



MBA Frequently Asked Questions on Climate Change Risk and ESG

1. What are climate-change policy, climate-change-related financial risk, and ESG?

While these three terms are related and are often spoken of together, it can be useful to view them as three different concepts.

Climate-change policy refers to governmental actions to address climate change. These actions can be in many forms, including mandates, limitations or prohibitions, penalties, incentives or disincentives, subsidies, spending priorities, or direct governmental projects. Most relevant to commercial real estate, these actions can include changes in building codes, penalties for emissions above certain standards, or subsidies or incentives to reduce energy use or building emissions.

A recent example is Local Law 97 (LL97) in New York City, enacted as part of the city's Climate Mobilization Act. LL97 sets carbon emissions caps for energy use in buildings greater than 25,000 square feet, covering around 50,000 buildings and nearly 60 percent of NYC building area, including 41 percent of commercial buildings. LL97 sets penalties for non-compliance and increasingly stringent limits on carbon emissions per square foot in 2024 and 2030.¹

Climate-change-related financial risk is the risk of financial loss a business could suffer as result of factors related to climate change. As a result, financial institutions, investors, and prudential regulators are interested in climate-change-related financial risk.

A draft set of *Principles for Climate-Related Financial Risk Management for Large Banks* that the Office of the Comptroller of the Currency (OCC) issued for public comment on December 16, 2021, is an example of regulator interest in climate change financial risk.² The Securities and Exchange Commission (SEC) has similarly indicated an intention to issue a proposed rulemaking to address disclosure related to climate risk.³

Environmental, Social, Governance (ESG), sometimes referred to as “sustainability,” refers to non-financial criteria some investors consider when making investment decisions, and some company leaders consider, when determining how to manage their businesses.

¹ See NYC.gov [Local Law 97 webpage](#) for additional information on LL97.

² *Principles on Climate-Related Financial Risks*, [OCC News Release 2021-138](#) (Dec. 16, 2021).

³ See [SEC Press Release 2021-99](#) (June 11, 2021).

ESG is important because a rapidly growing number of investors, stakeholders, and company leaders say it matters. It has been reported that global “sustainable investment” accounts for over a third of current total global assets under management.⁴ As a result of its growing importance to market participants, ESG is also of interest to market regulators (in the US, principally the Securities and Exchange Commission (SEC)).⁵

2. What is the nature of climate change financial risk?

Climate-change-related financial risk is the risk of financial loss that could arise from factors related to climate change. This risk can be viewed as encompassing two categories of risk: physical risk and transition risk.⁶

Physical risks arise from climate-change-related events, such as, floods, hurricanes, and wildfires, that cause harm to property and infrastructure. Within the category of physical risk, risk can be viewed as acute or chronic. *Acute risks* are event-driven and may arise from hurricanes, cyclones, or other weather-related disasters. *Chronic risks* are driven by longer-term shifts in climate patterns, including sustained higher temperatures that may cause rise in sea levels or more powerful storms.

In real estate finance, climate-related events can cause physical damage that can increase operating costs or decrease rental revenues, or a reduce in the value of the property, each of which would increase credit risk on a loan secured by the property.

Transition risks arise from the impacts of policy, legal, technology, reputational, and market changes put in place to respond to climate change. For example, policy actions to impose tougher standards for building emissions and energy use could increase the costs of maintaining a commercial or multifamily property and could reduce property value, which would increase credit risk on a loan secured by that property. Changes in tenant

⁴ See Global Sustainable Investment Alliance, [2020 Annual Review](#), Executive Summary, p. 5 (The report notes that: “‘Sustainable investment’, as referred to in this report, is a term that is inclusive of investment approaches that consider environmental, social and governance (ESG) factors in portfolio selection and management across seven strategies of sustainable or responsible investment For the purpose of articulating our shared sustainable investment work in the broadest way, GSIA uses this inclusive definition, recognizing there are distinctions and regional variations in its meaning and use, and related or interchangeable terms such as responsible investing and socially responsible investing.”).

⁵ See, e.g., SEC Commissioner Elad L. Roisman, [Keynote Speech at the Society for Corporate Governance National Conference](#) (July 7, 2020).

⁶ The terms physical and transition risk are used, for example, by banking regulators (US banking regulators, the Bank of England, European Central Bank, and the Basel Committee on Banking Supervision), the Financial Stability Board’s Task Force on Climate-related Financial Disclosures (TCFD), and individual financial institutions in their corporate, social, responsibility and ESG reports, among others.

preferences in favor of “green” buildings could similarly increase credit risk on loans secured by non-green buildings.

The level of transition risk a change presents may vary depending on the speed, nature and focus of these changes, or other factors. For example, the pace of the policy or market preferences could affect the level of impact the change would have on credit risk, as could the availability of incentives or subsidies to support efforts to adapt to the change.

3. Is climate change financial risk a new category of risk?

While climate-related financial risk is receiving a lot of attention, conceptually, it is not a new category of financial risk. Rather, climate-related financial risk can be viewed as the direct and indirect impact that climate change may have across the well-established existing categories of risk: credit risk, market risk, operational risk, and liquidity risk.

In the case of commercial and multifamily lending, climate-change-related financial risk is principally an element of credit risk, specifically the risk that climate-change-related factors or events will increase the likelihood of default reducing operating income or increasing expenses, or by reducing the value of the property securing the loan.

Because climate-related financial risk is not a new category of financial risk, financial institutions can generally respond to climate-change-related financial risks by leveraging existing enterprise risk management frameworks. Similarly, financial institution regulators can supervise institutions’ exposure to and management of climate-change-related financial risk by leveraging existing supervisory frameworks.

On the other hand, it has become clear that financial institutions will need to be able to demonstrate to their boards, regulators, and other stakeholders that they are carefully assessing the potential impacts of climate-change risk on their businesses and are taking steps to adequately incorporate climate-change risk into their existing risk management frameworks, consistent with their business models and risk profiles.⁷

Climate change financial risk is widely recognized by prudential supervisors across the world, and those supervisors are exploring options to better understand and address.

4. What are the E, S, and G of ESG?

Environmental, Social, Governance (ESG) refers to non-financial criteria some investors consider when making investment decisions and some company leadership considers

⁷ See, e.g., OCC Principles on Climate Related Financial Risks at p. 3 and [FSOC Report on Climate Related Financial Risk](#) at pp. 29-32.

when determining how to manage their business operations. While there are no single definitions of the E, S, or G in ESG, the descriptions below are consistent with how these factors are typically viewed.

Environment (E): The E in ESG largely reflects an impact an organization or asset has on the environment. Factors that may affect the E in ESG may include energy use, contribution to greenhouse gas (GHG) emissions, carbon footprint, and supply chain sustainability efforts.

Buildings use energy and emit carbon dioxide. According to the United Nations Environmental Programme's 2021 Global Status Report, the construction and operation of buildings contributed 36 percent of global energy-related carbon dioxide (CO₂) emissions, down from a 2015 peak of 38 percent, in part as a result of the COVID-19 pandemic.⁸ As a result, energy savings and net zero efforts related to buildings may be attractive to investors or leaders interested in the E of ESG.

There is no one definition for how to quantify or count that level of impact or non-impact. However, property certifications, such as Leadership in Energy and Environmental Design (LEED), Energy Star, and Building Research Establishment Environmental Assessment Methodology (BREEAM), serve as important sustainability assessment tools for investors in real estate assets.

Social (S): The S in ESG generally reflects how an organization or asset contributes to a more equal and fair society. ESG investors focused on the S of ESG may favor real estate investments that can have a significant social impact, for example, in the form of rehabilitation of public spaces, or affordable housing, social housing, or care centers. Other S-related social factors may include the level of a company's efforts to address inequalities in society, improve consumer protections in product safety, focus on labor law issues, or mitigate corruption. Here too, there is no one definition for how to quantify or count that level of impact or non-impact.

Governance (G): The G in ESG generally reflects how an organization's board and executive leadership drive change. Again, there is no one definition for how to quantify or count that level of impact or non-impact. Relevant governance factors may include board diversity, executive training, interactions with shareholders, and transparency.

5. What is MBA doing to help members address issues of climate-change financial risk and ESG?

⁸ See United Nations, Environment Programme, [2021 Global Status Report For Buildings and Construction: Towards a Zero-emission, Efficient and Resilient Buildings and Construction Sector](#) p. 12 (Oct. 19, 2021).

MBA is working for members on climate and ESG across variety of perspectives: Policy, Research, and Practice.

Policy

Climate change financial risk and ESG are issues that are high on policymaker's lists of priorities. This is evident in President Biden's Executive Order on Climate Related Financial Risk, which communicated a policy "to advance consistent, clear, intelligible, comparable, and accurate disclosure of climate-related financial risk" and in New York City's enactment of Local Law 97.

MBA is committed to working with policymakers as they develop climate change and ESG policies that could have an impact on the real estate industry. For example, MBA has formally responded to federal and state agency requests for input on policy considerations around climate and ESG-related, including responses to the Securities and Exchange Commission (SEC), Federal Housing Finance Agency (FHFA), New York Department of Financial Services (NYDFS), Treasury's Federal Insurance Office (FIO), and the Office of the Comptroller of the Currency (OCC), in addition to informal communications with policy makers.

Research

MBA is a leader in housing-related research and economics and continues to work on research related to the intersection between real estate finance, climate change, and ESG. For additional information on MBA's latest research efforts related to climate and ESG, please visit our [climate and ESG webpage](#) or the [research and resources webpage](#).

Practice

MBA continues to provide its members with opportunities to stay up to date on the latest trends and topics related to ESG and climate change. Both MBA's Residential and Commercial Boards of Governors (RESBOG and COMBOG) receive updates and exchange views on climate risk and ESG, and the RESBOG has formed a Climate Risk Working Group.

Through the Green Lending Roundtable, MBA's commercial and multifamily lender members are working to navigate the intersection of climate risk, ESG, and other green lending goals.

MBA is collaborating with the Mortgage Industry Standards Maintenance Organization (MISMO), which is the real estate finance industry's standards organization, to facilitate the development of data standards to facilitate green/ESG lending. As part of this effort, MISMO operates an ESG Community of Practice that facilitates the development and adoption of

standards to support the exchange of ESG information, including, but not limited to, data, terms, and definition to support the flow of consistent information throughout the mortgage finance ecosystem.

On December 15, 2021, MISMO launched its updated Commercial Green Utility Dataset. The dataset and accompanying package of resources will help facilitate the efficient exchange of green utility information across the commercial real estate finance industry. The dataset standard has achieved "Candidate Recommendation" status, which means that it has been thoroughly reviewed by a wide range of organizations and industry participants and is available for use across the industry.

MISMO is also collaborating with MBA on other to-be-released initiatives that will support the real estate finance industry's implementation of green and ESG related standards and climate change risk management processes through a standardized borrower questionnaire.

MBA is also helping members understand and address climate change financial risk and ESG by presenting a series of webinars on climate change and ESG. Climate change and ESG are also frequently addressed in presentations and discussions across all of the MBA's various councils, committees, and conferences. MBA maintains a climate and ESG policy page, which includes information on climate and ESG policy developments, as well as updates on upcoming ESG and climate change webinar and educational material.