Real Estate Lenders Consider Refusing Loans on ESG Grounds

Some lenders have broached refusing loans to real estate borrowers that can't meet certain ESG standards over concern their status might impact exits.

By Shayla Colon|October 4, 2023

Some real estate market lenders in Europe are considering not lending to borrowers if they can't meet certain environmental, social and governance, or ESG, criteria, and the conversation is slowly trickling over to the U.S.

"I've seen in the U.S. a lot of lenders talking about it, but I haven't seen it so much in practice yet," said **Jeanne Roig-Irwin**, a partner at **Clifford Chance**.

Lenders are especially discussing their concern over ESG obsolescence, the concept that in a few years a property that doesn't meet basic sustainable standards also won't be able to meet other financial or non-financial goals, she explained. Over time, a borrower also might not be able to refinance the asset or pay back the loan, she added.

The conversation has been more robust in Europe due to its stricter regulatory regime around sustainable investments. It's becoming increasingly uncommon in Europe to see real estate deals that lack ESG credentials, either on the equity or debt side, said **Jason Rozes**, a partner in the global finance group at **Dechert**.

Lenders in Europe are also thinking about how unmet ESG requirements can ultimately reflect or factor into their own sustainability ratings, either at a fund level or with regard to Sustainable Finance Disclosure Regulation, or SFDR, reporting.

"This is now happening a lot in Europe due to the SFDR. In terms of transparency, we have seen stuff that is trickling down not just to the U.S., [but] to Canada, Australia, as well as the U.K. in that sense," said **Robert Bluhm**, a sustainability officer at **Universal Investment**.

Real estate debt providers now often say they can only lend if borrowers meet certain key performance indicators, and in some cases will even offer a premium for hitting those marks, Bluhm said. Lenders offering premiums will often specify what the loan money can be used for and identify what performance indicators, such as lower carbon dioxide emissions, borrowers would need to meet, he said.

For now, real estate lenders are primarily asking borrowers to provide information and data around ESG performance indicators. There have been a few instances in which lenders in Europe declined to provide a loan due to unmet standards, but it's still "too early" to dub it a full-on trend, Bluhm said.

Even as such conversations are unfolding, other market players see opportunity to create new products specifically focused on "green" deal financing.

Green loan funds have yet to establish industry standards, but meeting ESG criteria often plays a big role in the investment, said **Tobias Schulten**, another Clifford Chance partner.

"There is some sort of natural selection on the lender side that they are concentrating more on those ESG compliant buildings, which makes it then automatically sort of a green loan," he said.

There's also more borrower demand for sustainable-oriented financing as owners and managers ask for loans that will help them cover the costs of making buildings greener, particularly as municipalities and states draft more laws around building performance standards, Rozes noted. There are at least 40 cities and states in the U.S. that have enacted laws requiring property owners to report on metrics such as electric and water efficiency or greenhouse gas emissions, he added.

Rozes said he is working with several U.S. lenders to educate them on the ins and outs of green financing, with some focused on standard deals but others on Commercial Property Assessed Clean Energy, or C-PACE, loans, he said.

While the U.S. has yet to form federal legislation around green buildings as in Europe, various several municipalities have building codes that incorporate LEED certifications and guidelines from the Green Building Council, Roig-Irwin said.

A recent study conducted by Ocorian found that 98% of alternative asset managers it surveyed indicated it will become harder to launch new funds unless they have a strong ESG focus. Managers said ESG has become "central" to fund investment decisions and will have the second biggest impact on innovation in asset management, with the first being pressure from investors for new advances in technology, the research showed.

Due diligence and underwriting for ESG considerations are likely to encompass an analysis of local laws and the cost of complying with them; third-party energy audits measuring water usage, energy efficiency and carbon emissions; and an evaluation of physical risk to properties from flooding, wildfires, hurricanes and droughts, Rozes explained.

Borrowers able to progress on such measures have gotten benefits from lenders such as rebates or lower interest rates in Europe, according to Rozes. That incentive hasn't yet arrived in the U.S., he said.

"It's a competitive landscape, and I think whichever lenders, whichever banks can create these types of programs first, there's a real first mover advantage," he added. "If they can show the market that they're doing this ESG lending in a credible way, in a repeatable way that makes sense, they're going to have an opportunity to do a lot of business before their competitors."