Embedding sustainability in commercial real estate lending

Blog

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The UK has set ambitious targets to reach net zero greenhouse gas emissions by 2050. This will require changes across all sectors of the economy, including real estate. Property lenders have important roles to play in supporting the transition to more sustainable buildings, but there are some important factors to consider.

First, sustainable lending products must remain accessible for brokers and their borrowers. The incentives and benefits for landlords to improve energy efficiency need to be balanced with keeping financing solutions open.

Second, lenders should consider looking beyond just EPC ratings to encourage meaningful sustainable improvements. While EPCs provide a baseline measurement, more holistic measures of environmental performance and social impact are needed. "Sustainable tenancies" that enable long-term covenants are the future. Through smart building features, sustainable improvements and technology upgrades that lower utility costs and improve productivity, properties can address climate change concerns while becoming more attractive to tenants.

Last, lenders must anticipate that most UK properties will require retrofitting and refurbishment to comply with future regulations. Getting ahead of these changes through financing incentives will allow landlords to futureproof assets.

Lenders currently tend to position green financing products as niche offerings. However, there is a clear need and opportunity for sustainability to become integral to mainstream lending. By embedding sustainability criteria into standard lending practices, lenders can help steer the market toward low-carbon properties and support national climate goals.

Firms like TAB are leading the way with products designed to encourage sustainable outcomes. TAB's new commercial mortgage offering goes beyond EPC ratings and provides discounted exit fees for borrowers who meet positive ESG benchmarks. At the end of the loan term, borrowers are rewarded with reduced exit fees if they can demonstrate sustainability improvements. This is an example of how lenders can shift green financing from a niche product to a core part of their lending strategy. By making sustainability incentives available to as many borrowers as possible while letting them opt in based on their goals, lenders make environmentally conscious practices mainstream.

Other lenders need to follow suit by embedding sustainability criteria into their standard mortgage offerings. This includes defining what constitutes a "sustainable" property. Robust data collection and metrics are key to tracking the performance of buildings in lender portfolios, data will be the driver to the success.

Government and industry bodies can assist by providing frameworks, data infrastructure and consistent standards around sustainable properties. For example, the EU Taxonomy sets out technical screening criteria to determine whether assets qualify as green under its sustainable finance classification system. TCFD (Task Force on Climate-Related Financial Disclosures) has been formed to help companies provide better information to investors, lenders and insurance underwriters about the risks and opportunities posed by climate change. By following these recommendations, companies can provide more consistent, comparable and reliable climate-related financial disclosures. Which in turn helps with underwriting decisions.

Lenders should also consider incorporating sustainability risks into regular credit risk modelling and due diligence. Energy efficiency directly impacts operating expenses, asset values and rental income potential. Poor housing quality could deter tenants, undermining sustainable tenancy goals. Climate change also directly affects properties located in areas vulnerable to more extreme weather - for example, a risk map plotted by Climate Central shows that if the current rate of sea level rise continues, by 2050 Peterborough could find itself completely underwater. By accounting for these environmental risks, lenders can more accurately price sustainability features into their lending products.

Financial incentives like preferential rates, discounts and extended loan terms can be structured around meeting energy and emissions targets. This encourages developers and landlords to implement sustainability features that reduce operating costs over the long term.

Government policy can also play an enabling role. Adjusting regulations around permitted development rights based on sustainability criteria will motivate more comprehensive green retrofits. With a requirement for 340,000 new homes in the UK each year, there are 676,000 houses vacant and one in four privately rented properties fail to meet decent home standards. An adjustment to policy and sustainable financing could form part of the solution. Tax incentives for energy efficiency investments further support the business case.

The potential rewards are immense for lenders who position themselves at the forefront of sustainable finance. As tenant demand and regulatory pressures drive the transition to low-carbon buildings, lenders positioning themselves at the forefront will benefit the most. While embedding sustainability takes time, by proactively implementing environmental criteria into commercial mortgages, UK commercial property lenders can make a meaningful contribution towards net zero goals.

As seen in NAFCB Commercial Broker magazine.

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