Linklaters

The EU's Social Taxonomy and Real Estate Funds

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In recent years the "E" (for environmental) of ESG has been in the front of policymakers' and asset managers' mind. The "S" (for social) has started gaining momentum too. In the EU, the Platform on Sustainable Finance ("**PSF**") published earlier this year the draft report on social taxonomy for consultation (the "**Social Taxonomy**").

Does the creation of the Social Taxonomy create opportunities for real estate asset managers? For example, could real estate funds investing in affordable housing qualify as socially sustainable under this new classification regime and so would they benefit from it?

Europe's transition to net zero by 2050, with an interim goal for 2030, requires crucial changes in real estate sector considering the real estate sector is the source of around a third of global carbon emissions and consumer of about 40 percent of global energy. Environmental transition to greener buildings is expected to result in higher housing prices with the potential harm to certain groups of citizens and putting the EU's "just transition" efforts under pressure.

Opportunities

Despite being in an early stage of creation of the Social Taxonomy, real estate asset managers should stay tuned and seize the opportunities arising from the Social Taxonomy such as attracting public finance, investor interest and possibly tax benefits.

Considering the size of environmental transition which must take place withing a relatively short period of time, traditional ways of government spending alone will not do the trick to ensure just transition for housing. Hence, mobilising private capital through incentives has a crucial role to play. We would expect blended financed (i.e. public/private financed) funds for affordable housing to be on the rise incentivising private capital contribution through tranching (subordination of public investor's interest in the fund).

Increasing investor demand for social funds could create another opportunity for real estate asset managers. We see investors getting active in creating alliances not only for environmentally sustainable investments but also investors using their financial muscles for social good. For example, the Investor Alliance for Human Rights, of over 200 institutional investors, represents a total of over $6 trillion in assets that are managed across 18 countries.

The money invested in socially sustainable assets may create tax advantages. For example the Luxembourg government recently announced reduction in subscription tax to encourage direction of capital to environmentally sustainable activities. Considering the member states must participate in the EU's just transition, one would expect tax benefits for investing in socially sustainable real estate.

Why does Europe need Social Taxonomy for real estate?

As for green transition, lack of definitions and a standardized classification system is an obstacle to steering the capital towards socially sustainable real estate activities and risks "socialwashing". The Social Taxonomy will set out detailed technical screening criteria which will define when real estate related activities can qualify as socially sustainable.

The Social Taxonomy is expected to play a central role in public spending for housing (at EU and national levels). This means it will probably be used by the EU and the member states as a reference for investing public money in social real estate like EIB currently does with the Environmental Taxonomy when investing in green funds.

The structure of the Social Taxonomy

Under the current report for the Social Taxonomy real estate related economic activities could qualify as socially sustainable if they comply with the following requirements (similar to the Environmental Taxonomy):

1. Substantial contribution to a social objective;
2. Meet the do no significant harm principle;
3. Comply with the minimum safeguards.

The suggested starting point for developing criteria is the so-called availability, accessibility, acceptability and quality ("**AAAQ**") concept. *Availability* means that a certain good is available in a sufficient quantity and is functioning. *Accessibility* means that the good is economically (affordability) and physically accessible without any discrimination and that the related information is also accessible. *Acceptability* means culturally acceptable and respects the sensitivity of marginalised groups. *Quality* means that it is safe and that it meets internationally recognised quality standards that are scientifically approved.

Substantial contribution to a social objective

One of the main social objectives mentioned in the draft report is the promotion of adequate living standards which is linked to the Universal Declaration of Human Rights and to the International Covenant on Economic, Social and Cultural Rights. Housing is considered as one of the building blocks for promoting such adequate living standards (i.e. housing is a sub-objective).

The PSF makes a distinction between economic activities, such as job creation, which are inherently socially beneficial and those with added social value (the so-called "**additionality principle**") such as improving access to housing whereby the latter would qualify as socially responsible activity under the Social Taxonomy.

Improved availability and accessibility in the real estate sector could be the building and managing of apartments (NACE code 41.20), with x per cent lower rent compared to the average rent in a certain region and ensuring that these apartments are let only to certain target groups like those with low income could qualify as substantial contribution to the social objective of promoting adequate living standards.

Criteria for substantial contribution (and "do no significant harm") will be developed for these activities and it will be possible to calculate turnover, capital expenditures ("**CAPEX**")/operating expenses ("**OPEX**") for them.

Do no Significant Harm

The activity of building and managing buildings must not do any significant harm to other sustainability aspects.

While availability and accessibility could serve as substantial contribution, acceptability and quality of a product could well be used as criteria for the 'do not significant harm' principle.

For housing, this could mean that building cheaper apartments must meet certain quality standards such as for example having certain insulation standards.

While there would be a relatively common understanding of what availability, accessibility and quality in the housing sector mean, acceptability is very difficult to define (e.g. as opposed to healthcare or education). How should cultural differences be taken into account in the housing sector to determine whether the requirement of acceptability is met?

Minimum safeguards

As for the Environmental Taxonomy, minimum human and labour rights must be respected. In the context of real estate this could mean that working conditions must not violate labour rights when building accessible apartments. However, compared to the Environmental Taxonomy where the minimum safeguards requirements are very generic, for the Social Taxonomy the expectation is that the requirements will be more detailed/specific. The approach to the minimum safeguards requirements will largely depend on the model of the Social Taxonomy as described hereafter.

Interaction with the current Environmental Taxonomy

The Social Taxonomy is expected to be built into the existing Environmental Taxonomy creating a global taxonomy covering both environmental and social activities. This means that for the time being there is no intention to enact a separate regulation for the Social Taxonomy.

The PSF is considering two distinct models for the Social Taxonomy depending on the relationship with the Environmental Taxonomy. The choice will have considerable implications on whether a certain real estate activity will be considered socially sustainable.

Model 1

Under Model 1, the Social Taxonomy and the Environmental Taxonomy would be related merely through social and environmental minimum safeguards. The UN guiding principles would serve as minimum safeguards for the environmental part, while the environmental part of the OECD guidelines would serve as minimum safeguards for the social part. The respective social and environmental do no significant harm criteria would form the basis for detailed social and environmental criteria.

Objective	**SC criteria for**	**DNSH for**	**Minimum safeguard (UNGP, OECD)**
Climate mitigation	Environment	Environment	UFIGP OECD without environment
Climate adaptation	Environment	Environment	UNGP OECD without environment
Circular economy	Environment	Environment	UNGP OECD without environment
Pollution control	Environment	Environment	UNGP OECD without environment
Water	Environment	Environment	UNGP OECD without environment
Biodiversity	Environment	Environment	UNGP OECD without environment
Improving accessibility of products and services for basic human needs	Social	Social	OECD, governance and environment
Employment	Social	Social	OECD, governance and environment
Impact on workers	Social	Social	OECD, governance and environment
Impact on consumers	Social	Social	OECD, governance and environment

Objective	SC criteria for	DNSH for	Minimum safeguard (UNGP, OECD)
Impact on communities	Social	Social	OECD, governance and environment

Source: Draft Report by Subgroup 4: Social Taxonomy, July 21

This means activities which fulfil the environmental substantial contribution ("**SC**") and do no significant harm ("**DNSH**") criteria and undergo only general due diligence on the minimum safeguards (UNGP and OECD guidelines), but with some exposure to human rights risks, might still meet the criteria of the global taxonomy and be "environmentally sustainable". On the other hand, socially sustainable activities would only be required to meet general environmental standards below the "do no significant harm" criteria of the Environmental Taxonomy. In the context of real estate, the human rights criteria, for example, for building social housing would be stricter or at least more detailed than when building green apartments.

Model 2

Under Model 2, an activity would have to meet either at least one environmental or at least one social substantial contribution requirement. In addition, all activities would have to meet *all* relevant environmental and social do no significant harm criteria. Minimum safeguards would be replaced by more detailed social do no significant harm criteria for the Environmental Taxonomy, while the already existing do no significant harm criteria in the Environmental Taxonomy would be valid for the Social Taxonomy as well.

Objective	SC Criteria for	DNSH Social DNSH based on UNGP, governance based on OECD environmental DNSH, as worked out in environmental taxonomy
Climate mitigation	Environment	Environmental, social and governance
Climate adaptation	Environment	Environmental, social and governance
Circular economy	Environment	Environmental, social and governance

Objective	SC Criteria for	DNSH Social DNSH based on UNGP, governance based on OECD environmental DNSH, as worked out in environmental taxonomy
Pollution control	Environment	Environmental, social and governance
Water	Environment	Environmental, social and governance
Biodiversity	Environment	Environmental, social and governance
Improving accessibility of products and services for basic human needs	Social	Environmental, social and governance
Employment	Social	Environmental, social and governance
Impact on workers	Social	Environmental, social and governance
Impact on consumers	Social	Environmental, social and governance
Impact on communities	Social	Environmental, social and governance

Source: Draft Report by Subgroup 4: Social Taxonomy, July 21

Model 1 vs Model 2

The above means that Model 1 would result in more activities to be considered either socially or environmentally sustainable, while with model 2 there would be less sustainable activities, considering the do no significant harm requirements include both social and environmental criteria.

It would be surprising to see the regulator choose Model 2 as the latter would not work for existing funds investing in Environmental Taxonomy compliant real estate considering the illiquid nature of real estate assets.

The need for a social taxonomy is considerable and time is pressing to ensure just transition. However, the PSF's report on the Social Taxonomy is just the first step and it seems like the regulator will need to take important conceptual decisions.

For more information on the Social Taxonomy and related timeline see our dedicated blog post here.

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