

White Paper

*Climate Risk is
Investment Risk*

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AN INTRODUCTION TO CLIMATE RISK

If any business had been able to foresee the impacts of the COVID-19 pandemic prior to 2020, a pre-emptive review of corporate strategy and processes would have been undertaken to futureproof that business in advance.

Climate change poses an even potential greater threat to the economy and public health than COVID-19 over the long-term, so what is stopping many investment managers from acting with greater urgency on climate risks?

Like any major shift in demographics, technology or policy, climate change is a global megatrend that investors of any asset class would be remiss to ignore. Real asset investments are particularly exposed to climate risk for several reasons, including their relative illiquidity and long hold periods compared to other asset classes, their immobility, their significant contribution to global carbon emissions, and their vulnerability to physical damage from weather events.

Fortunately, there still exists a window of opportunity to adapt investment strategies and business models for greater resilience to a warming planet and a low carbon economy.

Though it is not necessary for investment and risk managers to become experts in climate science, a basic understanding is prudent for understanding the magnitude, scope, and timing of climate risk – and ensuring that the risks are appropriately considered in real estate investment processes as part of fiduciary duty.

A Primer on the Science and Regulations

The scientific consensus shows that the warming global temperature is due to an increase in human contributions to greenhouse gases in the atmosphere. The Intergovernmental Panel on Climate Change (IPCC) has reported that it is imperative to limit global warming to 1.5°C above pre-industrial levels, which implies reaching net zero carbon dioxide (CO₂) emissions by 2050 – and an interim target for carbon emissions to be approximately halved by 2030 (termed in the media as the ‘decade of action’).

If the world fails to meet these carbon reduction targets and emissions continue rising at current rates, the global temperature rise could exceed 4°C. In such scenarios, scientists agree that tipping points are likely to be reached that will cause severe, pervasive, and irreversible impacts to the earth’s ecosystems due to climate change.

Government regulation across the world is rapidly catching up and many are paying heed to the clear and unequivocal science. The UK and the European Union have enshrined into law that all buildings must be net zero carbon by 2050 to avoid the worst effects of climate change. In the Asia-Pacific region, the three largest economies have all made commitments to

achieve net zero carbon – with South Korea and Japan committing to a target of 2050, and most recently China by 2060. The United States has also renewed its focus on climate action, with a revised commitment to reduce emissions by 50-52% below 2005 levels in 2030.

Despite progress, today’s policies and pledges are only enough to limit warming to 2.7 – 3.1°C¹ and physical impacts are already unfolding with shocking severity.

Climate Risk is Investment Risk

For investment managers, the risks of climate change fall into two channels:

- The **physical risks**¹ of climate change from weather related events, such as flooding, extreme heat, and sea-level rise; and
- **Transition, or policy risks**, inherent in adjusting to a lower-carbon economy. This can include pricing for carbon dioxide emissions, costs related to the purchase of low-carbon technology, and shifts in social norms and preferences.

Climate risk itself also brings unique challenges, including a lack of historical precedent, long-term time horizons, and great uncertainty.

¹ Climate Action Tracker (2021). 2100 Warming Projections. May 2021 Update. <https://climateactiontracker.org/global/temperatures/>

Like the COVID-19 pandemic, the impact of climate risk to investments could be significant and sudden. It is incumbent upon investment managers to appropriately plan for and manage risk, in all its forms, using the best information and analysis that is available.

Investments can be impacted by climate risk through some of the following means:

- **Financial risk.** Extreme climatic hazards can cause physical damage to real estate and surrounding infrastructure, which may lead to impacts to building access and operability, rental demand, repair costs, and asset value. Additionally, the increased likelihood of extreme weather may lead to higher insurance premiums, or in some cases loss of insurability, with consequences to valuations and possible obsolescence. As well, property that is poorly rated on energy efficiency may require capital injection for costly retrofits, and assets that are significantly off-track from a Net Zero Carbon

(NZC) pathway may experience reduced demand and valuation from institutional buyers who have set their own NZC targets.

- **Reputational risk.** Investors and tenants are increasingly climate literate and societal expectations are evolving in relation to climate change; this can then affect asset valuation even before the more drastic physical impacts manifest. With increasing stakeholder activism, investment managers seen as not taking action on climate change can also face reputational risk that may undermine asset business models.
- **Liability risk.** Climate risks that are foreseeable but not managed or disclosed by investment managers can cause exposure to liability risk. It can be considered a fiduciary duty to minimise losses from climate change and to disclose climate risks transparently.

WHY IS THIS IMPORTANT FOR INVESTMENT MANAGERS?

All areas of the economy, including real estate, will face major disruption to business-as-usual resulting from climate change and emerging regulations coming into force.

To date, forward-looking climate risk has been slow to be reflected in asset value. The reasons for this failure include:

- Climate change having been considered an externality falling outside the responsibility of organisations and investment managers, and possibly covered by insurance,
- The perception that timescales at which negative consequences from climate change manifest are significantly longer than current holding periods of assets,
- Lack of disclosure of climate risks, partly due to challenges with data, and
- Lack of consensus on how to quantify and price climate risks.

Some of these inhibitors are being addressed. Through government and regulatory policy, the social costs of climate change are being internalised to organisations including investment managers. The prolonged and frequent media coverage of natural disasters, most recently in deadly flash-floods and sweeping wildfires, have led to an increasingly informed public that is demanding climate action now.

And importantly, a variety of forces are driving businesses and investment managers to disclose how climate risks (and returns) are being managed.

Climate Risk Management and Disclosure

As the adage goes, what gets measured gets managed – and climate risk is no different. Disclosure and reporting can be tedious topics, but transparency is crucial for informed pricing and capital allocation decisions.

The Task Force on Climate-related Financial Disclosures (TCFD) was established by the Financial Stability Board to develop a process for understanding and reporting on climate-related

financial information. The recommended disclosures are intended to help stakeholders understand how exposed or resilient an investment is to climate risks, leading to more accurate pricing over time. The TCFD Recommendations provide a means for proper management and reporting of climate risks and opportunities in the same way that other material financial risks are treated.

Commitments to align to TCFD Recommendations have skyrocketed in recent years, with the most recent tally at 2,600 supporters globally, including 1,069 financial institutions responsible for \$194 trillion.²

Drivers for investment managers to develop a climate risk management framework in alignment with the TCFD Recommendations include:

Investor Pressure

Many institutional investors and other stakeholders have started demanding information on climate risks and resilience in due diligence questionnaires and in on-going investor reporting, often driven by their own requirements to track and disclose this information. These requests are sometimes taken verbatim from the TCFD disclosure recommendations and have been increasingly focused on financial quantification of risk (often in terms of a “climate value at risk,” a “modelled average annual loss,” or potential impact to portfolio value) using scenario analysis.

Investment managers who have not yet begun their journey toward measuring and managing their climate risks and opportunities may be caught flat-footed by these investor demands. Since scenario analysis and financial quantification are more advanced stages of TCFD alignment, it’s recommended to start the process as soon as possible in order to be prepared to respond to such requests.

² TCFD (2021). 2021 Status Report. https://assets.bbhub.io/company/sites/60/2021/07/2021-TCFD-Status_Report.pdf

Inability to disclose climate risks and risk management strategies to investors may jeopardize those relationships and the ability to attract capital.

Regulatory Requirements

In November 2020, the UK became one of the first countries in the world to mandate economy-wide disclosures in line with the TCFD recommendations, impacting asset owners, asset managers, listed companies such as REITs, and large private companies.

Around the world, there are numerous regulatory authorities requiring or encouraging adoption of climate risk reporting aligned with the TCFD Recommendations. Some notable examples include:

- In March 2020, **Germany's** Sustainable Finance Committee encouraged the federal government to require all listed companies to disclose climate risk in alignment with TCFD by 2022,
- In May 2020, the **Canadian** government required all businesses seeking bridge financing from the COVID-19 pandemic to publish annual disclosures in alignment with TCFD,
- In December 2020, **Switzerland's** Federal Council indicated that authorities should prepare the binding implementation of the TCFD recommendations for Swiss companies across all sectors of the economy,
- Also in December 2020, **Hong Kong's** Green and Sustainable Finance Cross-Agency Steering Group published a new Strategic Plan, announcing that TCFD-aligned disclosures will be mandatory across relevant financial sectors by 2025,
- In April 2021, the **European Commission** issued a proposed Corporate Sustainability Reporting

Directive (CSRD), noting that reporting standards should incorporate the TCFD framework,

- In June 2021, the **G7** countries endorsed mandatory climate-related financial disclosures based on the TCFD framework,
- In July 2021, the **United States** SEC Chair announced likely mandatory climate risk disclosure rules by year-end.
- In August 2021, the **Singapore** Exchange Regulation proposed a road map for mandatory TCFD-aligned disclosure,

In Europe, the new Sustainable Finance Disclosure Regulation (SFDR) has also introduced disclosure requirements aiming to provide transparency on sustainability within the financial markets in a standardised way. This will help ensure comparability and prevent 'greenwashing'. This regulation covers all aspects of ESG, including climate risk, and became applicable from 10th March 2021.

Better Investment Performance

Although much of the drive toward adoption of TCFD-aligned climate resilience strategies is coming from external investor pressure and regulation, many firms are using the framework internally to improve their risk management processes and make their strategies more resilient to climate risks.

Although there will be significant costs associated with transitioning and adapting under climate change, there will also be opportunities for well-positioned companies and investors.

As climate risk is being incorporated into investment strategies more widely, it is becoming a competitive disadvantage to remain in the dark without valuable climate data and an informed investment thesis.

HOW CAN INVESTMENT MANAGERS ACT NOW?

The required changes to governance, identification of risks, and changes to business strategy can take several years to generate meaningful disclosures that are relevant to investors. So, how best to get started?

Obtain buy-in and establish common language

- Engage with the business – educate and upskill Board and C-Suite management about climate risks and opportunities
- Obtain buy-in from key stakeholders across the investment lifecycle, including risk managers, research teams, acquisitions teams, fund managers, asset managers, development managers, and property and facilities managers.
- Conduct training workshops on sustainability and climate risk so that all key decision makers are aware of their responsibilities in identifying and assessing climate risks and opportunities, and when they should be considered in the decision-making process.

Conduct materiality assessments

- Identify the potential material climate risks and opportunities, and their likely time horizon of impact to the portfolio. Consider scenario analysis as a tool to test the resilience of your assets and strategies.
- Utilise climate models or software that provides climate data analytics to better understand hazard exposure in the locations and markets in which you invest, ideally across multiple timeframes and scenarios (e.g. decadal results through 2100 for RCP 4.5, RCP 8.5, etc.). Also consider the vulnerability of your assets to those hazards, based on their structure and operation, and the potential financial impacts that these risks could inflict over time, such as unanticipated capital expenditures, higher insurance costs, and reduced rental demand from occupants.
- Measure exposure to transition risk in the portfolio by assessing current carbon intensity and absolute carbon emissions of assets, accounting for geography and sector.
- Utilise publicly available tools (e.g. CRREM) to gauge whether the portfolio's current carbon intensity is in alignment with forward-looking

emission reduction targets required to limit global warming to 1.5°C – and evaluate the capital expenditures and impact to asset value to achieve this alignment.

- Assess transition risk by reviewing emerging policy and regulation at national and local levels, such as energy performance requirements or carbon intensity caps; equally, examine opportunities including the supportive measures being introduced to incentivise low carbon investment.

Define appropriate action

- Assess your options for managing climate risks and opportunities within the context of the firm's and fund's investment strategies.
- Consider key decision-making points and degree of control post-acquisition. Assessing climate risk at the deal stage will be important to both equity and debt investments in real assets; however, with directly managed equity investments, there is greater ability to make changes to the asset and mitigate risks during the hold period. With debt, there is less opportunity to manage risks after the loan is issued, so screening deals and borrowers early on is important.
- Similarly, the degree of control and willingness for capital investment may vary by investment strategy, hold period, and lease structure. For example, a Value-Add fund could consider seeking out and refurbishing carbon-intensive assets. A Core fund may rely instead on adjusting acquisition and disposition strategies, with a preference for already resilient assets, as there may be limitations on capital available for major refurbishments.
- Where feasible, consider climate risks in the pricing of new acquisitions, and be prepared for future buyers to do the same when you intend to sell an asset. While many investment managers have expressed concern that climate risk-adjusted pricing simply will not win deals, there is growing anecdotal evidence that price-chipping is happening in certain markets, for both physical

and transition risks. This may manifest as building in additional capital expenditure needed to improve an asset’s energy performance, or adjustment to capitalization rates (particularly terminal cap rate) to account for perceived increases in flood and storm risk, for example.

- For standing investments that are directly managed, consider creating management plans to align assets with science-based target trajectories through energy efficiency retrofits and renewable energy installations.
- Review climate risk at the market scale. For example, investigate whether assets that are vulnerable to physical risk are within cities that are undertaking resilient infrastructure projects and have emergency preparedness plans – and that the market has ample availability and affordability of property insurance. Market liquidity scores and municipal bond ratings may serve as “canaries in the coal mine” for changes in perception of climate risks by investors and lenders. On the transition risk side, examine local and national decarbonisation policies, and whether local economies are heavily reliant on carbon-intensive industries.
- Be cognisant of exit strategy. While it may seem like climate risk is not consistently incorporated into real estate transactions today, we can be sure that in five to ten years more investors will be screening for climate risks and their methods of pricing in those risks will be more sophisticated. Even for assets with shorter hold

periods, there exists an opportunity to add value to the asset by minimising climate risk and marketing it as such to future buyers; climate risk in valuation will become increasingly common practice.

Report on climate risks

- Identify key climate-related metrics that should be measured, monitored and disclosed.
- Early disclosures have tended to be qualitative narratives reporting on progress toward TCFD alignment and plans for future improvement; however, pressure is increasing for disclosures to be more specific and quantitative.
- Provide transparent disclosures to stakeholders on the climate risks identified in your portfolio, how you assess their materiality, the associated financial impacts (historical, current, and forward projected under scenario analysis), and how you manage them.
- Describe your firm or fund’s Transition Plan, a recent inclusion in the TCFD’s updated guidance.³ A Transition Plan should be part of your overall business or investment strategy that lays out a set of targets and actions (such as reducing GHG emissions) supporting your transition to a low-carbon economy, and toward Paris alignment.

The massive changes required will ultimately be achieved through a team effort across all stakeholder groups, including regulators, insurers, lenders, asset owners, asset managers, and tenants. EVORA believes that the many of the challenges faced by asset owners and investment managers are addressable now and can be mitigated with a systematic and pragmatic approach.

Addressing climate risk in investment portfolios is now firmly part of fiduciary responsibility and this will not diminish. Failing to “grasp the nettle” and put a plan in place today will only magnify future risks and costs of corrective actions. Those who continue to wait for proof that these serious financial risks will manifest before acting may be in for a rude awakening. Those who proactively make changes to decarbonise and futureproof their portfolios will be better poised for success, and will act as facilitators – rather than blockers – of the necessary transition to a more resilient, low-carbon world.

³ TCFD (2021). Guidance on Metrics, Targets, and Transition Plans.

https://assets.bbhub.io/company/sites/60/2021/07/20-21-Metrics_Targets_Guidance-1.pdf