Tackling Task Force on Climate-Related Financial Disclosures (TCFD):

Early lessons in climate risk disclosure

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Like many of our investment management colleagues, at Principal Real Estate Investors we have noticed increased interest and questions from our investors on the topic of climate risk, whether through informal discussions or detailed RFP inquiries. The topic has definitely emerged as a new – and probably permanent – aspect of our fiduciary duty and what it means to assess, disclose, and manage these risks to our real estate investments.

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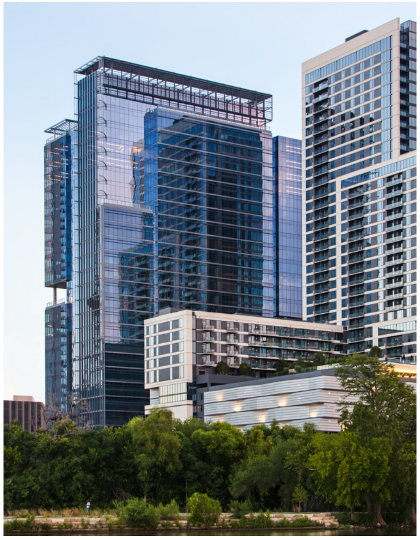
Recognizing the need to better understand and disclose risks associated with climate change, several industry initiatives have started to incorporate climate risk and resilience questions into reporting frameworks. In particular, the Financial Stability Board (FSB) Task Force on Climate-Related Financial Disclosures (TCFD) seeks to stimulate market dialogue and increased transparency on climate-related risks by providing information to investors, lenders, insurers, and other stakeholders. TCFD's work and recommendations are meant to cultivate market dialogue on climate change risks, and encourage companies and investment managers to align their disclosures with investors' needs. As of February 2019, over 580 companies, responsible for over $100 trillion of assets, have expressed support for the TCFD recommendations.



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Principal is currently evaluating the TCFD recommendations and considering applying its guidance to investment management, reporting, and stakeholder engagement practices. As a preliminary exploration of what this level of analysis and disclosure means, we recently initiated a pilot climate risk assessment of the assets in one of our private equity funds, with the objective of building organizational capacity on this topic, and positioning ourselves to better serve the needs of our investors in the future.

We are currently wrapping up the first phase of our TCFD disclosure pilot, which includes drafting language to summarize our findings. In doing so, we have learned many valuable lessons on the challenges and nuances of climate risk issues. We have taken an important first step in developing the institutional knowledge necessary to be able hold meaningful discussions on the impact of climate risks on our real estate investments, and have a clearer idea of how to tackle these complicated questions going forward.

As a result, we would like to share the following key lessons with our peers and colleagues in the industry, so that collectively we can all work together to develop best practices on climate risk and TCFD, and move these important topics forward on behalf of our client and investors:

1. Don't overthink it.

The topic of climate risk and TCFD can seem daunting and overwhelming. How do you deal with such diverse technical questions as sea level rise, drought, or wildfires – many of which operate on different timelines or can have wildly different financial impacts on a building. However, with regards to TCFD, one must step back and remember the overall objective. TCFD simply is a risk analysis framework, no more, no less. In real estate we are always analyzing risks – market risks, credit risks for tenants, economic risks, seismic risks, etc. – and TCFD is an addition to this list. First, you collect information, consult with experts, look at data, and conduct your analysis. Then, you share your findings with stakeholders and determine if investment management practices need to change, or other responses are merited. When put in that context, the idea of climate risk assessment and disclosure feels more manageable.

2. Separate assessment from response.

In our pilot, it was important for us to separate three key concepts in our minds – assessment, disclosure, and response. Each of these activities is distinct, and an important part of dealing with climate risk issues. Assessment is simply the identification of risks. Disclosure is the communication of the risks identified, and response is acting to minimize, mitigate, or resolve the risks. TCFD is focused on the assessment and disclosure of risks – it does not actually require you to discuss your responses. I like to think of TCFD as a conversation starter – putting data and information in front of our stakeholders. What comes next is working with our internal staff, property teams, investors, and clients to identify and implement our strategies to respond. Taking each phase in a sequential order – assessment, disclosure, and response – brings clarity to the process and improves organizational thinking.

3. Don't sweat the scenarios.

When you first begin to explore the literature and research on climate risk analysis, you quickly encounter the concept of scenarios. Essentially, with climate risk assessments you need to make an assumption on the amount of carbon that will accumulate in our atmosphere, which in turn drives the frequency, intensity, and overall risk profile of various climate related outcomes. These scenarios are defined by the Intergovernmental Panel on Climate Change, and are often referred to by a "Representative Concentration Pathway", each with a different assumption on when and at what level carbon concentrations will stabilize. The science behind these scenarios can be dense and hard to navigate, and it may at first seem that you need to account for every different scenario. Fortunately, for most investment real estate, the scenarios don't matter that much in the short term. Most of the scenarios have a similar profile in the next 7-15 years before diverging. This means that as long as the hold period for your real estate investments are within that timeframe, you can essentially pick any one scenario and proceed with your analysis. Only for longer term investment horizons should you conduct a multi-scenario assessment. Our conclusion – pick a scenario, be prepared to discuss why you selected that one, and don't worry about the others for now.

4. Recognize the many dimensions of risk.

Climate risks come in many flavors and intensities, and to adequately assess your risks you need to understand the different ways climate change can influence a real estate investment. TCFD clearly defines several risk categories to assess and disclose – from transition risks (risks associated with how climate change can alter regulations, technologies, economic conditions, or market assumptions) to physical or operational risks due to climate-related weather events. But it can get more detailed from there – is an investment exposed to a certain risk such as sea-level rise? If so, then you need to understand the probability of that risk occurring, and then the severity of the economic impact should an event occur. Further, risks should be evaluated both in terms of the physical risk of a specific asset and the overall allocation risk of the fund or portfolio at large. It's one question to determine that a building is exposed to hurricanes by being located on the gulf coast. It's another question to determine that your entire fund is overexposed to hurricanes and sea-level rise.

5. Decipher the data.

New data providers, models, and resources offer a wealth of climate risk information to aid in your assessment. But it is important to understand the limitations of each data source, and the nature of what that information can – and cannot – tell you. First, understand that climate change fundamentally disrupts many older, historic datasets. Resources that are backward looking or rely on historic data (such as FEMA maps) may not actually be able to fully describe your risk. Take time to understand the nature of your data. Is it historically based? Is it a forecast? What is the time horizon of the model, and does that align with your investment hold period? Lastly, what is the unit of geographic measure? If your dataset details risks at the county level – is that accurate enough? We had a building flagged as being highly exposed to wildfires – yet the building was located in the urban core of large East Coast city. It turned out that the data model we utilized was only able to flag risks at a county scale. Rural forests outside of the city triggered the risk, but when we investigated, we determined that wildfire risk was not material to that asset. The data is useful and key – but only if you understand what it is actually telling you.

6. Manage what is material.

Perhaps the most challenging part of assessing climate risks is determining what risks are material and relevant to the investment thesis. Does the timeline align with the hold period? How are increasing heat waves going to impact an office building? Is increased storm activity a new risk, or the extension of a previously known risk? This is the point that we are currently at with our analysis, examining the risk assessment data and looking building by building to determine if they are actually a threat to the investment proforma, and if so, what are appropriate response strategies.

7. Disclose and then discuss.

Ultimately, TCFD is about putting better information in the hands of investors and stakeholders, allowing for more informed discussions and dialogue on the impacts of climate change. It's an important starting point for us all, as we each are learning how to grapple with climate risk questions and how to fulfil our fiduciary responsibilities in the face of much uncertainty. Only by conducting these assessments, sharing results, and discussing the implications together can we arrive at thoughtful mitigation strategies.

Through our TCFD pilot, we have taken an important step in better understanding how to examine climate risks from a real estate investment management perspective. Yet, we still have much to learn, and I do not doubt that industry expectations, resources, data, and reporting practices will continue to evolve on this topic. We at Principal Real Estate Investors look forward to collaborating with our peers and colleagues further on this topic, and continuing to share lessons and best practices as they emerge.

Risk warnings

Potential investors should be aware of the risks inherent to owning and investing in real estate, including: value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk.

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