that the increased focus on the responsibilities of asset owners, as driven by the UN Principles for Responsible Investment, has led to greater scrutiny across wider asset classes. Just as the pressure is spreading across asset classes, so are the tools (such as the GRESB Debt Survey) that will help asset owners direct that pressure. As a result, alternative lenders, such as real estate debt funds, may soon witness a turning of the tide[9].

Additionally, there is a growing appetite from investors to go beyond simply understanding the sustainability impacts of their investments and seek out new investment opportunities that provide a financial return combined with an environmental and social benefit. Lenders have the opportunity to develop new lending products with a clear environmental or social purpose, as well as financial return e.g. through specifications for development finance, lending for the purpose of upgrading properties or providing cheaper debt for more sustainable properties.

Products such as this are already starting to emerge with FannieMae's green financing loan[10], where borrowers receive a 10 basis point reduction in the interest rate for multi-family properties with a green building ratings. Lenders then have the opportunity to securitise such loans providing the double benefit of not only creating a new product offering but one that will also attract a new type of investor. The growth of the green bond market for real estate financing demonstrates that the market is already heading in this direction with a number of banks and REITs (ABN-AMRO, ANZ, BerlinHyp and Stockland[11]) all issuing green property bonds over the past 12 months and others showing increasing interest.

Final thoughts

The introduction of Minimum Energy Efficiency Standards poses a material new risk for lenders. There is also a growing body of research suggesting that wider sustainability considerations will start to have a more tangible impact on commercial real estate lending. This is not a reason to panic, but neither can lenders continue to regard sustainability as something that doesn't affect them.

These risks can be managed through the practical steps outlined in this paper, and some lenders will see in them as an opportunity to go beyond risk management and enhance their customer relationships by supporting borrowers, or developing new products and business models that can unlock new sources of capital while also contributing to a more sustainable built environment.

The extent to which lenders attempt to monitor and mitigate sustainability risks and identify opportunities will ultimately be down to each individual lender and may become an area in which they compete (either in their relationships with borrowers, or in their relationships with investors/capital providers, or both). It should be clear that sustainability considerations within lending activities is a topic that's here to stay and its importance will only continue to grow.

1 CBRE European Commercial Real Estate Finance 2015 Update
2 Minimum Energy Efficiency Standards: the implications for rent review, lease renewals and valuation
3 Available to LMA members at www.lma.eu.com
4 CREFC Europe's Guidelines for Due Diligence on Real Estate in the UK provides a useful overview of the main issues the due diligence should address and specifically contains a section on sustainability (section D.2.11)
5 The Business Case for Green Building, World Green Building Council
6 Default Risk of Securitized Commercial Mortgages: Do Sustainability Property Features Matter?
7 Global Real Estate Sustainability Benchmark
8 The Financial Rewards of Sustainability: A Global Performance Study of Real Estate Investment Trusts
9 Why lenders should engage now…Before it's too late, Better Buildings Partnership
10 FannieMae Green Financing Loans
11 Climate Bonds Initiative

Authors

Christopher Botten
Programme Manager
Better Buildings Partnership

David Short
Chairman
BBP Commercial Real Estate Lending Working Group
Director
David Short Consulting Ltd

Acknowledgements

This paper has been developed through the work and with the support of the BBP Commercial Real Estate Lending Working Group. Consisting of assets managers and sustainability experts of real estate debt funds and institutional investors, as well as industry trade bodies, the Working Group provides a forum to share and develop best-practise around sustainability considerations for real estate lending. We welcome feedback on the paper and encourage those with an interest in the subject to get in touch.

The Building Centre
26 Store Street, London WC1E 7BT
info@betterbuildingspartnership.co.uk
www.betterbuildingspartnership.co.uk