



Environmental Legacy Insurance eases real estate transactions

**Opportunities.
Unlocked.**

About MX Underwriting Europe

MX Underwriting Europe (“MX”) is a European agent and part of the Specialist Risk Group (SRG), a leading UK insurance intermediary, specialising in complex insurance placement for clients across the globe.

MX and their team of underwriters in the UK and Ireland support clients in Germany, France, the UK and Ireland, providing insurance cover utilising its carrier’s insurance capacity for financial and legal risk in real estate, infrastructure, renewable energy development projects and transactions. Our vision and mission are to help deliver exciting sustainable real estate powered by renewable energy whilst making developments and transactions easier.

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Foreword

The commercial real estate market in Western Europe is rallying following the COVID-19 pandemic. Investment into this sector saw large increases in 2021 and there has been a sharp surge in demand across multiple asset classes. Investors and buyers, however, are increasingly looking to “ESG” (Environmental, Social and Governance) as key factors in business decisions and valuation. Sustainability and environmental focused investments have a growing presence and place in transactions and the wider real estate industry.

Insurance remains a vital part of the transaction process and is key to facilitating deals of commercial real estate. With the growth of ESG and expanding nature of investments into this sector, it comes as no surprise that insurance is taking an important role in managing environmental risks to assets.

Land Legacy insurance is a tool for buyers of operational real estate to manage potential exposure to liability from historic land contamination. To date, this liability has been largely internalised by site purchasers or owners. Often it is a risk they take on their balance sheets and usually emerges only when they come to sell the land and the asset value is affected. With the growing awareness of environmental risk and the growing demand for green, sustainable funds and lending, environmental issues are, and will continue to become, externalised. Insurance for Land Legacy issues is not about “box ticking” but rather protecting and enhancing asset values, improving liquidity and value at the time of sale.

As an important insurer of Land Legacy risks, MX Underwriting wanted to demonstrate the extent to which environmental risk presents obstacles for commercial real estate transactions. Along with our expert

partner, the M&A and transactional risks insurance professional Heloise Husson, and Faber Consulting, our consultancy based in Zurich, we embarked on an in-depth research project and survey with key stakeholders in the transactional, environmental and legal community – including lawyers, funders and other parties involved in this space – to learn from the market how it assesses and mitigates the risk of historic land pollution.

Our gratitude goes to all experts and companies who participated in this survey. We would like to thank everybody for the information and the expertise they shared so openly with us. In addition, we would like to thank our partners – Heloise Husson and Faber Consulting – who helped to make this report happen and largely contributed to its content and to Heloise for supporting us with market contacts.

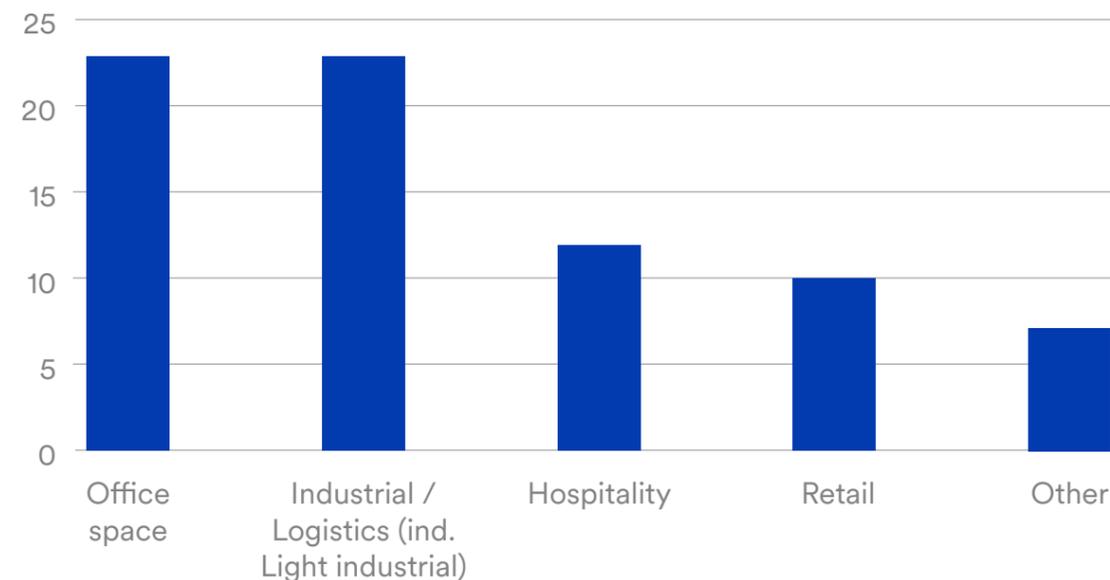
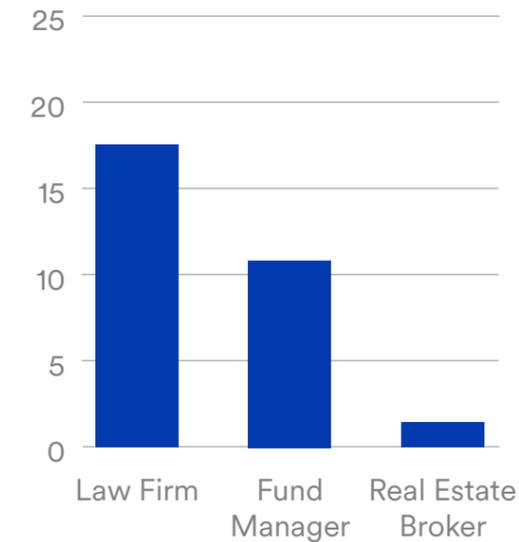
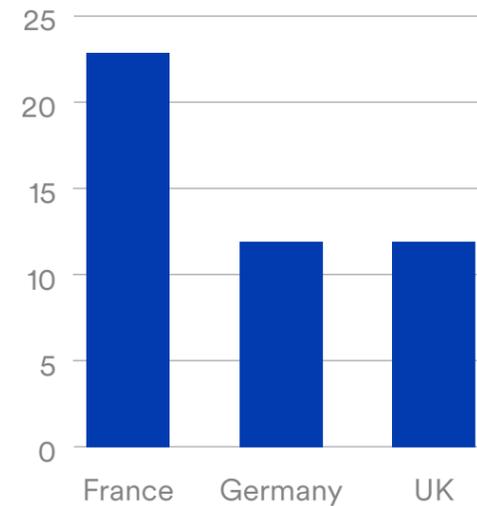
We hope you will find their responses interesting and wish you an inspiring read.

Methodology

The findings of this report are based on in-depth desktop research and structured telephone interviews with senior executives of leading investment and fund managers, law firms and real estate brokers operating in France, Germany and the UK. The interviews took place from April to July 2022 and were conducted by MX Underwriting and the independent insurance and real estate consultant Heloise Husson and Faber Consulting, a Zurich-based research and communications consultancy dedicated to the global insurance markets.

Our interviewees were all acknowledged specialists focused on M&A transactions of commercial real estate operating in France, Germany and the UK. Our sample had a slight bias on the France property market. However, the responses of our interviewees reflected a high degree of homogeneity. Market specific differences were less pronounced.

Most interviewees were either specialist law firms or investment and fund managers either for external investors or engaged to buy and sell for their company's funds or portfolio. Most of our interviewees pointed out that after two years dominated by the global COVID-19 pandemic, their transactions predominately focused on the M&A of offices space or industrial property including logistics and data centres given the rise in e-commerce and online technology. Due to the various containment measures enacted throughout 2020 and 2021 the transactions of retail space as well as hospitality objects were less frequent and also affected by the COVID-19 pandemic.



Key findings

A prolonged low interest rate environment, economic growth, and strong risk-adjusted returns have driven the continued growth of the property sector in France, Germany and the UK. In 2021, Europe's investments in commercial real estate reached an all-time high of €359 billion. Although France's commercial real estate sector still saw a -9% decline for the full year due to the COVID-19 pandemic and a weak economic outlook, Germany and the UK grew by 39% and 49% respectively.¹

The extended growth of the real estate sector which provided steady returns above most competing asset classes led to an internationalisation as well as a sophistication of the European property market. Due to the tightening of regulatory oversight as well

as heightened public and shareholder scrutiny – for instance with the recent rise of ESG rating – investors sought security products to hedge and transfer their risks, thereby improving the bankability of their assets, while documenting their diligence.

Since 2005 the London market has supported the transactional real estate market with Warranty & Indemnity (W&I) insurance, helping investors to cover legacy risks of their properties. Designed to address deficiencies found in UK real estates, other markets soon followed suit and adapted these products to their needs. While W&I insurance has turned into a global success, the insurance of environmental land legacy issues is still, in some senses, in its infancy.

Environmental Legacy insurance facilitates real estate transactions

According to our survey, environmental legacy pollutions are a major concern in real estate transactions – depending on the type of investor or the property sold. For institutional investors, environmental issues are almost a binary question. Either the contamination is resolved in a straight-forward fashion, or it is a deal breaker. Due to their potential impact on an investor's ESG rating, environmental issues pose reputational implications that go well beyond the cost of a remediation.

Environmental risks are systematically assessed in almost every transaction. Investors regard the risk as low if the transaction concerns an office building located in a Central Business District (CBD), for example. However, in brownfield developments or with manufacturing plants, whose purpose or future use will change, environmental issues are assessed diligently.

The assessment of an environmental pollution is first initiated by the vendor, who is legally obliged to provide documentation on environmental risks.

39%

Commercial real estate growth in Germany

49%

Commercial real estate growth in the UK

€359

All time high in Europe's investments in commercial real estate

¹ Euro Financial Review. "European property investment hits record €359bn." Euro Financial Review, Mark McSherry. January 2022. <https://eurofinancialreview.com/2022/01/26/european-property-investment-hits-record-e359bn/>

Key findings

It is followed-up by the buyer, who will call upon an external expert to provide an unbiased opinion on the contamination. Environmental pollutions pose a major hurdle to access financing as they call into question the very logic of a transaction. Investors and lenders thus require external expertise.

Following the asbestos cases which started in the early 1970s, environmental pollutions assumed top priority in real estate transactions in the early 2000s when databases, the need for state certifications and responsibilities to remediate pollutions became commonplace. Given the high public attention and the strict regulation of properties, investors are keen to avoid any conflict, as there are the questions on liability, but also on an asset's valuation and the ability to finance, use and eventually resell it.

Real estate investors try and manage the risk of an environmental pollution through a combination of solutions. Where the magnitude of the contamination is well understood, a decrease of the purchase price or even cleaning up the site before sealing the deal are preferred options. But in the more

complex cases, investors struggle with the counterparty credit risk in determining duration and magnitude of the warranties provided. This is true for escrows or contractual indemnities, where the parties often fail to agree on the length and the amount of capital to be held. For similar reasons standard warranty and indemnity (W&I) insurances tend to exclude environmental risks from their coverages.

However, awareness to insure for environmental legacy pollution is low. The insurance is most frequently used to top-up other measures, such as escrows, offloading the risk of a contamination to an insurer. In addition, environmental insurance serves to back-up to W&I policies. In “sophisticated” market segments it has become a standard risk management tool that covers the residual environmental risk in a transaction and thereby minimises the threat that the legacy risk will become a deal-breakers.

Although mostly sought by the seller, the insurance serves to indemnify the buyer who ends up being the insured party in most of the cases. The legacy insurance has become a necessity to comply with

board requirements in real estate transactions. It is also a pre-condition to access the financing of international lenders and provides additional security in transactions where the seller – especially if it is a fund or financial vehicle – may cease to exist after some time.

However, insurance is not without obstacles. Buyers of the cover are quite price sensitive. In addition, trust and transparency are key issues. Policy wordings, conditions and exclusions as perceived as opaque and, as in all long-tail risks, insureds want the confidence that even if a claim occurs years after signing, their claim is still paid. Finally, Environmental Legacy insurance is still a relatively new product with few providers limiting the choice of clients who would like to select a coverage best suited to their type of risk.

ESG plays a significant role among real estate investors, but the focus is mainly on the environmental performance of an asset rather than its legacy. Institutional investors and publicly listed companies already report on their ESG performance and follow a strategy to improve

Key findings

the rating of their portfolio. That is particularly relevant for those who manage green funds. But even non-institutional or smaller investors cannot ignore the impact of ESG on their property's valuation and its appeal to lenders or future buyers.

Although an established market standard and taxonomy to rate ESG performance is still missing in real estate, investors have already installed dedicated ESG directors, who have become decisive voices in the investment committee. While these companies may refrain from investing in assets with a low ESG rating, smaller players only have just started to define their attitude towards ESG.

The background features a dark blue field with a large, bright blue curved shape on the left and a dark blue geometric shape on the right. The word "Research" is written in white serif font in the lower-left area.

Research

Overview of the real estate market

The commercial real estate market in the UK, France, and Germany

The impact of COVID-19 is still being felt across Europe, as nations struggle to recover from the two-year economic downturn, compounded by the sudden rise of inflation and geopolitical tensions in the wake of the Russian invasion of Ukraine. Nevertheless, 2021 saw another record year of corporate real estate sales at more than €29 billion. Overall, European corporate real estate deals grew a staggering 30% in just five years, demonstrating the attraction of this asset class even during the last two crisis-stricken COVID-19 years.

During the pandemic, markets saw a sharp rise in demand for e-commerce, which significantly impacted the retail asset class as consumers turned to online shopping options. This was particularly noticeable in France and Germany. Despite the overall boom in online sales, the UK real estate market experienced an increase in demand for shopping centres, leisure parks and high street retail. The luxury retail segment performed well throughout the pandemic, particularly retail in Paris, in addition to demand for midscale and upscale hospitality in the UK, and prestigious office space in Germany. The lower end of these asset classes, by contrast, suffered to a greater extent.

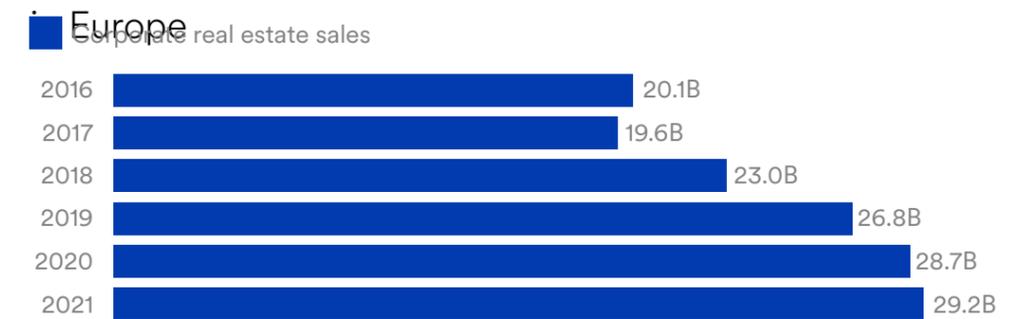
Despite the shift to hybrid and remote work, office space remained a high performing asset class throughout the three countries, although uncertainty as to the future role of office space persists.

UK

Investment into commercial real estate in the UK increased in 2021 and right into 2022. 2021 saw considerable investment into industrial/logistics real estate in the UK, with over USD 21.56 billion of industrial assets traded, marking a 60% increase from 2020.

Selling the silver

Buyout boom drives record corporate real estate sales



Source: JLL

Additionally, in 2021 the Greater and Southeast London office sector saw declining rates in vacancy of office spaces, combined with increasing rents. This marks a resurgence since 2020 when demand fell due to the COVID-19 lockdowns. This transactional activity fell only 2% below pre-covid times, denoting a healthy level of occupier activity in the market.

Overview of the real estate market

Commercial real estate in the UK is a competitive market, largely due to a sustained low level of market share concentration. The UK market therefore remains attractive to both domestic and international investors, with many current key players being Real Estate Investment Trusts. Most recent developments in the UK's commercial real estate market indicate strength, with two key purchases made in February 2022. British Land acquired three warehouses in a specially marked strategic industrial land location in Wembley, thus promoting industrial employment and development.² Additionally, Landsec signed eleven new deals in office space in London, as more businesses seek greater space.

The hospitality market is predicted to experience slower growth than other markets. This is largely due to economic uncertainty caused by Brexit, a strengthening pound against the Euro, which is stifling investment growth, and large amounts of new hotel supply entering the

market. Despite this however, investors from Europe and the Middle East remain active in the UK. Additionally, 15% of all new hotel supply consist of expansions, renovations, and refurbishments, with the remaining overall percent consisting of new constructions. A general trend of budget hotel popularity decreasing, and a higher demand for midscale and upscale hotels is predicted.³

Another three sectors showing significant yields that exceed the previous five-year average are shopping centres, leisure parks, and high street retail.⁴ Shopping centres have had the highest yield, with an increase of 121% for investment volumes in 2021. However, it should be noted that this is against the backdrop of the COVID-19 pandemic, which caused a decline in yield for 2020. Irrespectively, assets such as industrial and shopping centres were predicted to provide returns averaging 4% (shopping centres) to 11.5% (London industrial) per annum over the next five years.

Global rising inflation, accelerated by the Russian-Ukrainian war, and an increase of 54% in energy prices may inspire caution in some investors. In addition, investors are faced with rising interest rates as central banks struggle to contain inflation rates not seen in decades. Rising interest rates and government bond yields could lead to a re-pricing of financial assets, and inflation is predicted to remain a concern throughout 2023.^{5/6} This is largely because the economic and socio-political root causes of the current global inflation are unlikely to be resolved in the next year.

² Mordor Intelligence. COMMERCIAL REAL ESTATE MARKET IN UNITED KINGDOM - GROWTH, TRENDS, COVID-19 IMPACT, AND FORECASTS (2022 - 2027).

³ Mordor Intelligence. HOSPITALITY REAL ESTATE SECTOR IN THE UNITED KINGDOM - GROWTH, TRENDS, COVID-19 IMPACT, AND FORECASTS (2022 - 2027).

⁴ Lang, Steven, Market in Minutes: UK Commercial

⁵ Savills. Real Estate Outlook 2022

⁶ Barrett, Nicholas, Palumbo, Daniele. When might the inflation rate come down.

Overview of the real estate market

France

The COVID-19 pandemic hit French commercial real estate sector hard in 2020. However, investors returned to the French market in 2021, with Q4 marking stronger numbers than any quarter since 2020. Whilst recent investments are promising, the market's value decreased in size for the second consecutive year, as the nation's economy faces the impacts of COVID-19, rising inflation, and slow economic growth.^{7/8}

Regarding commercial real estate, offices have been the primary asset class, accounting for EUR 16 billion (± 60%) of the total EUR 27 billion invested in the sector. The capital Paris remains an attractive investment opportunity, being the second most expensive among major European markets, preceded only by London. However, vacancy rates have been increasing, and exceeded 10% in submarkets of Greater Paris in the first quarter of 2022. The COVID-19 pandemic has been a

major reason for this, as workspace transitioned into the digital sphere. Office space, industrial and logistics mark the second largest asset class, with 2.5 billion euro (± 9%) being invested. Unlike office space, industrial and logistics benefitted from the growth of e-commerce and saw a significant rise in demand.

Funds were the most active investor group in 2021. Second most active were SCPIs (société civile de placement immobilier), followed by insurance companies⁴. France's hospitality sector suffered greatly in the COVID-19 pandemic, with a sharp decrease in investment volumes in 2020 due to international travel bans. 2021 did see a slight uptake, with EUR 1 billion invested into hospitality. Whilst this is still below pre-covid times, it is a promising increase from the prior year.⁹

Contrastingly, the retail asset class remains stagnant, reflected in the Occupier Sentiment Index being down -10%. One reason for this is the growth of e-commerce,

which has drawn consumers away from retail shops. Social commerce platforms globally have also rapidly introduced e-commerce to their services, and as this grows, in-person retail is bound to suffer.¹⁰ Luxury retail is the exception with the internationally renowned luxury brands of Paris reinventing their flagship stores. This includes renovations along the Champs-Élysées Avenue, and a movement towards “experiential” luxury retail.¹¹

⁷ Statista Research Department. Commercial real estate in France - statistics & facts

⁸ Harrison, Chris. Investors return to commercial property market in France.

⁹ Statista Research Department. Volume of hotel real estate investment in France from 2017 to 2021

¹⁰ BusinessWire. France Social Commerce Market Intelligence Report 2022

¹¹ Ascher, Vincent. FRENCH LUXURY RETAIL MARKET IN 2022

Overview of the real estate market

Germany

The COVID-19 pandemic had a serious impact on German commercial real estate. However, investment has remained steady, and signs of a strong recovery were clear in the market. Germany's commercial transaction volume in 2021 was EUR 62.1 billion, only approximately 5% below the previous year, and approximately 8% below 2019 which was a record year.¹² Moreover, a total of approximately EUR 53 billion was invested in commercial real estate during 2021, putting the nation's investment volume at EUR 70 billion, an impressive post pandemic figure.

A change in demand for different asset classes has occurred, with prestigious office space and industrial and logistics in high demand. Although Germany has seen a surge in remote working, prestigious office spaces are highly valued, with office spaces being labeled as "the communication centres of the working world."¹³ While the

German working world may move towards concentrated work being done remotely, office spaces are expected to become centres for meetings, events, group activities and networking. This shift to hybrid working has been catalysed by Germany's declining age population, and an ever-increasing presence of "digital natives."¹⁰

Office rental contracts tend to run for extended periods of time, so the full impact of a remote working culture on Germany's office asset class will only be gradually revealed, the uncertainty of which caused some concern in 2021. However, thus far 2022 has seen a sharp increase in demand for office space, specifically the construction of new office facilities. This combination of high office demand, long rental contracts, and the normalisation of remote and hybrid working leaves the future of office real estate somewhat uncertain.¹⁴ As of now however, office spaces are in demand, with the sale of the Marieturm in Frankfurt and Brookfield's acquisition of 90% of Alstria

REIT and the properties, which include 122 office spaces estimated at EUR 4.5 billion.¹⁵

Industrial and logistics is another asset class that has seen high demand in Germany. This rise of industrial and logistics reflects growing demand for e-commerce and is negatively impacting retail sales. The surge in tourism as Germany reopened post-pandemic lockdowns has helped mask this decline, however, uncertainty around retail space fully returning to post-COVID times remains.

The hospitality sector dropped significantly in 2020 due to COVID-19. Whilst it did pick up to 2.5 billion euro in 2021, it is still short of pre-COVID times with the long-term average missed by almost 25%.¹⁶ The first quarter of 2022 has seen a modest start, as hospitality remains constricted by COVID-19. Investment volume is at 440 million euro, 36% below the 10-year average and approximately 16% lower than the previous year's quarter.¹⁷

¹² CBRE. Report Figures Germany Commercial Real Estate Investment Market H2 2021

¹³ DZ HYP. Real estate market Germany 2021

¹⁴ DZ HYP. Main regional real estate markets in Germany 2022

¹⁵ JLL. Investment Market Overview

¹⁶ BNP Paribas Real Estate. At a Glance Q4 2021 Hotel investment market Germany

¹⁷ BNP Paribas Real Estate. At a Glance Q1 2022 Hotel investment market Germany

The impact of ESG on the real estate sector

According to Blackrock, the world’s largest asset management firm, “environmental, social and governance (ESG) investing is about investing in progress and recognising that companies solving the world’s biggest challenges can be best positioned to grow.” It thus comes as no surprise that ESG, having originated in the investment community, plays a major role among real asset investors, particularly in the housing sector. In the wake of a global pandemic, rising disruptions due to climate change, and increasing socio-economic tensions, many investors integrated sustainable investing into their portfolio strategy.

In addition, the real estate sector is viewed with scrutiny by policymakers. Close to 30% of global carbon is emitted by the sector due to heating, cooling, and lighting. Another 10% is added in the form of embodied emissions such as materials and construction processes during a building’s lifecycle.¹⁸

Figure 1: Net-Zero Carbon Commitment by Select Real Estate Owners/Investors

Real Estate Owners/Investors	Headquarters	AUM (US\$ Billions)	Net-Zero Carbon By
Allianz Real Estate	Germany	88	2050
AXA Investment Managers	France	180	2050
Brookfield Properties	Canada	210	2050
CBRE Investment Management	United States	129	2040
City Development Limited	Singapore	5	2030
Heitman	United States	44	2030
Nuveen Real Estate	United States	133	2040
PGIM Real Estate	United States	190	2050

Source: Company websites, CBRE Research, October 2021.

The number of regulations and legal requirements that affect real estate investors are increasing rapidly on a national as well as supranational level.

¹⁸ CBRE Research, ESG & Real Estate – Top 10 Things investors need to know, October 2021

The impact of ESG on the real estate sector

Trends in Regulation in the UK:

- **Minimum Energy Efficiency Standards:**

After Government consultation Energy Efficiency Regulations 2015 and the Government's Energy White Paper published on 14 December 2020, commercial property owners who let will be required to attain a minimum Energy Performance Certificate rating of B by 1 April 2030. Additionally, commercial property owners will also be required to observe increasingly stringent inspections of heating and air conditioning systems.

- **Global Real Estate Sustainability Benchmark (GRESB):**

GRESB is a leading body in issuing standardised global benchmarks that are consistent with international reporting frameworks, such as the TCFD, the Paris Climate Agreement and country-specific disclosure guidelines and regulations. Institutional and financial investors can monitor their investments, connect with fund managers, and carry out ESG decisions making against these benchmarks. There is increasing

pressure on fund managers and financial institutions from investors to attain a comprehensive GRESB rating, such as 4 out of 5. In the absence of this, some investors may be unwilling to invest, or may even seek to withdraw their investment.

- **Climate Disclosures:**

In December 2015, the Financial Stability Board established a Task Force on Climate-related Financial Disclosures (TCFD). As of 2021, the Financial Conduct Authority requires premium listed companies to ensure that their climate related disclosures are consistent with the TCFD's framework. If this cannot be done, a written explanation must be provided. Additionally, as of November 2020, the Financial Reporting Council requires UK public interest groups (e.g., institutional investors and pension schemes that act as real estate asset owners and managers) to report in reference to TCFD's 11 recommended disclosures

and the Sustainability Accounting Standards Board metrics applicable to their sector.

- **Taxonomy Regulation:**

The UK Government has confirmed that post Brexit, it will generally maintain the EU Taxonomy Regulation, as published on 22 June 2020. However, the extent to which it will be maintained and what changes if any might be introduced is yet to be confirmed.^{19/20/21/22}

¹⁹ Linklaters. ESG and the Real Estate Sector

²⁰ Hopper, Helen. ESG Regulations

²¹ Wright, Aaron. UK's New ESG Law

²² British Business Bank. What is ESG

The impact of ESG on the real estate sector

Trends in Regulation in Europe:

There are generally three pillars to EU ESG:

- **EU Taxonomy:**

Regulation (EU) 2020/852 came into force in June 2020 and established an EU's classification system to determine to what degree economic activities can be considered sustainable, applying to financial products and corporate bonds, their sales and distribution as well as their disclosure. The directive requires investors to disclose the degree of alignment of their financial products with the Taxonomy objectives, meeting at least one of six sustainability objectives, such as climate change adaptation and mitigation, pollution prevention and control or boosting green investments, against which company activities and investment can be assessed.²³

- **EU Disclosure Regulation:**

Regulation (EU) 2019/2088²⁴ requires sustainability related disclosures for the financial services sector and falls under a wider piece of legislation known as the European Commission's Sustainable Finance Action Plan.²⁵ It requires companies to disclose how they strategise their approach to ESG decisions in business and policy and must be disclosed on the companies' websites and in pre-contractual and periodic disclosures. It includes both environmental taxonomy and social taxonomy.

- Additionally, Non-Financial Reporting Disclosure (NFRD) will be replaced by Corporate Sustainability Reporting Directive (CSRD) which provides a more comprehensive and stringent reporting framework.
- Moreover, regulation (EU) 2019/2088 known as The Sustainable Finance Disclosure Regulation

(SFDR) introduced sustainability related disclosure requirements at the product level, specifically for financial market participants and financial advisers. Non-EU fund managers may also be impacted.

- Lastly, Corporate Sustainability Due Diligence Directive (CSDD) will require due diligence on behalf of companies' regarding the entirety of their value chain.

- **Products and Labels:**

The European Parliament and Council are due to approve EU Green Bond Standard (EU GBS).²⁶ This will be a voluntary and will set a gold standard regarding how companies and public authorities use green bonds. It aims to facilitate the use of green bonds to raise funds on capital markets as finance large scale investments while still maintaining stringent sustainability requirements and protecting investors.^{27/28/29}

²³ Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation). Green Finance Platform.

²⁴ Deloitte. Environmental, Social and Governance

²⁵ European Commission. Overview of sustainable finance

²⁶ European Commission. European green bond standard

²⁷ Froud, Lora, Haran, Gavin, Cox, Tiffany., Garnham, Emma. ESG regulations

²⁸ Platform on Sustainable Finance. Final Report on Social Taxonomy

²⁹ Mayson, Hayes & Curran. Sustainable Finance Disclosure Regulation

The impact of ESG on the real estate sector

Strategies for Real Estate Managers:

Real estate managers are employing a variety of strategies to deal with ESG. One such strategy is to invest in retrofitting and setting net zero carbon targets in buildings and on premises. TCFD is another resource real estate managers are turning towards. The TCFD recommendations report explores strategies for real estate managers to cope with climate change and ESG. The recommendations are structured around four areas that represent core elements of how organisations operate: governance, strategy, risk management, and metrics and targets.^{30/31}

³⁰ TCFD. TCFD Recommendations

³¹ Kumar, Rakhi., Dayaramani, Natasha., Rocha, James D. UNDERSTANDING & COMPARING ESG TERMINOLOGY

³² Interlaken Group. Land Legacy Issues Guidance on Corporate Responsibility

Figure 2: SSGA's Framework for Understanding and Comparing ESG Strategies³²

	Exclusionary Screening	Positive Screening	ESG Integration	Impact Investing	Active Ownership
Definition	Excludes, from the investment universe, companies, sectors or countries involved in activities that do not align with the moral values of investors or with global standards around human rights, labor practices, the environment and anti-corruption	Tilts portfolio toward one of the following: Best in class: companies outperforming peers in ESG measures ESG momentum: companies improving ESG measures more quickly than peers Thematic investing: companies solving specific ESG challenges (climate change, gender diversity, etc.)	Incorporates ESG data, alongside traditional financial analysis, into the securities selection process	Targets a measurable positive social and/or environmental impact. Investments are generally project specific	Entails engaging with companies and voting company shares on a variety of ESG issues to initiate changes in behaviour or in company policies and practices
Common Objectives	Align portfolios with investors' moral and ethical values Mitigate ESG risks Influence a company to change its business model or stop an objectionable practice	Mitigate ESG risks Achieve higher returns Support a business model that aims to solve an environmental problem Improve or maximize a portfolio's ESG score	Mitigate ESG risks Achieve higher returns	Generate and measure specific social and/or environmental benefits that align with purpose	Influence company strategy for long-term value creation Help company management capture value by mitigating risk or seeking opportunities Advance ESG disclosure and practices
Investment Considerations	Introduces tracking error and potentially impacts performance	Securities selection is based predominately on ESG scores and ratings. Sourcing quality ESG data remains a challenge	Sourcing quality ESG data remains a challenge. Securities selection is based on quantitative and qualitative assessment of ESG factors, requiring analyst expertise. A long-term mindset is necessary as it is difficult to time the occurrence of a negative event resulting from an ESG issue	Investments may be illiquid and investment returns could aim to be at or above the market rate	A significant ownership stake is needed to exert influence. Substantial resources are also needed to engage with companies. Active ownership is crucial for index strategies
Impact Considerations	Generally can't impact companies in which you don't own shares, but well-coordinated divestment campaigns can be effective	Rewards companies that have higher ESG scores with capital. Impact is generally targeted around specific sectors or themes (e.g. climate change, gender diversity, etc.)	No deliberate impact strategy as the primary objective is to achieve higher returns and/or mitigate ESG risks	Impact is highly targeted on specific outcomes	Broad impact due to continued engagement with company management on ESG issues
Examples	Equity fund that excludes companies that generate more than 5% of their revenue from the sale of tobacco products	Equity fund that invests in oil & gas companies deemed to be least carbon intensive	Actively managed fixed income fund that considers ESG issues during the securities selection process	Community investment fund that provides micro financing to low-income or disadvantaged communities	Could apply to any fund (including those not tagged as ESG funds) where the asset manager or asset owner is committed to active ownership

Land Legacy issues

Land legacy issues can partially be defined as: “an enduring grievance with affected communities or historic land occupants or their descendants related to the terms and processes by which land was previously acquired and subsequently used by a company or other entity and which has been left unresolved, in part or in full, by the predecessor or existing project developer.”³² Land legacy issues encompass pollution, a common example being soil contamination from previous use of the land. In this regard, there are two key considerations:

1. How pollution and contamination can impact public health.
2. How pollution and contamination can impact the environment.

In this sense, land legacy issues are unique for a variety of reasons:

- The issue or impact is pre-existing. The UK, France and Germany follow the principle of “the polluter pays” for damages caused to water, land, biodiversity or – as a result – human health.
- The liability may be contractually transferred to the “operator” of the property, although that contract may only bind the contractual parties.
- The characteristics of the issue are not fixed and can change over time.
- In many circumstances, the issue is connected to existing and developed assets, meaning the producer has a higher risk of substantial loss if the issue is not remedied.
- Land legacy issues are not clear-cut, which poses unique challenges “due to the interplay of past and present, which can involve ingrained distrust and

polarised positions, issues of justice, and unclear roles and responsibilities.”²⁵

Pollution as a land legacy issues

Pollution can be a major land legacy issue and can have a negative impact on both public health and the environment. The most notorious pollutant, asbestos, is still found in many buildings although the UK, France, and Germany banned it already in 1999, 1995, and 1993, respectively.^{33/34/35} Today, asbestos has to be properly removed and disposed whenever it has been released as part of a renovation or demolition.

Other types of pollutants may harm soil, water – on- and offshore, as well as biodiversity and human health. Causes can include slurry leakages, fertilizers, and animal waste, all of which can result in nitrate pollution which is common throughout Europe.³⁶ Other common soil pollutants include pesticides, petroleum products, radon, lead, chrome-plated copper, arsenate and creosote.

³² Interlaken Group. Land Legacy Issues Guidance on Corporate Responsibility

³³ Public Health England. Asbestos: general information

³⁴ Anses. Asbestos

³⁵ Baua. Asbestos Information Platform

³⁶ Geological Survey Ireland. Groundwater pollution

Land Legacy issues

PFAS or “everlasting chemicals” are of particular concern, especially in the UK.³⁷

Liability in land legacy issue by country (legal situation: who is liable, who becomes liable, if polluter no longer exists)

UK:

The UK will continue to follow the “polluter pays” principle also post-Brexit. Under Section 78F of Part IIA of the Environmental Protection Act 1990, the “appropriate person is liable,” meaning the person who “caused or unknowingly permitted” the pollution. In the case that this person cannot be found, the owner is liable for remediation. This approach also applies to historic contamination.³⁸

France:

France also follows the “polluter pays” principle. In the case that pollution has occurred from historic contamination, the French Supreme Court deems title

ownership insufficient in warranting the landowner liable for remediation required by environmental authorities. However, if established that pollution has occurred due to negligence on behalf of the landowner, then the landowner can incur liability.³⁹

In the context of an asset purchase where the buyer has “operator” status, French regulation stipulates that environmental liability transfers to the buyer, i.e., the buyer has a new operating permit to conduct out “classified activities for the protection of the environment.” Subsequently, the operator is liable for both historic and recent pollution where they have conducted “classified activities” on site. The operator can be cleared of this liability, if they can prove that the previous operator was responsible, and they can be traced.⁴⁰

Germany:

German law also follows a general “polluter pays” principle, however, an extensive list of parties could potentially be liable. Under the German Federal Soil

Protection Act, in effect on March 1st, 1999, potential parties that can be considered liable for land pollution are:

- The polluter
- The polluter’s successor
- The property owner
- The property occupier
- The former property owner post dereliction of title
- A guarantor for a legal person under German company law, in case that the legal person is an owner of contaminated land
- The former property owner, if the title transfer happened post 1st March 1999 and the owner knew or ought to have known that a contamination was present

³⁷ Chem Trust. PFAS – the ‘Forever Chemicals’

³⁸ Landmark Chambers. Contaminated land and the transfer of liabilities to successor bodies

³⁹ Baker McKenzie. Global Corporate Real Estate Guide

⁴⁰ DLA Piper. Environmental liability

Land Legacy issues

However, authorities are not obliged to seek the polluter prior to other parties on the list for liability. Rather, they are obliged to find a person most likely to have the financial means to fulfil remediation.⁴¹

Other types of land legacy issues: permits, titles, etc.

Land legacy issues can also encompass judicial review matters such as permit challenges. A permit challenge can stall the progress of a development significantly. Title problems are another potential land legacy issue. Issues can arise over title deeds: deeds could be missing, poorly drafted, planning problems, mapping errors, rights of way or other easements, possessory title claims, boundary disputes or other problems that prevent a sale proceeding or a refinance of the property.⁴²

“We assisted a client five years ago with the acquisition of an industrial site which was subject to the French classification as an ICPE (Installation Classified as Environmental Protection). Since it is impossible to ensure a third-party land pollution issue that we had on this deal, the issue was treated as a condition precedent to the sale promise. The issue evolved over time and facing the difficulties to assess the financial consequences of the pollution and/or the way it should be treated within the deal, the time between the signing of the sale promise and the deed of sale took four years. Based on my experience, it is clear that if at the time we would have been able to insure the risk, the deal would have closed considerably quicker and would have ensured a peaceful completion of the transaction.”

From a Corporate Real Estate partner in a prominent UK law firm, Paris Office

“In a portfolio acquisition in 2018, valued at approximately EUR 215 million and consisting of six industrial assets for a REIT located in France, due diligence findings revealed – with respect to one of the assets valued at approximately EUR 30 million – a significant soil contamination with lead and arsenic in a Phase 1 and Phase 2 environmental audit. The risk was further exacerbated by a groundwater zone under and near the site with the risk of a contamination.

Given the potential remediation costs, we were unwilling to acquire the asset unless the seller agreed to fully indemnify the buyer for a long period of time. Given the structure of the seller (a private equity fund), it was not willing to entertain such trailing liabilities and instead offered a material discount to the agreed purchase price of the portfolio against an indemnity for all potential liabilities. However, we were not prepared to take such a liability onto our books. As a result, the seller had to exclude the asset from the portfolio prior to the completion of the transaction, which was neither beneficial to the seller nor to the buyer.”

From a Chief Investment Officer of an International Fund Investment Manager

⁴¹ CMS. Liability for contaminated land under the German Federal Soil Protection Act

⁴² O’Shea Legal. Title Problems

Transactional and Environmental Insurance

On transactional insurance – definition, characteristics

Transactional insurance protects a party against a wide variety of risks associated with mergers and acquisitions (M&A), regardless of whether a buyer or seller.^{43/44}

Warranty and Indemnity insurance (W&I) is increasingly common in transactional insurance and acknowledged as a cost-effective way to facilitate M&A deals.⁴⁵

Warranty & Indemnity insurance

Warranty and Indemnity (W&I) – also known as Reps & Warranties – insurance came out first in the 1980s following the development of the M&A activity and the sophistication of the transactional contracts. It emerged as a Lloyd’s of London product issued on the sell side to respond to the needs of sellers who were not capable to back the warranty liability newly required by the buyers.

The product then declined in the 1990s but resurfaced in the years 2000 in the US with the development of the LBO (Leveraged Buy-Out). This new kind of funds’

backed transactions called for a Buyer side product and the professionalisation of the underwriting. First used in large transactions and under specific conditions mainly in the US and in the UK, the W&I solution managed to convince the M&A actors all over Europe and, by 2015, became a relevant addition to the M&A toolbox. By 2020, W&I insurance had reached all continents and is now established and regularly used as a differentiation means and/or a strategical solution.

The ability to adapt to the M&A market and the expertise of the M&A insurance professionals have been key for the development and success of this product. This explains why W&I insurance has expanded to cover additional specific risks (such as Tax, Title or Litigation risks) which have been designed as separate M&A insurance solutions. It is reasonable to assume that this trend will continue with further M&A insurance solutions, such as Land Legacy products, becoming available to adequately respond to the increasing risks protection need in the M&A context.

W&I insurance can cover either the buyer or seller in an M&A transaction, although it is more common to find the buyer seeking W&I insurance. The cover is typically structured on a claims-made basis, costs between 1% to 3% of the coverage purchased, and protects against unknown and unforeseen risks assuming that the buyer carried out its due diligence, that the deal has been negotiated on an “arms’ length basis” and that an appropriate disclosure exercise has been completed.⁴⁶

Examples of risks that W&I insurance covers include:

- Unwillingness of a buyer to sue the seller due to the dynamics of the deal.
- Unwillingness or inability of a seller to provide warranties and indemnities.
- Disagreement of parties on the seller’s liability cap.⁴⁷

⁴³ Aligned Insurance. Transactional Insurance Explained

⁴⁴ Marsh. Transactional Risk

⁴⁵ Dac Beachcroft. Transactional Liability

⁴⁶ Brady, George. What Role Does Warranty and Indemnity Insurance Play in the Irish M&A Market

⁴⁷ LK Shields. Warranty and Indemnity Insurance

Transactional and Environmental Insurance

Distinction between “known” and “unknown” risks and how they are insured

How known and unknown risks are handled can vary between insurance policy types. However, a legal due diligence is always carried out, during which specific issues will be flagged that then constitute known risks, while unknown risks will be anticipated in the underwriting.

In the UK, recurrently title issues may occur due to missing documents or undisclosed restrictive covenants. These unknown risks are somewhat anticipated and written into the structure of the insurance policy.

The same approach applies to environmental and land legacy insurance. However, in this case unknown risks can be better anticipated. For example, if hypothetically a plot of land was at one point used as a petrol station, it is probable that there is a risk for petroleum pollution, irrespective of whether a soil and groundwater report flag it. Typically, both known and unknown risks can be covered by the insurance.

Title insurance

Title insurance is a form of indemnity insurance that protects the policy holder from financial loss associated with comparative deficiency of land records allegations and defects in a title to a property such as liens, back taxes, or conflicting wills. The policy may cover multiple risks, including flawed records, incorrect ownership, and falsified documents.⁴⁸

Renewable environmental liability insurance

Renewable environmental liability insurance is a casualty insurance which insures the policyholder against the risk of being liable for the consequences of a damage caused while operating the property. This insurance type is also often referred to as Environmental Impairment Liability (EIL) covering liabilities claims arising from gradual or sudden and accidental pollution, brought forward from regulatory bodies or third parties. They might require the payment of damages incurred or the clean-up of the site or migrated off-site.⁴⁹

Environmental land legacy insurance

While environmental liability insurance covers damages caused post signing the policy, environmental land legacy insurance looks backwards and covers damages prior to signing the policy. The demand for this kind of coverage emerged on the back of the positive experience with W&I products covering legacy risk in an M&A transaction. Environmental Land Legacy Insurance thus frequently serves as an additional product to a W&I policy covering the title risks.

The Environmental Land Legacy Insurance Operational cover on the other hand, deals with risks related to other environmental warranties agreed in the transaction. The policy indemnifies either seller or buyer against the counterparty risks that arise when needing to remediate a legacy pollution.⁵⁰

Typically, these risks can impair the construction or future purpose of a site or result from an off-site migration of the pollutant. Mostly the insurance is required in brownfield

⁴⁸ Surety Bonds. What is Title Indemnity Insurance

⁴⁹ Marsh. Environmental Impairment Liability Insurance. 2017

⁵⁰ Aon. Legacy Environmental Liabilities, June 2020, <https://www.aon.com/getmedia/79b8a1c3-8e82-4a77-bdc7-47a295ba3527/Legacy-Environmental-Liability-Solutions.aspx>

Transactional and Environmental Insurance

construction or reconstructions where the purpose of a site changes. It is less common that the policy is bought for inner city office buildings where their use has been unchanged for decades and is well-documented. Thus, Land Legacy insurance is commonly used to bridge the gaps in the traditional W&I insurance – which excludes environmental risks – or serves as a stand-alone environmental cover, according to the transaction's profile.

“A real estate fund was purchasing a portfolio of light industrial sites. A buy-side W&I policy was being taken to cover general and tax warranties as well as a tax covenant. Cover was also sought for the fundamental warranties to the full embedded value of the asset.

The W&I insurer had excluded cover in respect of any environmental warranties contained in the Share Purchase Agreement – but the fund wanted a more complete solution and remained concerned about historic contamination on the sites. In addition, the fund had large ESG commitments and statements – and investors wanted confidence with the ESG statements made.

MX reviewed the portfolio using the environmental reports provided and structured a comprehensive Land Legacy protection programme for historic known and unknown risks (as well as covering a top-up to the fundamental and title to property warranties). For the Land Legacy cover, a limit of indemnity was ring-fenced per site, giving flexibility and ease of managing the policy, both in allocating premium, but also in facilitating future transactions. The premium on the environmental aspect of cover represented a rate of around 0.2% on the limit of the indemnity.”

From MX Underwriting Europe

The background features a dark blue field with large, overlapping, curved shapes in a lighter blue shade. The shapes create a sense of depth and movement, with some appearing as if they are layered on top of others.

Market survey

Market survey

I) Environmental pollutions are a major concern in real estate transactions

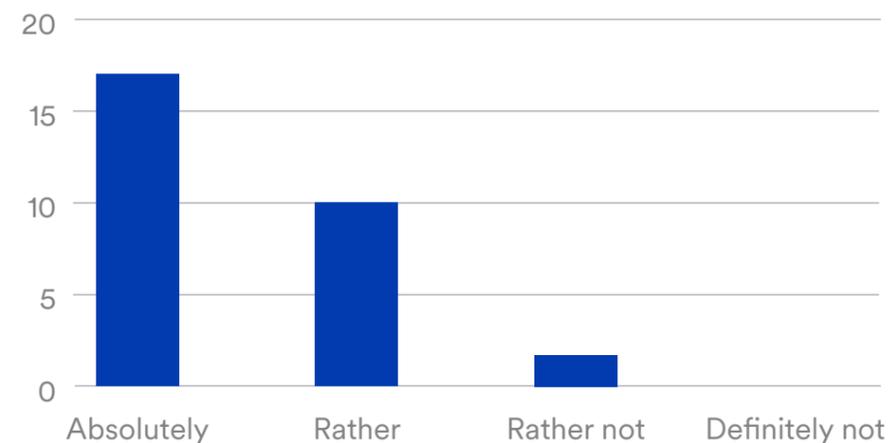
Land legacy issues, namely environmental pollution, is to most of our interviewees an absolute concern and plays a prominent role in almost all their real estate transactions. The extent to which environmental pollutions are an issue, however, depends on both the type of investor and the property being traded.

Publicly listed companies, institutional investors or pension funds, specifically those representing large corporations, tend to be risk adverse. To them the possible costs for a remediation are not their main worry. Rather, they also consider the reputational risk that they might acquire whilst holding an environmentally harmful property.

The risk of an environmental pollution is often assessed quite differently. In fact, according to many of our interviewees the industry has built up substantial experience how to deal with most pollutants and found ways to also address the associated cost in transactions. Thus, smaller or not publicly listed real estate buyers or investors take a more moderate approach towards environmental pollutions and differentiate quite clearly if the cost to clean up a contamination is quantifiable or not.

In addition, the kind of asset sold as well as its former or future use play a significant role regarding the relevance of a potential environmental pollutant. Interviewees agreed that in city centres where industrial sites are sparse and mostly well documented, the risk of an unresolved environmental contamination is rare – with the exception of asbestos for instance in office buildings. The risk is heightened though in case of brownfield sites, or industrial or logistic assets, particularly if its function changes with its ownership.

In commercial real estate transactions are potential land legacy issues, i.e. environmental pollution, a concern?

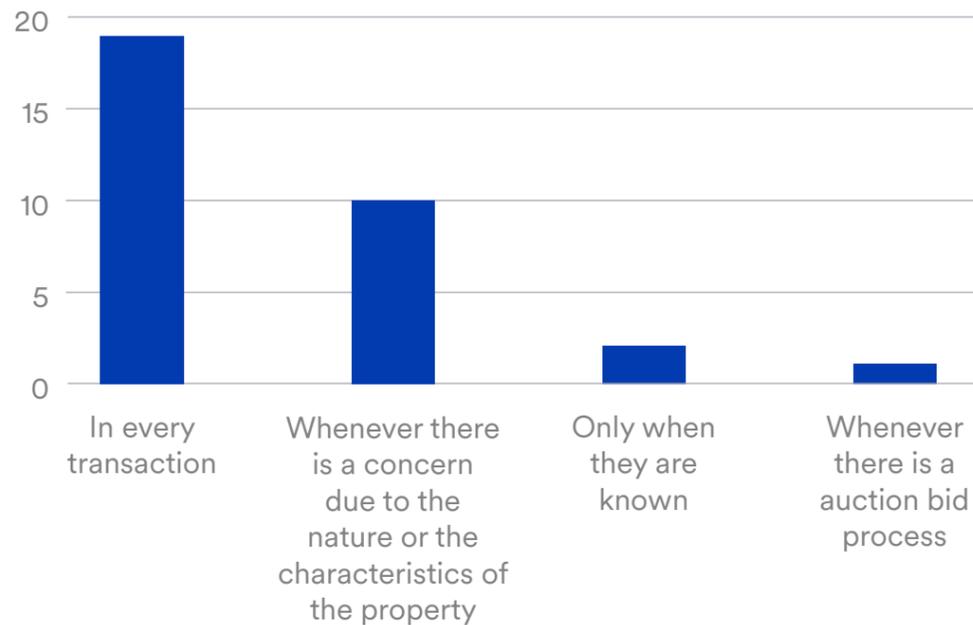


II) Environmental pollutions are systematically assessed

The risk of environment pollutions is systematically assessed in commercial real estate transactions. 60% of our interviewees stated that they evaluate this risk in every single transaction, regardless of the type of real estate site that is traded. This reflects the high relevance of environmental land legacy issues for commercial transactions. Due to today's importance of ESG, many interviewees regard environmental issues not only as a cost concern but also as a regulatory as well as a reputational risk and thus potentially an unquantifiable risk that they will shy away from. Furthermore, asbestos, and in some markets also lead, are still issues that need to be assessed. However, today's property owners are accustomed to deal with these risks that peaked some decades ago and only major asbestos contaminations are regarded as a hindrance for acquisitions.

Market survey

Are environmental issues systematically assessed in real estate transactions?



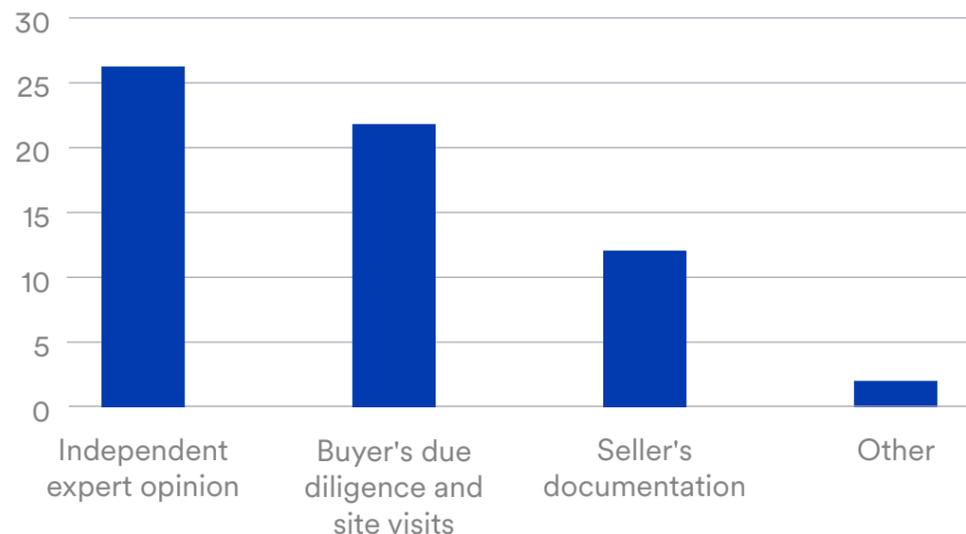
Again, the assessment of an environmental risk depends on the type of property that is acquired and on its past or future use. For example, many interviewees stated that they regard the risk of an environmental pollution as unlikely, if the transaction concerns an office building located in a Central Business District (CBD) of Paris, London or Frankfurt. In addition, countries like France and Germany register environmental issues, and – given the high degree of maturity of Europe’s business districts – most contaminations will have been recorded already.

However, if a property is redeveloped and has been used as a manufacturing plant and, in the future, will turn into some kind of a hospitality site, environmental risks will surely be assessed with heightened scrutiny.

III) Comprehensive assessment of environmental pollution

The assessment of an environmental pollution is usually a process kicked-off by the vendor’s documentation which is part of its obligation to provide transparent information on known risks. This is followed-up with the buyer’s due diligence, which, mostly, will call upon an independent expert to thoroughly investigate the pollution and provide an unbiased opinion of the type of contaminant.

How are environmental issues assessed?



Many companies thereby rely on dedicated advisors on pollution. Investors or lenders require their expert opinion to assure that the pollutant is properly assessed and the issue is adequately reflected in the purchase agreement. Besides, the testimony assures that the future owner will comply with environmental laws and duties and its potential ESG obligations.

Obviously, the more complex the findings in an environmental due diligence, the more thorough the investigation, including site visits, drillings and excavations. As part of this investigation, the vendor’s, buyer’s and expert’s due diligence will determine the magnitude of the contamination, propose ways to resolve and remediate this issue and how to address the risks contractually – possibly through insurance.

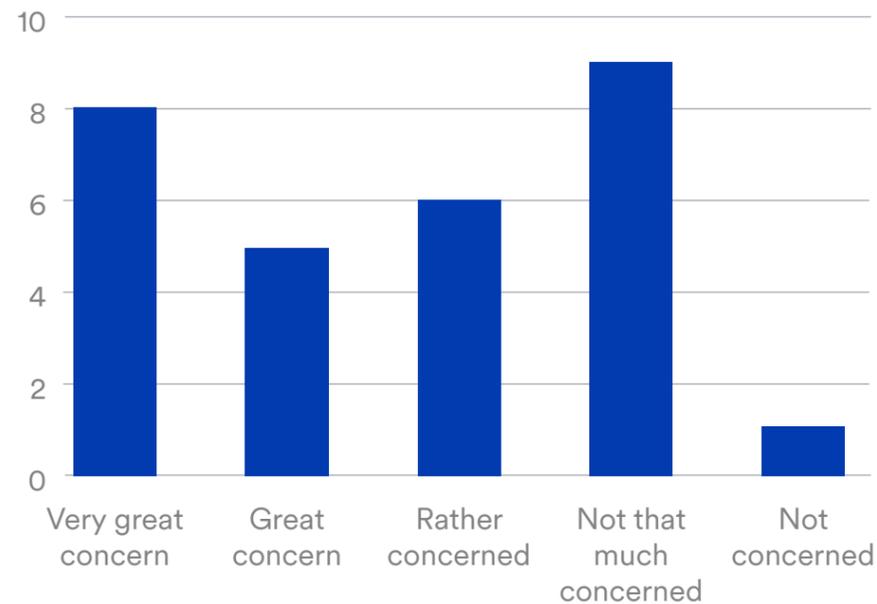
IV) Environmental pollution met with heightened attention

Environmental pollutions have been high on the agenda of real estate vendors and buyers for quite some years. Initially started with the asbestos cases, pollutions have assumed top priority in real estate transactions since the early 2000’s when databases, the need for state certifications and responsibilities to remediate pollutions became commonplace. Ever since, environmental

Market survey

pollutions present a major hurdle to access debt financing from banks or external investors as it threatens to cause additional cost or call into question the very logic of a transaction.

Has the concern about environmental issues risen in the past years?



Given its prominence, for some interviewees the relevance of environmental issues has declined in recent years, as the market has become accustomed to deal with these kinds of risks. Today asbestos has lost some of its horror, as builders and developers can assess fairly accurately the

eventual cost of a contamination and its remittance. The same holds true for some other pollutants, causing some interviewees to state that the overall professionalism and routine with which these kinds of land legacy issues are handled has improved significantly.

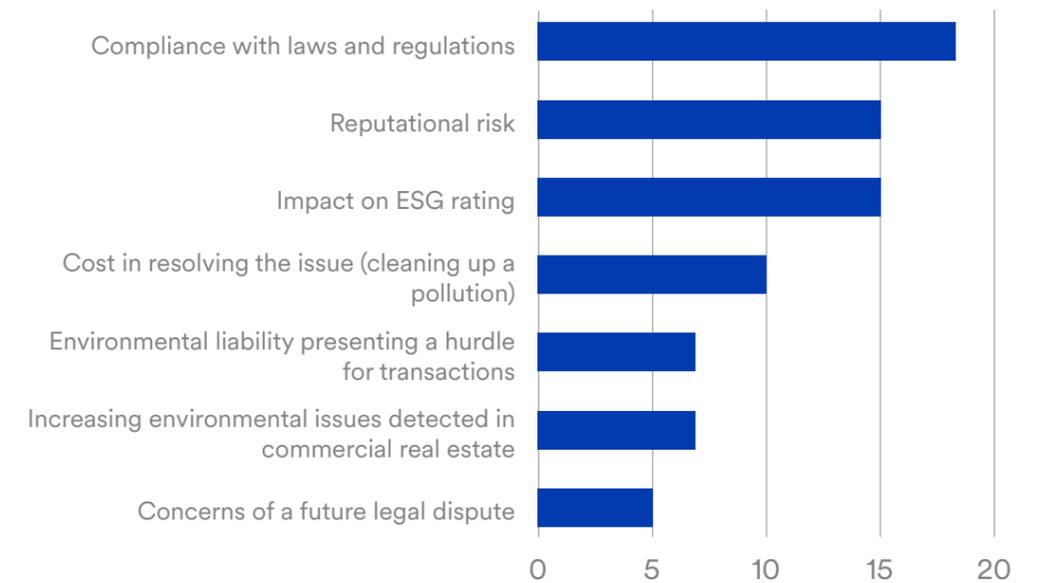
However, for the last three years ESG is seen to have introduced a new dimension. According to some of our interviewees ESG has assumed a relevance which surpasses even the question of finance in real estate acquisitions. Thus, some funds first assess the ESG rating of a property before they even discuss price and financing. However, real estate managers emphasise that ESG must be distinguished from environmental legacy issues, as ESG is less about historical contaminations than about a building's environmental performance, its carbon emissions and energy efficiency.

V) Concern of environmental pollution driven by legal and reputational considerations

To comply with laws and regulations is the top priority when considering the impact of environmental pollution on a property. Not only is there the question of liability, which ultimately rests with the owner of a property, but also its valuation and the ability to finance, use and eventually sell a property, is directly impacted by a potential

environmental pollution. Given the high public attention that these questions receive among policymakers and with the public in general it comes as no surprise that a breach in complying with laws and regulations is perceived as a loss of reputation and therefore as a damage potentially of a far larger dimension than the pollution itself.

What are the main drivers for a heightened concern of environmental issues?



Market survey

Thus, our interviews basically revealed a bifurcation in assessing the environmental pollution of a property. If it is a common case of pollution, that property managers and developers are well accustomed to quantify and resolve, the pollution will have a cost impact but is unlikely to derail the transaction. However, if the magnitude of a pollution and its resolution are difficult to ascertain, it may no longer be a question of cost, but might pose a reputational risk and some buyer might walk away from the deal – in particular, if an institutional investor or a public company is involved, or the transaction is financed through a lender.

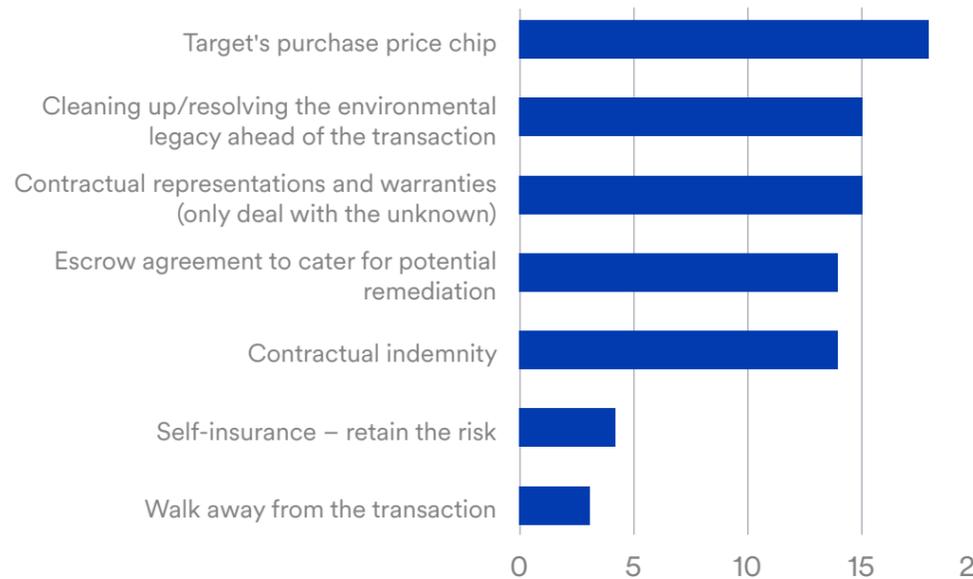
ESG has further aggravated this concern. Although large parts of the framework have still to be translated into regulation, particularly international investors and pension funds, which are perceived as rather risk sensitive, assess properties according to their impact on their ESG rating. In case a contamination might contribute to a deterioration of their rating, they fear a reputational damage and are likely to shy away from an acquisition, unless the cause is resolved.

VI) Quantifiability of the risk is key

How real estate buyers and sellers manage the risk of an environmental pollution of an asset depends very much on the nature of the risk and is addressed on a

case-by-case basis through a combination of solutions. Interviewees emphasised the importance that an environmental pollution – if known – is addressed upfront in a transaction, as it is required in most jurisdiction. This bears the risk that some investors will walk away from the deal. But according to most others, the earlier the risk is disclosed, the higher the chance to resolve the issue.

How do you generally manage the environmental risks in real estate transactions?



A decrease of the purchase price was regarded as the most straightforward and preferred option by many of our interviewees – provided the magnitude of the risk was quantifiable. Alternatively – and equally straight

forward – is the option to resolve the issue and clean up the asset before concluding the transaction. However, since environmental pollutions are often complex and time consuming, it is unlikely that a contamination is removed in time for the closing of a deal. Investors will thus seek additional contractual solutions, such as an escrow or (unlimited) indemnity to cover the risk.

In fact, interviewees also mentioned the reverse practice that the buyer cleans up the site and will benefit from an escrow, should remediation costs exceed initial assumptions. However, escrows are often regarded as an insufficient solution. The buyer and seller might struggle to agree on the sum to be held in escrow and find it difficult to determine the duration until the risk is resolved and the escrow is released.

As an instrument to mostly protect the buyer in a transaction, the parties often also consider the option of contractual indemnity to cover the risk of an environmental pollution. Although this agreement provides some protection against future losses, it is not popular with all sellers and buyers as the parties have to agree on a meaningful duration, have to back it for that time and have to agree on an amount sufficiently large (or even unlimited) to cover future losses.

Market survey

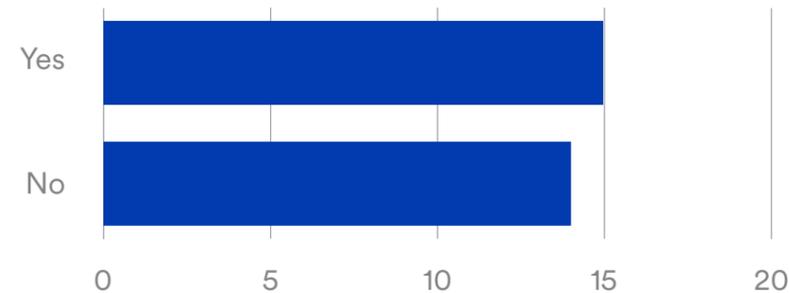
Finally, as a standard measure in real estate transactions, investors will also seek contractual representations and warranties. Although this solution deals with unknown risks in a transaction and might be partially covered through a warranty and indemnity (W&I) insurance, it is only suitable to matters aside from environmental risks, which are traditionally excluded from the W&I coverage. In fact, environmental land legacy insurance has been introduced to cover the risk of an unknown and known pollution and comes into play – according to our interviewees – when the magnitude of the pollution is hard to quantify, and the investors are keen to offload this uncertainty to an insurer.

VII) Insuring against the legacy of environmental pollutions in real estate transactions

About half of our interviewees were aware of the possibility to insure against the impact from an environmental pollution arising in a real estate transaction. While in the UK and to a lesser extent in France, the awareness for this kind of insurance solution is already somewhat advanced, in Germany it is still a rather novel concept. Some players had heard about the opportunity to also protect against related risks, such as against permit challenges, but had not used it or were not aware of the mechanisms and coverage of the insurance.

Similarly, most interviewees were aware of W&I insurance as the standard insurance to cover land legacy risks in M&A transactions, but – since they knew that this policy excludes environmental legacy pollution – assumed that no insurance would be available for this type of risk.

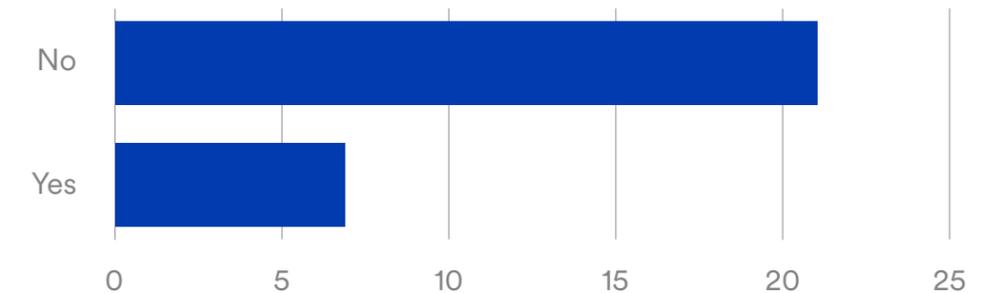
Are you aware that you can insure against the legacy of an environmental pollution?



Those who confirmed that they are aware of the possibility to insure against legacy pollutions, see its benefits in the opportunity to transfer risk to an insurer and thereby resolve uncertainty that could otherwise derail the transaction. Insurance is also perceived more efficient as trying to address the implications of an environmental pollution in the contract and is thus seen as a welcome add-on to top up other measures, such as escrows, addressing particularly the uncertainty of the magnitude of an environmental pollution. However,

interviewees are also concerned about the limits of insurance, as the exposure in cases of environmental pollutions might well exceed an insurance limit.

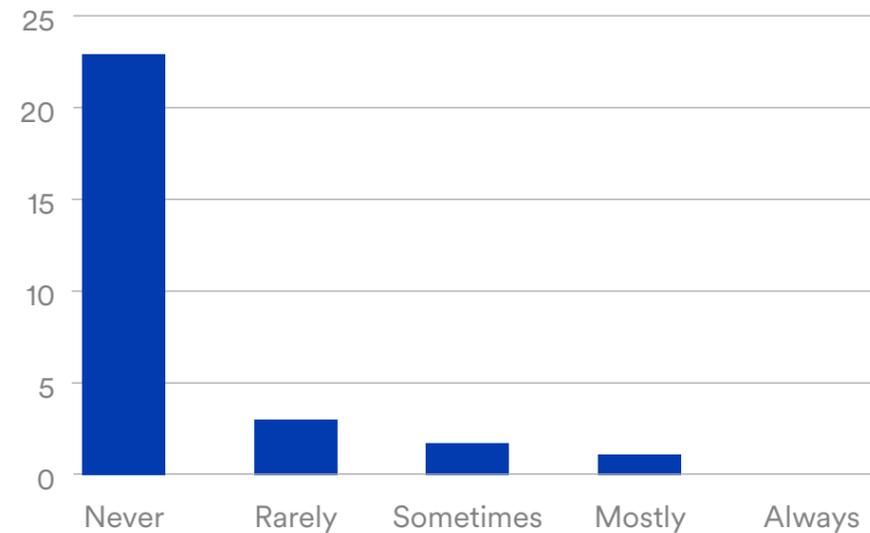
Have you ever insured against the risk of an environmental pollution in a real estate transaction?



Given the limited awareness for environmental legacy insurance, even less interviewees have had first-hand experience with the product. Although some interviewees confirmed to have explored the option to insure, the insurance was most frequently sought in international transactions, where often Anglo-Saxon investors requested an environmental protection as a top-up to their standard W&I policy.

Market survey

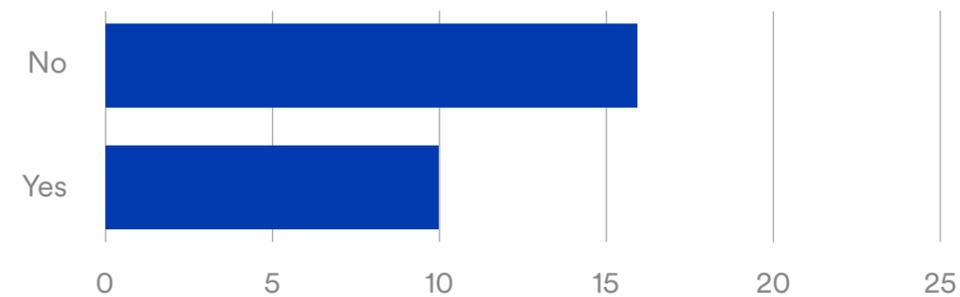
How often do you insure against an environmental issue in real estate transactions?



The insurance for the legacy of environmental pollution still has to prove its point, according to some of our interviewees. ESG has added a reputational dimension to environmental risk, which is forward, but not backward oriented. Otherwise, many investors believe to have a firm grip on environmental risks as they are mostly well documented and the measures to remediate the pollution are established. They deal with the risk through contractual agreements or other means of risk management. Where the tool is known, it is used mostly as an additional security to cover the

residual risk in a transaction, complementing a W&I policy which in “sophisticated” market segments is perceived as a standard “tick-the-box” tool.

Do you perceive a rising demand for environmental insurance / do you insure more frequently against environmental issues than 3 years ago?



Due to the prominence that ESG considerations assume today in an investor’s portfolio, interviewees see environmental issues playing a growing role in real estate transactions. W&I insurance is perceived to potentially point the route for an environmental legacy insurance to evolve that might address the risk of environmental pollutions on a company’s ESG rating. However, thus far, investors need to distinguish between, on the one hand, the reputational risk that an environmental legacy may add to their overall recognition and brand perception

and, on the other hand, the actual cost related to remediate an environmental pollution and which the current insurance of land legacy pollution covers.

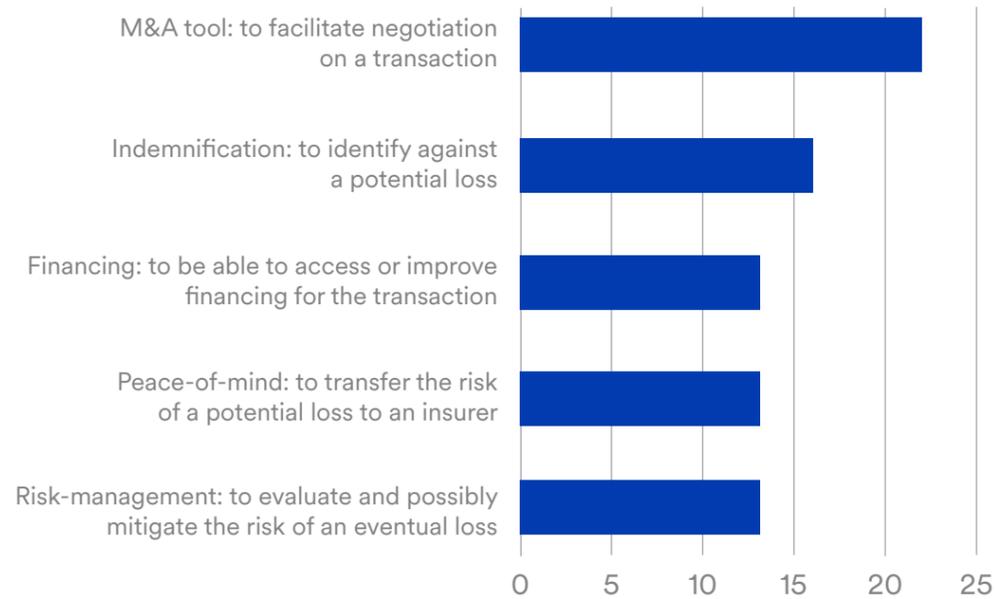
Still, interviewees expect that on the back of the W&I cover which is becoming more and more commonly used in real estate transactions, the demand for an environmental legacy cover will grow, simply because the W&I demonstrates the ability to protect against unknown and sometimes identified legacy risks – other than environmental pollutions. Investors are thus expected to also seek protection for this risk, particularly in cases where the risk is regarded as potentially high, as in brownfield developments.

VIII) Benefits of insurance

Environmental issues have the potential to turn into deal-breakers – not only due to the possible damage they may cause, but also because they may erode the confidence in the counterpart of a transaction. Thus, interviewees emphasise that it is important to address a potential contamination upfront and to resolve the issue between the parties as soon as possible.

Market survey

What is your motivation to insure the risks of an environmental legacy?



Insurance is seen as an efficient way to deal with environmental legacy issues. The cover is mostly used in combination with other risk management tools. Similarly to the effect of W&I insurance, environmental legacy insurance is clearly accredited with the advantage to transfer the risk to an insurer and to enable the transactional parties to focus on the other conditions of their deal. It is also used as tool to smoothen a transaction, as for instance in brownfield transaction the seller will take out insurance to indemnify the buyer, who in turn might be more inclined to accept a higher purchase price.

In environmental legacy insurance the seller in a transaction is still most frequently the insured, indemnifying the buyer. However, W&I insurance has paved the way for the buyers to take out insurance, easing the transaction and protect their own risks.

Covering at least part of the financial exposure posed by an environmental legacy is the second most frequently mentioned motivation for insurance. It protects against some of the downsides – although not all. As one interviewee put it: if an environmental pollution presents a financial risk, he chooses insurance as a protection. However, should the pollution pose a high reputational risk or breach his investors’ recommendations the buyer will choose to pull out of the deal.

To large investors insurance is becoming or has become a standard risk management tool or requirement of their board. Furthermore, international lenders may also demand insurance as a pre-condition for financing. Insurance is perceived to provide peace-of-mind, particularly as in real estate transactions the seller, especially if it is a legal entity, may cease to exist after some time. Insurance also offers the benefit to gather an additional opinion of the magnitude of the risk, as in the underwriting process the insurer will also assess the contamination.

IX) Hurdles to insure

As environmental legacy insurance is not yet commonly used in all real estate transactions, some buyers of the cover are quite price sensitive, and they might look for additional options to manage the risk. The cost of insurance may also be shared among seller and buyer, which might drive the sensitivity too. However, some interviewees also took the opposite attitude, considering that, as compared to the overall purchase of the asset, the cost of insurance may be viewed as relatively low.

What are the barriers/hurdles to insuring against an environmental legacy?



Market survey

Apart from the cost, transparency of policy wordings and the limited familiarity of insureds with the coverage are perceived as key hurdles to insure. For insurance to become a recognised security it is essential that policyholders are confident which risks are covered and will be indemnified in case of a loss. Some interviewees also pointed out that the insurance clauses might be quite standardised, and they would expect more flexibility in the terms and conditions.

Furthermore, environmental legacy insurers are often niche providers that are not part of the big household names commonly known in commercial or personal insurance. Given the fact that environmental issues are longer-tail risks, policyholders want the security that even if a claim occurs year after the policy payment, the insurer will still be there to respond and cover the loss.

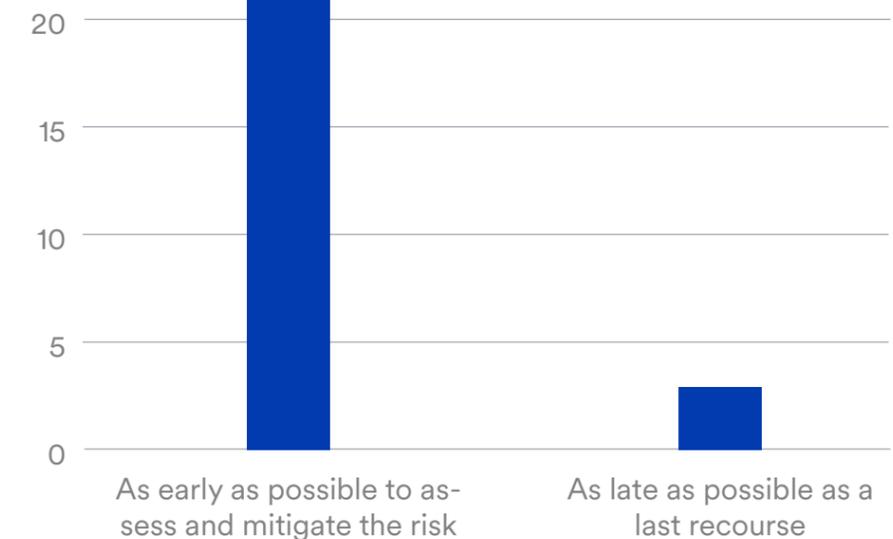
In addition, the underwriting process is often perceived as laborious. Given the complexity of the risk that might not be surprising, particularly as insurers do not benefit from scale but rather need to evaluate each case on its own merits. The parties in a transaction, however, usually work against a tight schedule and clearly prefer a speedy underwriting process to cover the risk before the transaction is sealed.

Finally, another complaint is the lack of choice between different offerings. In fact, since environmental legacy insurance is still a fairly new product which requires considerable expertise, there are few insurers who offer the product yet. That obviously limits the choice of clients who would like to select a coverage best suited to their type of risk.

X) The best time to buy insurance

Investors in real estate prefer to insure the environmental legacy risk as early as possible in a transaction. Firstly, according to many of our interviewees the insurance is part of the due diligence and therefore must be addressed upfront. In fact, it has to be resolved early as to many it is a prerequisite to close the transaction. Secondly, by agreeing on insurance, the parties have more time to take care of other issues and finally, insurance is rarely a stand-alone solution be tied together with other risk management approaches. Often it complements the reps and warranties and thus needs to be negotiated as early as possible.

When in time do you (or would you) buy insurance?



However, there are also some arguments which speak for a late underwriting process. The complex underwriting process often leads to a late signing after the closing of the transactions. Also, some investors try to avoid the laborious underwriting process and see insurance as a risk management tool of last resort, which they will only utilise if other means are insufficient to cover the risk. Explicitly, interviewees said that they prefer to negotiate with the seller a guarantee for the risk and only if that does not work turn to insurance.

Our interviewees agreed that with increasing complexity of the risk insurance is coming in rather late into the process.

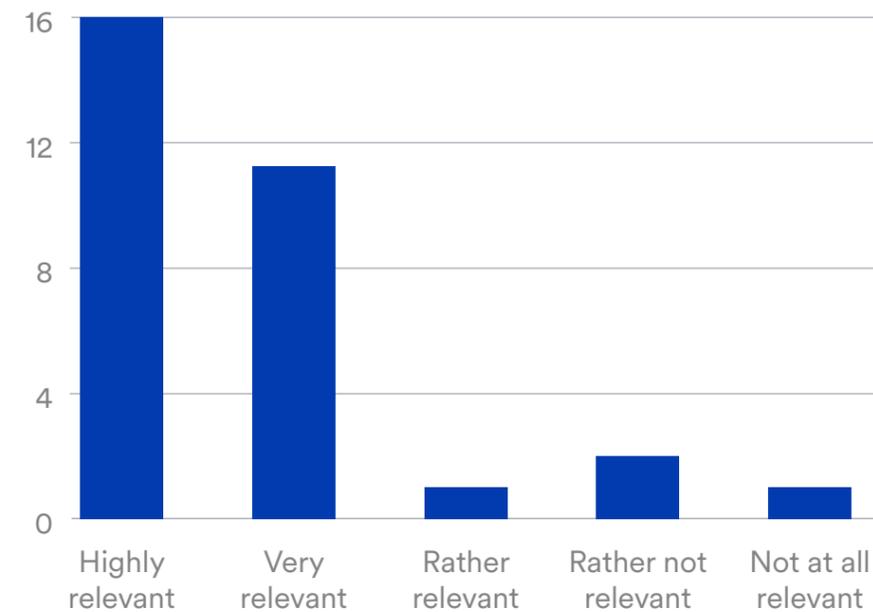
Market survey

By contrast, risks which are fairly easy to determine tend to be insured quickly. Therefore, insurance is often treated as a safety net against uncertainty, frequently used when there is a potential risk for a pollution and the seller might not be ready to provide protection against it.

XI) Impact of ESG on the perception of environmental pollution

Having originated in the investment community, it comes as no surprise that environmental, social and governmental (ESG) metrics play a significant role among real estate investors. However, important differentiations must be made with regards to environmental legacy pollutions. ESG in real estate mostly concerns the environmental performance of a property: for instance, if it still is to be built – how much carbon emissions the construction may cause, or, if it has been built – how much carbon a property will emit or how energy efficient it performs when heating or cooling the building. These performance indicators may well influence the investment decision of an investor, but they are not related to a potential legacy pollution. This perception may however change, if – as announced – upcoming European and British ESG regulation includes existing pollution reporting as an obligation.

Is ESG of relevance to real estate investors?



According to our interviewees ESG has become highly relevant or at least very relevant to real estate investors over the course of the past two to three years – many expect its relevance to even increase further. Investors, the public and also governments have a keen eye on the environmental performance of a property. In France the housing sector is regarded to be responsible for about 50% of the country’s carbon emissions. In 2020 the French government issued a decree that companies need to reduce their carbon emissions, and that publish their performance.

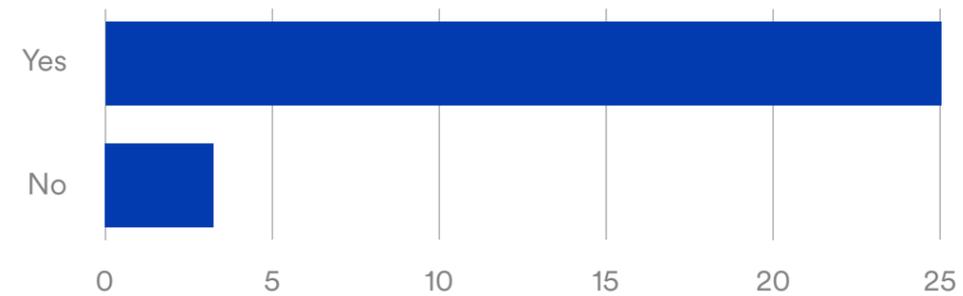
Thus, particularly institutional investors or publicly listed companies (like REITs or “Foncières”) are highly conscious, and most often, already reporting on their ESG performance. To non-institutional or smaller investors, such as family offices, ESG might be less relevant at this stage. They are however becoming more and more aware of the fact that ESG now affects a property’s valuation and its appeal to lenders or future buyers.

ESG matters most to international investors, who are concerned about their credentials and overall ratings in terms of their environmental performance. Those investors who also exclusively manage green funds are likely to pull out of a transaction, if the asset under consideration is affected by an environmental pollution which is unlikely to be resolved before or immediately after the closing of a transaction.

Those interviewees who see less relevance for ESG clearly distinguish between the environmental performance of a property and its legacy and consider the two items as quite separate. Furthermore, they remarked that an established market standard and a specific taxonomy on how to rank and rate ESG performance is still missing in real estate.

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Do you have a strategy in place to improve your ESG rating in your real estate portfolio?



Many institutional investors have started to report on ESG. In some markets they have entered contractual obligations to provide information on the ESG performance of their property. As a result, the most sophisticated funds or investors have defined a strategy to manage and improve their ESG rating which is overseen by a dedicated ESG director. Often enough, their assessment has become a crucial voice in the investment committee. These companies are thought to refrain from investing in assets with a low ESG rating, unless it is obvious how to improve it. The situation is different for the smaller players which have just started to define their attitude towards ESG.

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