The Legal 500
Country Comparative Guides
Hot Topic | Real Estate

Esg Legislation And Real Estate In The European Union And Italy. Overview, Effects And Prospectives.

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ESG LEGISLATION AND REAL ESTATE IN THE EUROPEAN UNION AND ITALY. OVERVIEW, EFFECTS AND PROSPECTIVES.

1. Meaning and scope of the concept of ESG. Impact of real estate on ESG.

The acronym ESG (environmental, social, governance) indicates the combination of those qualifying factors that enhance social and personal living experience by improving, protecting and making sustainable economic growth and human activities in general. Sustainability is, in fact, the ultimate goal of the debate around ESG.

In this regard, understandably in the most recent years the attention has primarily focused on those threats to sustainability stemming from the climate change as an effect of the carbonization of the atmosphere. The following are a few numbers that will give the sense of the impact of real estate on carbon emissions in the European Union.

Within the EU, buildings account for:

- 50% of the fine particulate matter (PM2.5) emissions that cause premature births and illness,
- 40% of final energy consumption
- 36% of its energy-related greenhouse gas emissions

Also, buildings are energy-inefficient in 75% of the cases, since they largely depend on fossil fuel, including natural gas for 42%, oil for 14% and coal for 3%.

The following table provides an impressive visual impact of the contribution of buildings to the total carbon emissions in some of the largest cities in the world:

2. The sources of ESG standards: international agreements and EU legislation.

2.1 Standards and goals.

The current internationally accepted standards and goals aimed at curbing the climate change are to be found in three main sources:

The UN Sustainable Development Goals (2015): also known as the Global Goals, were adopted by the General Assembly of the United Nations on September 25, 2015, and set forth 17 Sustainable Development Goals, expanded into 169 targets for 2030.

The Paris Agreement (2015): is a legally binding international treaty on climate change, adopted by 196 Parties at the UN Climate Change Conference (COP21) in Paris, on December 12, 2015 and entered into force on November 4, 2016. It sets the goal of the global warming not to exceed 2 C° above pre-industrial (1850) levels.

The EU Green Deal: is a package of policy initiatives presented by the European Commission on December 11, 2019***,*** setting the goal of the EU to:

- 2050 zero carbon emissions
- Economic growth independent from use of natural resources
- EU «Fit for 55» package which sets the target of -55% carbon emissions by 2030 with respect to the 1990 level (Reg. 2021/1119).

It is noticeable that, while the importance of lowering carbon emission has been recognized in major international treaties and agreements, ESG has not translated in major pieces of legislation in most developed countries, with the notable exception of the EU and its member states, which, in fact, have become the forerunners in the effort of turning ESG into rules and codes of conduct that should ultimately lead to the achievement of the ESG goals.

2.2 EU legislation addressing ESG internationally recognized principles.

The European Union has been the most prolific institution in the production of legislation on ESG principles, ranging from carbon emission limitations, disclosure, corporate governance and building regulations. However, for the purposes of this article, in this section we will focus our attention in particular on the following EU legislation:

- Regulation 2019/2088 (Sustainable Financial Disclosure Regulation (SFDR)),
- Directive 2020/852 (Taxonomy Directive),
- Directive 2022/2464 (Corporate Sustainability Reporting Directive (CSRD)).

2.2.1 The SFDR Regulation.

The SFDR Regulation 2019/2088 sets forth financial markets participants transparency and financial disclosure obligations in financial reports on ***(i)*** the ESG policy of the financial players/institutions and ***(ii)*** the ESG impact and characteristics of the financial products being traded.

An important feature of this regulation is the definition of "*sustainable investment*" (under Art. 2, 17) and the imposition of common rules for different categories of financial operators on the disclosure of information on sustainability issues. According to this Regulation, financial operators and advisors must disclose data on how they take environmental, social, and governance (ESG) factors into account in the processes they follow to make investment decisions and in all financial products they sell in European markets. Specifically, each financial entity must disclose on its website how it integrates sustainability risks into its decision-making processes and how its compensation policies are consistent with risk integration. The ways according to which it identifies, analyzes, and commits to reducing the negative impacts of its investment policies on sustainability factors shall also be disclosed and, if such information is not available, the company shall explain the relevant reason (*address or explain* approach).

In addition, financial products information on how sustainability risks are factored into investment decisions and what consequences they might have on returns will also need to be disclosed, together with information on the negative impacts of investment policies on sustainability factors.

Finally, SFRD regulation requires that more detailed information shall be disclosed in relation to products defined as "*sustainable*" according to the definition provided by the same regulation. In particular, these are products that promote environmental and/or social characteristics (as described under Article 8), i.e., products that incorporate certain sustainability criteria in the investment process in a binding manner and products that target sustainable investments (as described under Article 9).

2.2.2 The Taxonomy Regulation

European Regulation n. 2020/852 introduced into the European regulatory system the taxonomy of environmental oriented economic activities, *i.e.* the classification of activities that can be considered sustainable based on alignment to European environmental objectives and compliance with certain social clauses.

The Taxonomy Regulation sets forth technical criteria for determining under what conditions each economic activity makes a substantial contribution, *inter alia*, to at least one of the six identified environmental objectives (*i.e.*, climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems) without causing significant harm to any of the other five which are included in this regulation and the ones related to the same.

The Taxonomy Regulation also provides instructions on how to set corporate policies implementing greater environmental sustainability, and to report in a more comprehensive way, to: ***(i)*** stakeholders and investors, to the effect that they are in the position to understand the environmental impact of the economic activities in which they invest or may invest and can include sustainability issues into their own investment policies; and ***(ii)*** public institutions, so that they use the vocabulary and measurement instruments provided by the taxonomy to define and improve their policies on ecological transition.

2.2.3 The Corporate Sustainability Reporting Directive

The CSRD – amending the European Non-Financial Reporting Directive n. 2014/95, or "NFRD" – provides further reporting (including non-financial reporting) obligations for thousands of companies throughout Europe, starting from financial year 2024, for reports published in 2025.

The companies subject to the CSRD include:

– non-listed companies meeting at least two of the following requirements: ***(i)*** 250 average number of employees, ***(ii)*** asset value of no less than Euro 20 million, ***(iii)*** annual revenues of no less than Euro 40 million;

– listed small to medium sized enterprises, including small financing entities and insurance companies;

– enterprises and branches having extra European parent companies generating in the European Union net revenues of more than Euro 150 million for each of the last two consecutive exercises and at least ***(i)*** a subsidiary having CSRD size requirements or ***(ii)*** a branch having generated revenues of more than Euro 40 million in the previous year.

Disclosure and reporting requirements will become effective as of 2024 for Relevant Entities of Public Interest[1] (2025 reporting on 2024 fiscal year), 2025 for large non-listed companies (2026 reporting on

2025 fiscal year), 2026 for listed small to medium sized enterprises, including small financing entities and insurance companies (2027 reporting on 2026 fiscal year).

The companies subject to this Directive are bound to prepare and publish ESG sustainability reports in accordance with the European Sustainability Reporting Standards ("ESRS"), adopted by the Commission in July 2023, which shall be available online and included in the management reports to be certified by certified statutory auditors.

Sustainability reports shall include information on material impacts, risks and opportunities on value chain of sustainability measures as resulting from due diligence activities, materiality analysis and sustainability risks assessments.

2.2.4 Aims and effects of the Financial Sustainability Disclosure Regulation, the Corporate Sustainability Disclosure Directive and the Taxonomy Directive on the real estate industry.

As the reader may have appreciated from our overview, almost none of the directives, regulations, treaties, and agreements referenced above seem to talk about real estate in particular, nor to establish binding rules affecting how buildings should be constructed, equipped or used. So, what is the aim and the effects, if any, of this mass of rules, specifications and requirements that is contained in the EU and member states' legislations?

There are at least three order of effects that we see happening, on ***(i)*** the corporate behavior of the participants to the real estate industry, ***(ii)*** the investors' behavior and ***(iii)*** the financing parties behavior.

On the first point, all participants to the real estate market, to include investment funds, asset managers, real estate traders of advisors, developers and constructors are including in all information, documentation and contracts regarding their own action and business plans or the implementation of these instruments, information focusing on addressing or explaining how they are dealing with ESG issues. This will provide any stakeholder, regulator and any other individual or entity dealing with such participants, the opportunity to assess their position and, ultimately, future value, resilience and looking forward ability in their business planning or, in short, the business risks related to their activity.

On the second aspect (investors' behavior) the effect is being symmetrical: anyone investing, assessing, or advising in relation to the financial real estate products (being the units into any fund or any other equity instrument being invested or participated to) will appreciate, thanks to the EU taxonomy, the investment value and risks carried out by such financial instruments. It is imaginable that this transparency as to the underlying real estate products held or traded by the disclosing entity will inevitably orient also the behavior of the disclosing entity itself, which will be driven towards compliance with all good practices that will define them as "ESG compliant" businesses.

As to the third aspect, subject to our additional coverage of financial related issues of section 6 below, it is common experience of anyone involved in real estate financing that, especially in days of expensive and risk adverse lending, it is becoming more and more evident how difficult financing real estate products and developments which do not carry sufficient evidence of their belonging to "ESG compliant" products or investments is. In addition, the flow of public or state grants, aids and financial support (including insurance and guarantees) that is coming from the EU and national level recovery plans from the effects of the pandemic and the actual/threatened recession, will focus primarily on ESG investments *i.e.*, in our case, existing, under renovation or newly constructed buildings. This will in turn drag more private financing towards such ESG compliant assets.

3. Prospective Regulations

3.1 Energy Performance of Buildings Directive (EPBD)

The Energy Performance of Buildings Directive 2010/31/EU promotes policies that will help achieve a highly energy efficient and decarbonized building stock by 2050. It has been amended in 2018 by Directive 2018/844/EU and the Parliament and the Council are currently in interinstitutional negotiations for further amendments. It purports to cover methodology of ESG sustainability performance and minimum performance requirements for renovation works in both existing and new buildings. Furthermore, it aims to and recommends, *inter alia*, the use of sustainable construction materials and reduction of like-cycle energy consumption and carbon emissions, the adoption of energy consumption certifications adopted at national level, the repelling of fossil fuel in heating systems for new buildings or «deep renovations», the development of public-private partnership to foster ESG sustainable projects, the promotion of long term renovations with long term contracts and of district or neighborhood programs for building or urban renovations or regenerations.

3.2 Member State Legislation. The Italian Case

The environment as a constitutional value

Notably, EU directives, as opposed to Regulations, have limited direct enforceability in that they rely on national legislation for their implementation.

Italy has, however, not remained idle in this respect. In response to the increasing concern and amount of legislation expressed by the EU, Italy has, first and foremost, amended Articles 9, paragraph 3, and 41, paragraph 2, of the Italian Constitution, providing that the Italian Republic "*protects environment, biodiversity and ecosystems, also in the interest of future generations*" and that private economic initiative "*may not be carried out in conflict with social utility or in such a way as to be detrimental to health, the environment, security, freedom and human dignity*."

In order to address more closely environmental issues, which as we have seen have been elevated to constitutional level, a new dedicated ministry has been created, *i.e.* the "Ministry of Environment and Energy Security", following the enactment of Art. 2, paragraph 1, of Law Decree n. 22 of March 1, 2021, converted with amendments into Law n. 55 of April 22, 2021, on "*Urgent provisions on the reorganization of the attributions of ministries*". The main attributions of the Ministry include, pursuant to Art. 35(2)(b) and (c) of Legislative Decree n. 300 of July 30, 1999, as amended by Law Decree n. 22 of 2021, in particular: ***a)*** the definition of the objectives and guide lines of national energy and mining policy; ***b)*** the authorization of energy production plants under state jurisdiction, including those from renewable sources, and those located at sea; ***c)*** plans and measures regarding alternative fuels and related distribution networks and facilities for the recharging of electric vehicles; ***d)*** policies to mitigate climate change and supporting financing.

The institution of this ministry is closely functional to the achievement of the goals set by the NRRP

(National Recovery and Resilience Plan), and specifically in "Mission 2," which is the mission relating to the green revolution and the ecological transition.

The National Recovery and Resilience Plan (NRRP). The government backed financial incentives for real estate ESG friendly investments.

As part of the EU-wide effort to provide financial support to the economic recovery after the pandemic and to mitigate the consequence of an economic worldwide scenario of high interest rate, inflation and a looming recession, the Italian cabinet has approved on January 12, 2021 a recovery plan, to be implemented mostly with EU funds and in cooperation with the EU, *i.e*, the National Recovery and Resilience Plan (NRRP), which introduces *inter alia*, significant incentives to renovate existing public and private real estate assets.

In particular, the PNRR has given the opportunity to significantly re-finance the economic incentive programs sponsored by INVITALIA SpA. This is an Italian government agency, incorporated in the form of a corporation with shares, entirely owned by the Italian central government, which scrutinizes and ultimately finances investment in business activities, through either debt financing, at reduced interest rates, or, alternatively, one-off non-refundable cash grants, which in the aggregate may cover up to 75% of the total investment. Similar financing and grants are also being organized and funded at Regional Level through variously featured schemes modelled on the INVITALIA pattern.

Most of the inflows of public monies coming from these programs include, either as a pre-condition or a highly scoring feature in the ranking of the financing requests from investors, the fact that any subsidized investment, in so far as real estate is concerned, are characterized by their compliance with ESG standards, in accordance EU and National legislation.

*The census and certification of the energy performance of the Italian real estate stock of assets***.** *The "APE".*

Energy Performance Certificates (EPCs) are documents outlining the energy efficiency of a building and providing valuable insights into its environmental impact, which are playing a crucial role in ESG compliance within the real estate sector, particularly in the European Union (EU).

The certification process involves an assessment of various factors, including insulation, heating systems, and renewable energy sources use.

In general, by assigning a grade, typically ranging from A to G, where "A" represents the most energy-efficient structures, and "G" denotes the least efficient, Energy Performance Certificates can have an important role in green-oriented investments since they offer transparency to potential buyers, tenants, and investors enabling informed decision-making by providing a clear understanding of a property's environmental performance and by increasing the market value of the buildings due to reduced operating costs and a smaller carbon footprint.

Since the year 2005 (Legislative Decree n. 192 of August 19, 2005) Italy has introduced legislation to the effect that, *inter alia,* buildings be provided (with the exception, by and large, of those which do not require or carry energy consuming technical equipment) with the Italian Energy Performance Certificate ("**APE**"). The APE describes the energy characteristics of a building, with a scale from A4 to G (10-letter scale) of the energy performance of buildings and is mandatory when selling or renting a property. The validity of an APE is, in most cases, 10 years and, in order to maintain such validity, one must commission technicians to ensure that mandatory inspections required by law are carried out within the provided timeframe.

Since January 2012, energy performance indices (value in kWh/sq m per year) must be included in real estate advertisements. It is not mandatory in the case of renting or selling a property for which there is already a valid APE certification and no renovations or alterations have been made.

APE is also mandatory for obtaining a building permit and building's fitness for use certificate, as it is necessary to demonstrate compliance with minimum energy performance requirements, but also for the access to the available tax deduction mechanisms introduced by the government to incentivize energy efficiency works.

Generally, licensed technicians such as engineers, architects and surveyors are involved in the preparation of APE certification, since in order for the same to be properly drafted, it requires that the certifier must perform at least one inspection to gather all information about the building's characteristics, such as its geometry, the types of structures with which it is made, and the systems present.

4. The ESG Real Estate Due Diligence

As the ESG concepts enter into the real estate transactional environment on the wake of the increased ESG awareness of investors and debt providing stakeholders in real estate projects also the due diligence process associated with real estate transactions introduces the ESG as part of the assets/transaction scrutiny.

In this connection, Italian practice has evolved to include an assessment of the ESG sustainability of the transaction.

This exercise is usually twofold. The first one relates to the classic due diligence relating to the environmental aspects of the asset. During this phase technical advisors verify whether the asset is compliant with applicable environmental laws and the absence of any material or substance such as, for example, asbestos and radon, which may be detrimental for the health and safety of persons and workers within the premises. In this part of the due diligence process, investigations will also cover: ***(i)*** energy performance and possible improvements relating to the asset and its systems, ***(ii)*** energy consumptions and individuation of renewable energies to be implemented, ***(iii)*** greenhouse gas emissions and their intensity, pollutant gas inputs and the impact of the asset on biodiversity and natural capital, ***(iv)*** waste management and water footprint are also verified, and, last but not least, ***(v)*** whether any ESG certification is present.

The second part of the due diligence is related to the already mentioned taxonomy and disclosure obligations, in this respect, the due diligence will assess, based on the seller's compulsory corporate and/or financial disclosure, any existing or prospective measures that will have a positive impact on the ESG compliance of the asset or portfolios of assets being traded. This may include examination and assessment of the following aspects:

1. living and labor conditions of the asset(s) users,
2. social impact of the assets in terms of requalification or improvement of the territory and other positive impacts on public interest,

- mobility and accessibility,

1. health and safety standards,
2. presence of tenants bound by ESG compliance or cooperation obligations with the landlord,
3. prospective possible improvements of the ESG position of the assets,

- presence of “smart” technologies that improve the ESG performance.

5. ESG clauses in real estate contracts

As the industry is shifting towards buildings or real estate projects that comply with and meet ESG requirements, the documentation of contractual arrangements, either as purchases or leases, is also evolving to devise and introduce ESG clauses into agreements regarding trading, constructing or leasing real estate.

In acquisition contracts, these clauses generally define the level of ESG compliance or status of the property that either the seller represents and warrants or (in case of new developments, substantial refurbishments, regeneration or reposition of assets on the market) are a requirement or condition precedent for the closing.

In this regards, one aspect to be consolidated is that local legislation still carries limited regulations (other than as indicated in section 3.1 above) which may serve for the purpose of providing a benchmark, comfort or measurement of an asset ESG compliance. However, as highlighted in section 3.1 above, the new directive on energy performance will shed some light and provide guidance, in conjunction with the EU taxonomy, in terms of technical specifications and characteristics of the buildings and construction techniques. In the meantime, contractual clauses in acquisition agreements will in most cases make reference to internationally accepted certifications to testify the level of ESG compliance that assets being traded carry or will carry prior to closing. LEED, BREEAM and WELL certifications are among those more widely recognized and used in construction and real estate transactions.

In lease agreements, ESG clauses usually focus on the parties’ reciprocal obligations on energy efficiency, waste management, community engagement, and ethical business that the parties will conduct, including cooperation between landlord and tenant in order to identify the most appropriate strategies for improving the environmental performance of the leased assets.

A crucial feature of the lessor/lessee relationship is the ability to constantly monitor the data relating to the environmental performance of the building in relation to the application of agreed upon policies in energy consumption and, as the case may be, production of energy from renewable sources. Cooperation obligations, periodical access to the asset and the monitoring equipment and the involvement of a third-party technical expert in collecting and assessing the information are, among others, becoming more and more a common feature of the commercial lease agreements. In particular, the tenant usually undertakes to prepare and send to the landlord quarterly reports showing the consumption of gas, electricity or other energy or utilities supplied to the leased asset, according to agreed-upon standards and policies.

Other common features of the ESG clauses in lease agreements will include: ***(i)*** regular meetings between landlord's and tenant's representatives held as often as reasonably necessary, but no less than on a quarterly basis; ***(ii)*** sharing of environmental performance data and their analysis in relation to agreed goals and strategies to improve such environmental performance; ***(iii)*** joint discussion and suggestions to improve such performance; ***(iv)*** the introduction of user manuals as a tool to foster awareness, compliance and efficiency; ***(v)*** obligations of the tenant to provide to its employee or affiliates regular training on the implementation of environmental-friendly practices during day-by-day operations.

6. Green Financing

6.1 Green Bonds

As we have highlighted in several parts of this article, financing is one of the most important drivers of the shifting of the participants to the real estate market towards ESG compliance and the green economy. One of the main instruments of "green" financing are the "green bonds". As a general remark, green bonds are debt securities funding environmentally friendly projects. In particular, capital raised through green bonds is used by issuers to finance or refinance projects that have positive environmental impacts, such as sustainable water management, renewable energy or energy efficiency. Green bonds are attractive for investors for their potential for both financial returns and positive contributions to environmental goals.

This investment form has become an important part of the environmental aspect of ESG since it directly finances projects that promote ecological well-being. In this respect, the European Parliament has adopted on October 5, 2023, a new regulation which ***(a)*** lays down uniform requirements for issuers of bonds who wish to use the designation 'European Green Bond' or 'EuGB' for their bonds that are made available to investors in the Union; ***(b)*** establishes a system to register and supervise external reviewers of European Green Bonds; and ***(c)*** provides optional disclosure templates for bonds marketed as environmentally sustainable and for sustainability-linked bonds in the Union. In particular, this regulation provides for the obligation of the companies adopting the EuGB mark to respect specific prerequisites which include the disclosure of information on the destination of the bond proceeds and evidence that the bond issuance supports a strategy for transitioning to a sustainable economy and demonstrate that their investment contributes to reach such aim. Also, a registration system has been created to which companies issuing green bonds shall adhere and a supervisory framework for external auditors evaluating green bonds which must be independent entities which have no conflict interest and will evaluate the compliance with applicable laws.

The real estate sector is making extensive use of green bonds to finance the industry adaptation to new standards and represents 12% of the GSS (*i.e.*, bonds categorized as green, social or sustainable) bonds issued in 2022.

6.2 Green mortgages

Although they are not the subject of specific regulations, green mortgages, *i.e.,* real estate financing given at favorable conditions in connection with properties or projects that meet certain ESG requirements, are gaining ground and consideration as a tool that is appreciated by both lenders and borrowers because they provide additional financing to ESG compliant businesses and real estate products at a reduced risk for the lender. In fact, it is generally accepted by the banking and real estate community that investing and financing ESG compliant projects carries more resilience in terms of value over time of the property and better perspectives for both the borrower and the lender.

Industry and banking players, including the European Mortgage Federation are concurringly working on these financial products, with a view that also local and central governments will join forces in creating conditions for financing at better terms ESG compliant products[2].

[1] Relevant Entities of Public Interest are most recently defined in the Directives 2013/34/EU on accounting (the Accounting Directive) and 2014/56/EU on statutory audits (the Audit Directive) as follows: "***(a)*** *entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC;* ***(b)*** *credit institutions as defined in point 1 of Article 3(1) of Directive 2013/36/EU of the European Parliament and of the Council, other than those referred to in Article 2 of that Directive;* ***(c)*** *insurance undertakings within the meaning of Article 2(1) of Directive 91/674/EEC; or* ***(d)*** *entities designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees."*

[2] For the purposes of this article we considered the following regulations: Legislative Decree n. 192 of August 19 2005, Directive 2009/28 (Renewable Energy Directive), Energy Performance of Buildings Directive 2010/31, as amended by Directive 2018/844, Energy Efficiency Directive 2012/27, Law n. 63/2013, Ministerial Decree dated June 26, 2015, Regulation 2019/2088 (Sustainable Financial Disclosure Regulation (SFDR)), Directive 2020/852 (Taxonomy Directive), *National Recovery and Resilience Plan (NRRP) dated* January 12, 2021, Law n. 55 of April 22, 2021, Directive 2022/2464 (Corporate Sustainability Reporting Directive (CSRD)

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