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The management of transitional climate risks

In the context of environmental, social and governance (ESG) and sustainability in the real estate industry, a major focus is currently placed on the energy performance of properties and their respective carbon dioxide (CO_2) balances. This often happens because of regulatory mechanisms such as the EU Energy Performance of Buildings Directive (EPBD) or CO_2-pricing, as well as changing demand patterns, particularly in the office sector.

What many market participants may not be aware of is that these regulations and market changes should be explicitly captured and analyzed as climate risks in a systematic climate risk analysis. These risks are known as transitional climate risks. Transitional climate risks are risks resulting from the transition to a more sustainable economy. These risks do not arise from direct physical impacts of climate change (physical climate risks), but from the societal, political, technological, or economic changes stemming from efforts to fight climate change. Physical climate risks directly affect the structure and operation of properties, including acute risks from weather events such as storms or floods, as well as chronic ones that manifest, for example, in long-term and permanent changes in rainfall patterns or number of heat days per year.

On the contrary, transitional climate risks include:

1. **Regulatory risks:** New environmental laws and regulations may require investments in 'greener' technologies and building materials. Stricter emissions regulations may require older, energy-inefficient buildings to be modernized.
2. **Market risks:** Demand for energy-efficient buildings and those with a small CO_2 footprint is increasing. Properties that do not meet these requirements will lose market value.
3. **Technological risks:** The development of new, sustainable building technologies could require the modernization of existing properties. For example, buildings without modern heating and cooling systems based on renewable energy could lose competitiveness.
4. **Reputational risks:** Real estate companies that do not take sufficient measures to reduce their environmental footprint could lose prestige. Investors and tenants could migrate to more sustainable competitors.

The economic relevance of these transitional risks should be indisputable. Nevertheless, many investors and investment managers deal with individual points in isolation, such as a specific regulation, like the national legislation on the rentability of non-sustainable offices in the Netherlands or residential properties with a poor energy efficiency grade in France. This approach tends to react to individual risks as they arise, rather than acting proactively and strategically.

Strategic management of transitional climate risks as a competitive advantage

The more complex the portfolio (in terms of usage types, regions, and tenant structures), the more challenging the systematic management of physical and transitional climate risks gets. However, a concrete analysis of the physical and transitional risks and opportunities will be required for most companies in the future due to the requirements of the Corporate Sustainability Reporting Directive (CSRD – required in the 'climate change' standard ESRS E1).

Companies should not see this analysis as a burdensome documentary obligation but should use it to align their portfolios to gain competitive advantage in the future. Figure 1 shows a simplified representation of the interplay between external (physical and transitional) climate risks and the individual portfolio. Specifically, the risks relevant to the portfolio must be identified and assessed according to regions and types of use, so that their relevance can then be validated on an individual object level. Ultimately, relevant adaptation measures (e.g., construction measures, insurance strategies or even divestments) and time points are derived. This analysis is also essential for positioning the future acquisition strategy on economically sustainable feet.

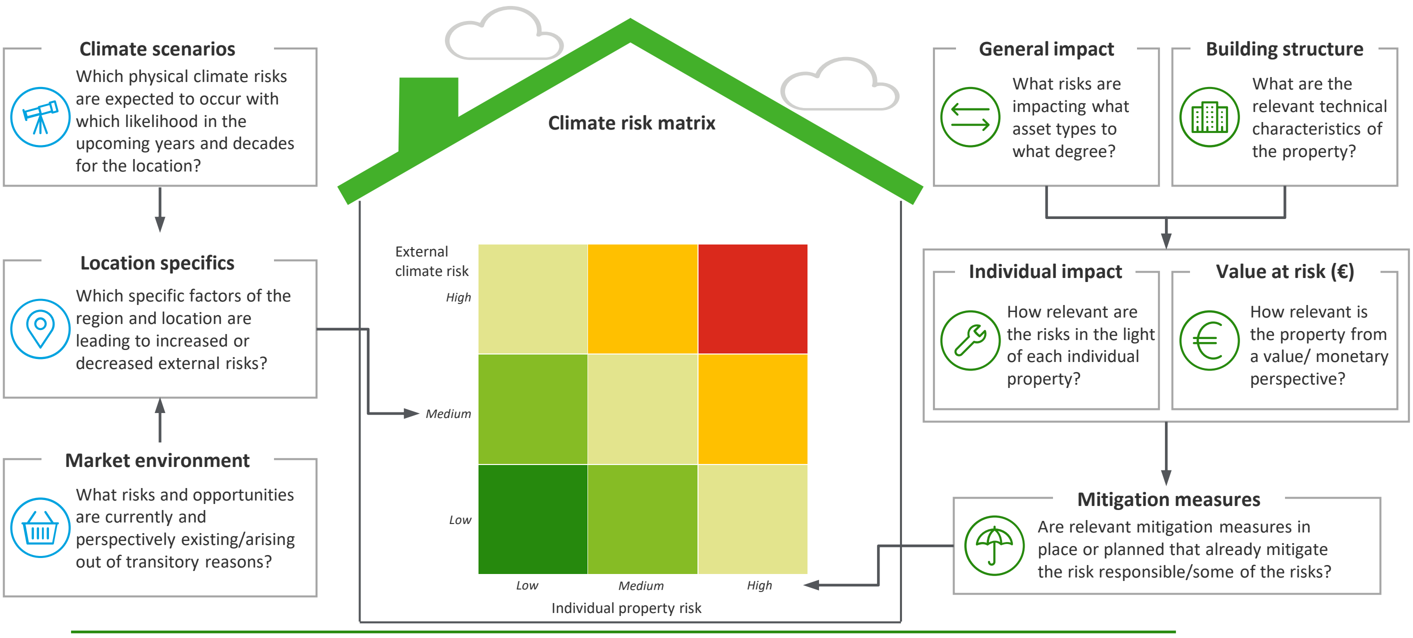

Figure 1: Simplified illustration of a climate risk matrix for real estate portfolios

While there are various professional providers for physical climate risks that evaluate the portfolio against the 28 climate risks defined in the EU taxonomy, this task is often more difficult for transitional risks. In the first step, existing and already announced regulatory interventions should be recorded at continental, national, federal and sometimes even municipal level, and evaluated for relevance. It is important to look at the potential impact of regulations that have been announced but are not yet in force, to avoid slipping back into short-term problem-solving instead of a long-term strategic perspective. Other risks such as rental and marketing risks, as well as opportunities for optimization through new technologies, should be continuously analyzed and evaluated by portfolio management. Thus, understanding the changing market requirements is crucial. Real estate companies should regularly conduct market analyses to become familiar with technological innovations and understand the preferences of tenants and investors. This often also includes the need for education of employees, who should regularly be trained in new requirements and sustainability issues to ensure understanding within the company at an operational level.

Conclusion: Economic benefits outweigh regulatory obligations

Companies of all kinds - but particularly real estate companies - should familiarize themselves with their portfolio climate risks from a financial self-interest perspective and implement strategic decisions based on them. Transitional climate risks pose a complex challenge but are essential to ensuring a realistic risk profile of their investments in the medium to long term and thus also the stability of the investors' returns. Therefore, climate risk analysis should not be 'checked off' as a regulatory obligation, but rather should be established as a key planning, steering and controlling element within the portfolio and risk management.

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