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POLAND
Growing impact of ESG factors in commercial real estate financing

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He has more than 10 years' experience in real estate finance, project finance, general corporate lending and acquisition finance as well as soft financial restructurings. He has been involved in several of the biggest real estate financing transactions in the Polish market, which related to a wide variety of assets, including student housing, residential rentals, warehouses, office and retail. He provided advice on numerous complex cross-border transactions.

He assists both investors, including private equity funds, public and private companies, as well as Polish and foreign financial institutions. He advises clients on all stages of transactions and works on deal structuring, term sheets, loan agreements, including contracts based on the LMA standard, intercreditor agreements and security documents.

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Growing Impact of ESG Factors in Commercial Real Estate Financing

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The attribution of a key role to financial institutions in connection with the achievement of the UN's Sustainable Development Goals[1], i.e. the action plan to transform the world so that the needs of today's generation can be met in a sustainable way while respecting the environment and taking into account the needs of future generations, is now one of the more frequently repeated theses. Considering, amongst others, the goal relating to climate actions, the role played by banks financing commercial real estate sector, which is considered producing substantial part of global carbon emissions and global energy demand, seems particularly important.

The European Union's climate change legislation sets out the long-term direction of EU climate policy. The EU's goal is to achieve zero net greenhouse gas emissions by 2050 (climate neutrality). Transformation risks affect mostly sectors with higher levels of greenhouse gas emissions (including commercial real estate). Banks with exposures to borrowers that are unable to successfully adapt to carbon-neutral economies and other requirements may suffer greater credit losses.

The concept of ESG, i.e., all issues related to environmental, social, and corporate governance, is becoming increasingly important for many companies and institutions, but also for the economy as a whole (with a strong emphasis on "E" when it comes to the commercial real estate sector). This has to do, among other things, with increasing regulatory pressure in the EU, market pressure, ownership requirements (with a growing segment of investors opting for "green" investments) and the ability to raise finance, especially in the long term. Although the ESG principles apply to every sector, the impact will vary.

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Redirecting capital flows towards more sustainable operations and investments has a real impact on the activities of financial institutions. While they do not have a significant share in the CO2 emissions, they can influence the development of specific industries with their financing. Banks, among others, are the entities that — as intended by the European Commission and politicians and given the scar city of public funds in the EU — will play an important role in redirecting funding from carbon-intensive sectors towards low-carbon sectors or the energy transition. This will be achieved through changes in the investment and lending policies of financial institutions, among other things, affecting lending to the real economy.

Non-financial reporting, the scope of which has expanded over recent years mostly due to the entry into force of the Corporate Sustainability Reporting Directive (CSRD)[2], requires banks to analyse the impact of their activities on the achievement of sustainability objectives. The specific nature of the banking sector's activities means that measures of this impact are linked to the financing provided to the banks' customers. Banks interact with their customers to implement and fulfil their obligations imposed by EU legislators and have been assigned a special role in the EU economy as a catalyst for green change by gradually redirecting the flow of finance to green companies and green projects. The most important and direct impact will be achieved through the modification of the criteria for financing provided by banks.

1. www.un.org/sustainabledevelopment/sustainable-development-goals/
2. Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, regardin corporate sustainability reporting.

Energy use in buildings is associated with a noticeable contribution to greenhouse gas emissions, making upgrading the energy efficiency of existing buildings or stringent requirements for new buildings a key aspect of climate transformation policy in the EU. In this regard, differences in the energy efficiency of buildings may be associated with different levels of exposure to transition risk, potentially materialising in the market value of the building through changes in the market demand towards a preference for energy-efficient buildings or policy changes regarding energy-related building regulations. It seems that zero-emission buildings will gain in value in the future, while others are likely to depreciate or, in the longer run, even become unsaleable.

Banks active in the Polish commercial real estate market have almost universally incorporated components of sustainable finance into their range of products and services and are already taking many actions in response to regulatory requirements. The banking sector in Poland shows a strong commitment and willingness to support sustainable development goals and this approach is having an increasing impact on financing of commercial real estate sector.

We have observed a growing number of loans provided by banks on the commercial real estate market in Poland classified as "green loans" or quasi green loan type. The frameworks for such loans vary across the lenders' internal standards and requirements. However, based on the Loan Market Association's Green Loan Principles (GLP) and Guidance on Green Loan Principle, to qualify as a green loan, the loan must comply with the following four components of the GLP: 1) use of proceeds, 2) process for project evaluation and selection, 3) management of proceeds and 4) reporting. This also includes applying the loan's proceeds to an eligible green project including a green building that meets regional, national or internationally recognised standards or certifications. This type of financing can be summarised as loans that must contribute to sustainable development and can be provided to projects and investments in buildings with specific green credentials that satisfy bank's requirements subject to the LMA-based framework. From the financial point of view, such a green loan offers better terms than a corresponding loan that is not green and for this reason, but also because of the growing maturity and awareness of investors, such loans are becoming more and more popular.

Apart from green loans, other ESG related factors started influencing the approach of banks to financing commercial real estate, e.g., banks have started considering certification of a building with BREEAM certificate with a rating category of either "outstanding" or "excellent" as an absolute standard necessary to implement financing rather than a nice thing to have by the property owner.

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Regulatory pressures are driving change in the EU financial sector, and financial institutions are subject to an increasing number of requirements related to environmental financial risk management and sustainability-linked disclosures. The reporting obligations are passed on to the borrowers considering the need of the lenders to collect significant amounts of ESG data necessary to review the ESG performance of the financed portfolio, hence lenders constantly seek improvements within information undertakings in the loan agreements.

Another practical implication of the ESG-driven approach of the banks financing commercial real estate assets that can be observed in financing documentation concerns undertakings relating to the reduction of energy demands or obligations to implement and comply with ESG strategy.

It has become a market standard that every facility agreement, regardless of whether it provides for green or non-green financing, relating to commercial real estate, contains environmental provisions. We expect to see ESG-related elements to further develop within property due diligence examination requirements of the banks and also at the level of LMA-based financing documentation. In addition, investors have noticed strong reputational advantages relating to sustainable financings.

Summarising, green finance is no longer a new phenomenon, but rather a permanent part of the Polish commercial real estate lending market. We expect further developments in this area and increased numbers of financing transactions based on green loans.

Private Rented Sector with potential to growth

Rampant inflation, rising interest rates and the introduction of the recommendations by the Polish Financial Supervision Authority, which tightened credit score calculations for mortgage-backed residential loans, were the factors that negatively impacted Polish residents' ability to obtain residential loans. In addition, the outbreak of war in Ukraine and the ensuing influx of refugees, has extended plans to address the housing shortage (currently estimated at around 2 to even 2.5 million units, depending on the source), progressive demographic and social changes and high prices of new apartments – all of these factors have constituted grounds in recent years for the growth of Private Rented Sector (PRS) in Poland. Also, Polish people live in overcrowded flats, as, according to Eurostat data, Poland's overcrowding rate is 19.4 pp above the EU average. The average number of rooms per person in Poland is 1.2 (0.4 less than the EU average).

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PRS in Poland recorded a surge in growth last year. This has resulted in more than 10,300 apartments being available for rent from institutional investors by the end of 2022 according to a report by Knight Frank and Dentons. Market data clearly suggests that PRS apartments are still in demand. It is confirmed by extremely low vacancy rates in the sector estimated at ca. 3%. In many projects, the majority of apartments are rented before the project is completed.

Until recently, the rental housing market in Poland has been dominated by private investors. The sector was not of interest to institutional investors for a long time. Institutional rental has started to gain popularity and funds specialising in this sector are now thriving in the market. Many entities already investing in the commercial real estate market are beginning to consider PRS as a key complementary strategy for their investment portfolios. Many owners of old office and retail projects are considering demolishing them and replacing them with PRS projects.

From the lending point of view, we observe an increasing number of financial institutions eager to finance PRS projects at both the construction and the investment stage. Noteworthy is the financing of PRS projects in Poland by the European Bank for Reconstruction and Development (EBRD), which closed a number of transactions last year under the EBRD's Resilience and Livelihoods Framework program which aims to support Ukraine and countries affected by the Russian invasion of Ukraine.

Tenants in PRS projects pay rent in Polish zlotys. At the same time, the cost of lending in zlotys remains relatively high, as interest rates remain high. We have observed a noticeable increase in investors' willingness to secure euro loans with a sponsor's guarantee which seems to remain the only option for the banks to accept a currency mismatch.

The projected pipeline of projects is around 55,000 flats in the coming five to seven years. The PRS sector currently accounts for only ca. 1% of all apartments available for rent in Poland. Even if all planned projects are built, the institutional rental market will remain marginal. The above data confirms there is a lot of space for further PRS growth, especially since the above-mentioned reasons for the development of the PRS sector in Poland are likely to continue in the coming years. The market is awaiting major built-to-sell developers to decide to deliver more PRS projects instead of apartments for sale which should fuel further growth in the PRS sector.

Growth of demand for private debt lending

Private debt lending (sometimes called 'private credit' or 'direct lending') has increased in popularity as an alternative to bank financing and DCM (debt capital market). Characteristic of this type of financing is that it is provided by non-licensed lenders, very rarely within syndicated structures and the loan amounts tend to be medium sized. Financing transactions involving private debt providers are, compared to bank financings, usually more time efficient (including the decisions making process) and the terms of such transactions are more tailor-made and generally more flexible. Another advantage would be fewer administrative and reporting obligations on the borrowers' side.

Banks active in the Polish real estate market have become more selective about financing certain classes of assets, the retail sector being a good example of that. In addition, the Polish government mandated mortgage holidays, which cost the banks billions and led to a reduction in their activity. These were the factors that created space for the activity of private debt lenders. However, we prefer not to classify private debt as direct competition to the services provided by banks, but rather as a means to bridge the void left by the decline in loan-to-value (LTV) ratios offered by banks.

All of the above advantages of private debt financing come at a price as borrowers have to pay accordingly. The high tolerance for risk demonstrated by private lenders is combined with an appetite for high returns. Interest rates on private debt loans are relatively higher than pricing offered by the banks.

As tax gross-up clauses are standard in financing transactions involving private debt providers, before entering into cross-border financing transactions with private debt lenders seated abroad an investor should primarily consider the tax implications, including whether any withholding tax would apply, the so-called pay & refund mechanism and what procedural formalities would be necessary for the borrower to obtain authorisation to make interest payments without or with the lowest tax deductions the given double taxation treaty or Polish law permits.
On the lending side, private debt lenders should note that, under Polish law, the contractual, capital interest on hand can be freely set by the parties to the loan agreement, but it cannot exceed the maximum interest, i.e. twice the statutory interest on an annual basis pursuant to the provisions of the Polish Civil Code. If the amount of interest under the loan agreement exceeds the maximum interest, the maximum interest is due. Contractual provisions may not exclude or limit the above provisions on maximum interest, also in the event of a choice of foreign law. If the parties choose foreign law in the agreement, the above statutory provisions will apply to maximum interest anyway. The provisions of Polish Civil Code on maximum interest would not apply to bonds' coupons nor foreign law financing at holdco level seated abroad, however, in the latter case, any debt pushdown mechanism should be carefully analysed. Private lending is still a relatively small market with a lot of room for growth. Given the increased activity of private lenders, we can expect to see more and more financing transactions involving private debt.

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