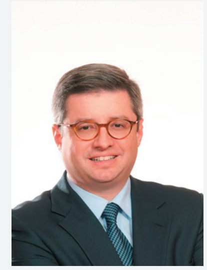
Sustainable Finance, Climate Change, ESG Criteria, and Real Estate: Are You Ready for a Sea Change?



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Introduction

In the aftermath of COP21 and the adoption of the Paris Agreement,[1] climate change has imposed its agenda on the global scene. Considered as a threat to human existence if no concerted action is undertaken, international organizations and world leaders are increasing the pressure for results to be achieved in the short term, to reduce our collective carbon footprint by 2050.

Among the priorities of the Paris Agreement is the need to develop a more sustainable finance system that will allow a transition to a greener and more resilient economy [I].

Our critical common path, however, is seen as an occasion to transform a threat into an opportunity, not only to change for the better but also for unprecedented economic growth.

In this fashion, the ESG criteria, which are trying to measure any progress made regarding **E**nvironmental, **S**ocial (or societal), and **G**overnance factors in any organizations, are more than ever at the center stage of this quest for a greener economy.

ESG criteria and climate-change-related risks will therefore have a huge impact on the real estate sector, estimated to be currently responsible for 39% of global-energy-related carbon emissions,[2] thereby creating opportunities for real estate lawyers [II].

As they adopt decarbonization strategies for their own businesses and assets, investors and financiers will increasingly require the same from companies before they invest or lend money to them.

Capital markets are therefore setting and imposing new standards by progressively mandating disclosure of climate-related matters and linking executive compensation to ESG targets.[3]

Securities lawyers will give advice on disclosure requirements, corporate lawyers will draft ESG policies, banking lawyers will work on banks' climate governance; real estate finance lawyers will see the normalization of "green loans"[4] and "green leases";[5] construction lawyers will adapt construction agreements accordingly; and lawyers practicing in mergers and acquisitions and compliance (regulatory and conformity), as well as in litigation, insurance, bankruptcy, and insolvency, will also be solicited.[6]

Of course, mandatory disclosure of ESG and climate-change-related risks and ESG criteria in and of themselves and as a movement are not without criticism.[7]

While acknowledging that this could be the object of much debate, the purpose of this article is not to discuss the merits of this new approach to finance nor to advocate in its favour, but rather to provide a general overview and introduction to this new area of law that is expanding rapidly and could not be ignored at the risk of being left behind, as this represents a major paradigm shift of capital markets that will have lasting effects. We will therefore express no opinion in that regard at this point, but will instead highlight some of the opportunities it will generate for legal practise.[8] More specific issues will eventually be addressed in subsequent articles.

I. Sustainable Finance: A New Approach for a Transition to a Greener Economy

The 26th United Nations Climate Change Conference of Parties ("COP26") was held in Glasgow, UK, from October 31 to November 12, 2021. The purpose of the summit was to bring parties together to accelerate action toward the goals of the Paris Agreement and the UN Framework Convention on Climate Change.[9]

COP26 had four goals: first, to secure global net zero carbon emissions by mid-century and keep the limiting of global warming to 1.5 oC within reach; second, to adapt to protect communities and natural habitats; third, to **mobilise finance**; and fourth, to make the parties work together to deliver on this ambitious agenda.[10]

Of interest to us is COP26's third goal, concerning the necessity to mobilise the world of finance [A], as such mobilization will bring significant changes both at the public and private finance levels.

In addition, the necessity to develop uniform sustainability disclosure standards that are focused on enterprise value, on a global scale, has been identified as a pillar for the world of finance that will allow the achievement of the objectives fostered by the Glasgow Climate Pact, adopted by the parties at COP26.[11]

Hence, the creation of the **International Sustainability Standards Board (ISSB)**, which will aim to develop and propose global and uniform ESG reporting standards, constitutes a major step in that direction [B].

A. COP26 and the Necessity to Mobilise Finance

A large consensus emerged from COP26 whereby "to achieve our climate goals, every company, every financial firm, every bank and investor will need to change."[12] Therefore, all forms of finance will need to contribute to this collective effort: public and private; domestic and international.

This paradigm shift is well described by the following summary:

To do this, every financial decision needs to take climate change into account:

1. This includes **all private investment decisions**, but also **all spending decisions that countries and international financial institutions are making** as they roll out stimulus packages to rebuild economies from the pandemic.
2. Companies need to **be transparent about the risks and opportunities** that climate change and the shift to a net zero economy pose to their business.
3. Central banks and regulators need to **make sure that our financial systems can withstand the impacts of climate change** and support the transition to net zero.
4. Banks, insurers, investors, and other financial firms **need to commit to ensuring their investments and lending is aligned with net zero.** [Our emphasis][13]

In terms of public finance, developed countries have pledged to assist developing countries in this transition process by funding more than $100 billion per year from 2020 to 2025, allowing the latter access to "climate finance." Such target was not met for 2020, but many developed countries have since then increased their pledges.[14]

In terms of private finance, the COP26 Private Finance Hub is working on four priorities to ensure that every professional financial decision takes climate change into account. In their objectives, they are focusing on the reporting, risk management, returns, and mobilization aspects of the private finance sector to develop the appropriate strategies and resources to make that happen. Simply put, "[t]he focus for the private finance work is to build the right framework so that the sector can allocate capital to manage climate risks and seize climate opportunities."[15]

Practically speaking, this means that the regulations, norms, and standards in the financial sector, whether formal or informal, will evolve and change rapidly, as they have already started to change.

The financial markets, the regulators, and the consumers are expecting to be informed of the manner in which the companies are managing their climate risks and whether they are seizing the opportunities to transition to a net zero business model. This "top-down" capital markets driven approach, which could be characterized as a *soft* harmonization of laws method,[16] is imposing itself on the world stage, as illustrated by the very recent creation of the International Sustainability Standards Board.

B. ESG Reporting and the Creation of the International Sustainability Standards Board

On November 3, 2021, during the COP26 Summit, the IFRS Foundation Trustees announced the creation of the International Sustainability Standards Board (ISSB), a new standard-setting board, to meet the demand of "international investors with global investment portfolios requiring high quality, transparent, reliable and comparable reporting by companies on climate and other environmental, social and governance (ESG) matters".[17]

The setting up of the ISSB had been in the making for some time.

In 2019–2020, as part of their strategy review conducted every five years, the IFRS Foundation Trustees identified sustainability reporting as a theme of pressing interest among their various stakeholders.[18]

In September 2020, they eventually released a consultation paper to find out whether there was a demand for global sustainability reporting standards, and if so, whether the IFRS Foundation should play a role and what would it be.[19]

In early 2021, a preliminary analysis of the consultations indicated that there was a demand for such standards and that the IFRS Foundation should play a role in this respect in establishing a new standard-setting body within the foundation in addition to the International Accounting Standard Board (IASB), the other IFRS Foundation standard-setting body, responsible for the IFRS Accounting Standards (mandated in more than 140 jurisdictions around the world). The International Organization for Securities Commissions (IOSCO) then announced it would work with the IFRS Foundation regarding the creation of the ISSB.[20]

As some have explained,

> [t]he ISSB's formation, first announced a year ago, is a response to criticism by investors and companies around the world that sustainability issues, such as climate risks and work force diversity, get reported using multiple frameworks that lack uniformity, creating unneeded complexity. This is in contrast with financial reporting, where standardization of accounting principles has long been enforced.[21]

In March 2021, the IFRS Foundation created two working groups, namely the Technical Readiness Working Group (TRWG), composed of existing organizations in the sustainability reporting area, and the Multilateral Working Group, which recommended the creation of the Sustainability Consultative Committee, an advisory forum to the ISSB under the trustees' oversight.[22]

In October 2021, the IFRS Foundation Constitution was amended to allow the creation of the ISSB.

In this journey leading to the launch of this new standard-setting body, Erkki Liikanen, chair of the IFRS Foundation Trustees, explained the purposes, approach, and first deliverables of the ISSB:

> […] Our shared ambition is to introduce a global baseline of standards for sustainability-related disclosures which are focused on meeting the information needs of investors globally when assessing enterprise value. **Enterprise value is a key concept, designed to capture expected value creation for investors in the short, medium and long term, and is interdependent with value creation for society and the environment.**
>
> For example, the global baseline might describe how companies should disclose the impact of climate-related risks and opportunities, and, for each identified risk and opportunity, the impact on its financial performance. This could include capital allocation plans, supply chain innovation or investments in technology or new business areas.
>
> **The new board would begin with climate.** Its work would be expected to move with pace to consider other sustainability-related issues important for enterprise value.
>
> **This investor focus on enterprise value is where the IFRS can contribute most.** While the proposed board would work on sustainability-related disclosure standards, its work would be complementary to the work of the [International Accounting Standard Board] IASB. Sustainability related factors are already connected in the financial statements. Investors are interested in information about sustainability irrespective of its location within the financial statements or in broader reporting. […] [Our emphasis][23]

The ISSB will thus develop global sustainability standards that will cover important sustainability topics (e.g., environmental, social, and governance – ESG), starting with climate, with the intent to develop both thematic and industry-based requirements, with a focus on enterprise value.[24]

In this endeavour, the ISSB is not starting from scratch. Indeed, other existing sustainability standard-setters, including the Climate Disclosure Standards Board (CDSB), the IASB, the Task-Force for Climate-related Disclosures (TCFD), the Value Reporting Foundation (VRF, at the origins of the Integrated Framework and the SASB Standards), and the World Economic Forum, have joined their forces and regrouped within the ISSB's Technical Readiness Working Group (TRWG), allowing the ISSB to build on those existing initiatives and to give it a "running start."[25]

On November 3, 2021, at the ISSB's inception, its TRWG published two prototypes and a summary document as recommendations for consideration by the ISSB.[26] Those documents, until adopted by the ISSB pursuant to the IFRS Foundation's due process is intended to be informative only but will certainly provide guidance in companies' reporting until then.

In this fashion, the summary document explains the composition, objectives, deliverables, and agenda of the TRGW.[27] The General Requirements Prototype[28] is considering general requirements for disclosing sustainability-related financial information relevant to the sustainability-related risks and opportunities an enterprise will encounter. The Climate Prototype[29] is providing requirements for the identification, measurement, and disclosure of climate-related financial information.

Even though it is said that the ISSB does not intend to foster or impose the adoption of clear policy framework by governments, but rather to provide a global baseline of standards for sustainability-related disclosures,[30] leaving it to jurisdictional authorities to decide whether to mandate use of the ISSB's standards, the ISSB work will inevitably have an impact on the policy approaches to be articulated in each different country, as "the ISSB will engage with a range of stakeholders in its standard-setting, including jurisdictions. The Trustees have established a working group to create a mechanism for formal engagement on standard-setting between the ISSB and jurisdictional representatives, including those from emerging markets."[31]

The ISSB's central offices will be in Frankfurt (the seat of the board and the office of the chair) and Montréal, working together in charge of key functions supporting the ISSB and to develop cooperation with regional stakeholders. Complementary offices in San Francisco and London will provide technical support for market engagement and encourage cooperation with regional stakeholders. ISSB will commence work early in 2022.[32]

The announcement of the hosting of one of the ISSB's central offices in Montréal was welcomed with great enthusiasm, not only by government officials,[33] but first and foremost by the players of the financial sector in Québec,[34] who had previously joined forces in October 2021 to tackle the climate emergency and social inequalities in their *Statement by the Quebec Financial Centre for a Sustainable Finance*. [35]

This statement was signed and supported by over 20 institutions representing more than CAD $900B in assets under management. The signatories acknowledged that "[t]he future of finance must be sustainable and promote the integration of environmental, social and governance (ESG) considerations in investment and capital allocation decision-making"; they pledged to promote and uphold this vision, within their organizations and in their assets or loans portfolios, and to be held accountable by a clear reporting mechanism of their activities.[36]

Thus, investors and financiers, both in Canada and globally, are becoming central in the transition to a low-carbon economy and the reduction of climate risk. This phenomenon has been described as a new form of private environmental and climate governance, whereby

> […] rather than government regulators dictating compliance with environmental standards to address climate risks and promote sustainable economic activities, banks themselves are acting as change agents with respect to their lending portfolios in the first instance and also, in some cases, in regard to their securities underwriting and asset management businesses.[37]

One area to experience these new developments is the real estate sector, as it will be deeply reshaped by ESG criteria compliance (and its disclosure) in response to climate change for a transition to a greener and more resilient economy.

II. ESG Criteria and Climate Change Risks: Some Considerations on Their Impact in Real Estate

Considering the carbon footprint of the real estate sector and with a view to achieving the net-zero objective by 2050, its various players will be under great pressure to integrate ESG criteria and to properly assess climate-change-related risks in their business model, to respond to the increase of ESG and climate-change-related disclosure requirements [A], as many aspects are at play.

Decarbonization strategies of existing assets and net (or zero) carbon strategies for new assets, including "green leases," will become mainstream in most economies, as it is already the case in many jurisdictions, notably in the European Union [B].

A. Integrating ESG Strategy as a Response to Disclosure Requirements

ESG and climate-change-related risks and opportunities disclosure requirements, as they will increasingly become the norm, will certainly be key for the transitioning of the real estate industry to a net zero business model by mid-century and, optimistically, by achieving this net-zero objective.

However, there is currently no uniformity regarding such disclosure requirements, whether they are considered from one jurisdiction to another, or from one entity to another (e.g., public issuers or private companies), or by industry sectors, or by categories of assets, or by types of investors or lenders (e.g., banks, pension funds, private equity funds) and whether they are mandated or to be disclosed on a voluntary basis only.[38] The ISSB work will hopefully bring more certainty in an area where it is mostly needed.

In Canada, corporate directors, in exercising their powers and discharging their duties, shall not only act honestly and in good faith in pursuing the best interests of the corporation, and exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances, but in doing so, they *may* also consider the interests of shareholders, employees, retirees and pensioners, creditors, consumers, governments, the environment, and the long-term interest of the corporation.[39]

It has been interpreted, considering Canadian case law, as requiring the directors' engagement and consideration of climate-change-related risk, imposing on them a positive duty to act accordingly.[40]

Also, even though public (or reporting) issuers have to disclose some information in their annual notice or management report with respect to the environment, no precise disclosure is required regarding climate-change-related risks or opportunities per se, other than on a voluntary basis and according to guidelines proposed by the Canadian Securities Administrators (CSA).[41]

But this is all about to change, as the CSA recently published a proposed National Instrument 51-107 Disclosure of Climate-related Matters and its companion policy, that would, if adopted, introduce disclosure requirements regarding climate-change-related matters for reporting issuers (other than investment funds).[42] Similar developments are under consideration in many other jurisdictions, including in the United States.[43]

As the regulatory landscape will evolve rapidly in the coming years, stakeholders in the real estate sector will need to be vigilant and adapt to these changing—and challenging—realities. While being in a state of flux on our side of the Atlantic, it is interesting to look at the European Union and to some of its member states, notably France, which have enacted more precise disclosure requirements for a longer period, and for which the real estate sector has already had some experience.

B. Decarbonization Strategies, Including Green Leases

Four months ahead of COP21, France adopted its Energy Transition for Green Growth Act.[44] President François Hollande explained that it aimed "to make France—following on from the Paris Climate Summit—an exemplary nation in terms of reducing its greenhouse gas emissions, diversifying its energy model, and increasing the deployment of renewable energy sources."[45]

Pursuant to this statute, France became the first country in the world to mandate disclosure of ESG and climate-change-related risks information from investors, with a view to direct investments toward greener and more responsible stakeholders and assets.

More stringent obligations were imposed on investment firms with assets under management exceeding €500M, but disclosure information obligations were as well imposed on smaller firms.

Among others, larger firms are required to report on the integrating of ESG criteria and climate-change-related risks in their investment policies. As a result, property managers have been forced to increasingly provide information on their ESG-climate practices and impacts.[46]

Another central feature of France's Energy Transition for Green Growth Act is to ascertain a green transition of the real estate sector, by speeding up the energy renovation of housing and improving the energy performance of new buildings while encouraging a circular economy to develop. Such "circular economy" implies the limiting of the consumption of raw materials, the reducing of household waste, and the recovering of construction and civil engineering waste.[47]

Afterwards, similar measures have been adopted at the European Commission level, as part of the European Green Deal,[48] including the EU Sustainable Finance Disclosure Regulation[49] and the EU Taxonomy Regulation 2020/852.[50]

For the construction industry, this means optimizing the use of resources, reducing emissions and waste, and extending the lifespan of assets, such goals being in line with those expressed by industry leaders such as the World Green Building Council.[51]

In addition, industry stakeholders will seek to ensure that their buildings are resilient or "climate-proof"; in other words, that they are prepared for and can recover from natural disasters. Property managers will, in turn, adopt best practices that optimize the operation and maintenance of the building, including energy costs, waste management, and the well-being of their tenants.[52]

One of the tools available to property managers to achieve ESG and climate-change-related risks best management practices is the "green lease," which has been defined as a lease "where building owners and tenants collaborate to reach voluntary agreements with regard to energy saving and other environmental burdens of real estate as well as improvements of indoor environments through contracts, memorandums of understanding (MOU) and implement the contents of these agreements".[53]

While green buildings certifications such as LEED, WELL, DGNB, BREEAM, ÖGNI are already market standards, "green leases" will become more important as this transition to a green economy unfolds, not only for financial market participants and large real estate companies, but also for other property owners, as it will, for instance, confer a higher resale value to the property, offer better financing conditions, and generate higher rents.[54] In some European jurisdictions, green leases have become standardized and common practice.[55]

In 2014, the U.S. Department of Energy's Better Buildings Alliance and the Institute for Market Transformation launched the "Green Lease Leaders" national program, which sets standards for what constitutes a green lease and recognizes cross-sector landlords and tenants for creating and implementing those leases, including the "Green Lease Library," which offers a collection of green leasing resources.[56]

Conclusion

As the standards, norms, and regulations evolve regarding ESG criteria and climate-change-related risks, lease agreements, but also many other agreements or policy documents, will need to be implemented by the various stakeholders and adapted to various circumstances and industry areas, including real estate.

It is up to us to make our contribution to this collective effort, and I like to think there is an opportunity for the American College of Mortgage Attorneys to make our voice heard, including, when warranted, to challenge the assumptions pursuant to which the practise is developing. Are you ready for a sea change?

Endnotes

1 The Paris Agreement was adopted by the Conference of the Parties under the United Nations Framework Convention on Climate Change on its 21st session ("COP21"), held in Paris from 30 November to 13 December 2015, https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement/key-aspects-of-the-paris-agreement; Decision, *Adoption of the Paris Agreement*, 1/CP.21, UNFCC, 2015, 21st Sess, UN Doc FCCC/cp/2015/10/Add.1: https://unfccc.int/resource/docs/2015/cop21/eng/10a01.pdf.

2 According to the World Green Building Council, "[b]uildings are currently responsible for 39% of global energy related carbon emissions: 28% from operational emissions, from energy needed to heat, cool and power them, and the remaining 11% from materials and construction. [Our] vision to fully decarbonise the sector requires eliminating both operational and embodied carbon emissions." World Green Building Council, News Release, "New report: the building and construction sector can reach net zero carbon by 2050" (23 September 2019), https://www.worldgbc.org/news-media/WorldGBC-embodied-carbon-report-published; to consult the report, see also World Green Building Council, "Bringing Embodied Carbon Upfront: Coordinated action for the building and construction sector to tackle embodied carbon," September 2019, https://www.worldgbc.org/news-media/bringing-embodied-carbon-upfront.

3 Mark Segal, "AllianzGI to Vote Against Companies That Fail to Link Exec Pay to ESG Goals," *ESG Today* (24 February 2022), https://www.esgtoday.com/allianzgi-to-vote-against-companies-that-fail-to-link-exec-pay-to-esg-goals/.

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5 Please see our discussion, below, *infra* notes 53 to 56.

6 For the risks climate change poses to financial institutions, please see Janis Sarra & Elisabeth (Lisa) DeMarco, Climate-Related Legal Risks For Financial Institutions: Executive Brief, Global Risk Institute, August 2021, https://ccli.ubc.ca/resource/climate-related-legal-risks-for-financial-institutions-executive-brief/.

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9 COP26 website, https://ukcop26.org.

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12 COP26 website, https://ukcop26.org/cop26-goals/finance/.

13 *Id.*

14 Glasgow Climate Pact, *supra* note 11, par. 41, 43 and 44.

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19 *Id.*

20 *Id.*

21 Jeffrey Jones & James Bradshaw, "Canada loses bid to host corporate sustainability data office to Frankfurt at COP26, but gets a secondary hub," *The Globe and Mail* (3 November 2021), https://www.theglobeandmail.com/business/article-canada-loses-bid-to-host-corporate-sustainability-data-to-frankfurt-at/.

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23 Erkki Liikanen, "Is there a path to global sustainability standards?" (keynote speech delivered at the CFA Institute's Global Financial Regulatory Symposium, 29 June 2021), https://www.ifrs.org/news-and-events/news/2021/06/is-there-a-path-to-global-sustainability-standards/.

24 ISSB's website, https://www.ifrs.org/groups/international-sustainability-standards-board/issb-frequently-asked-questions/.

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29 IFRS Foundation, Technical Readiness Working Group – International Sustainability Standards Board, "Climate-related Disclosures Prototype," November 2021, https://www.ifrs.org/content/dam/ifrs/groups/trwg/trwg-climate-related-disclosures-prototype.pdf.

30 Liikanen, *supra* note 23.

31 ISSB's website, https://www.ifrs.org/groups/international-sustainability-standards-board/issb-frequently-asked-questions/.

32 *Id.*

33 Department of Finance Canada, Statement, "Deputy Prime Minister welcomes announcement of International Sustainability Standards Board office in Canada" (3 November 2021), https://www.canada.ca/en/department-finance/news/2021/11/deputy-prime-minister-welcomes-announcement-of-international-sustainability-standards-board-office-in-canada.html. For some, however, this comes as a "consolation prize for Canada," as the head office and chair will nevertheless be located in Frankfurt. Please see, in that respect, Jeffrey Jones & James Bradshaw, *supra* note 21.

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[36] *Id.*

[37] Sarah E. Light & Christina P. Skinner, Banks and Climate Governance, 121 Colum. L. Rev. 1895 (2021), 1898.

[38] Pierre-Olivier Charlebois, David Heurtel & Mélina Cardinal-Bradette, "La divulgation des risques liés aux changements climatiques: la transparence comme moteur de changement et de création de valeur à long terme," in Barreau du Québec – Service de la formation permanente, ed, *Développements récents en droit de l'environnement* (2020) (Montréal: Éditions Yvon Blais, 2020), https://edoctrine.caij.qc.ca/developpements-recents/487/369112835.

[39] *Canada Business Corporations Act*, RSC 1985, c C-44, ss 122(1) and (2).

[40] *Commonwealth Climate and Law Initiative/Canada Climate Law Initiative, Primer on Climate Change: Directors' Duties and Disclosure Obligations – In support of the Principles for Effective Climate Governance*, January 2021, at pp 39-43, https://ccli.ubc.ca/resource/primer-on-climate-change-directors-duties-and-disclosure-obligations/. This primer is offering a survey of directors' duties and disclosure obligations in several jurisdictions, including the United States, United Kingdom, France, Germany, and Australia, with practical recommendations for directors to consider.

[41] CSA Staff Notice 51-358 Reporting of Climate Change-related Risks, 1 August 2019, https://www.osc.ca/en/securities-law/instruments-rules-policies/5/51-358/csa-staff-notice-51-358-reporting-climate-change-related-risks. See also, in such respect, Pierre-Olivier Charlebois, David Heurtel & Mélina Cardinal-Bradette, *supra* note 38, at p 198, where they explain that this "staff notice" does not create new legal disclosure obligations regarding climate change-related risks but brings more clarity as to what type of information should be disclosed in such respect.

[42] Canadian Securities Administrators, Consultation – Climate-related Disclosure Update and CSA Notice and Request for Comment Proposed National Instrument 51-107 *Disclosure of Climate-related Matters* (18 October 2021), https://www.osc.ca/sites/default/files/2021-10/csa_20211018_51-107_disclosure-update.pdf. This paper was open for comments to the public until January 17, 2022, and the deadline was extended to February 16, 2022. It provides a survey and status update of similar initiatives in Canada and globally. It is worth noting that the implementation of this national instrument will require the approval of the provincial governments in Canada once the review process is completed, as they have jurisdiction over such matter (not the federal government).

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