

EPISODE 22 • MI

DEBT MARKET SIGNALS: WHAT SPREADS ARE TELLING US

Signals: S2 — Credit & Mortgage Markets | S4 — Valuation Gap & Market Repricing | S1 — Insurance Repricing & Availability

Friday, we saw how equity capital is beginning to sort real estate into resilience tiers — scoring portfolios, overweighting the top quartile, reviewing the bottom. Today, we look at the debt markets. The credit signal usually arrives before the equity repricing. And the spread data is already telling a story that most equity investors have not yet read.

Before we dive in, for those of you who haven't been here before, welcome to Climate-Ready Real Estate Investing. I'm your host, Jamie Wolf. Each week, in addition to guest expert interviews, our audience receives three short briefs focused on market intelligence, strategy and underwriting, and narratives of current events with future implications. The theme underlying Climate-Ready Real Estate Investing is a deep concern for the well-being and viability of our planet, today and tomorrow, and a desire to explore how best to support this USD \$393 trillion industry in making both profitable and forward-thinking, big-picture decisions, borrowing from the Hippocratic Oath to 'first do no harm.'

Last month, we reframed climate change as a matter of market structure rather than ideology. This month, we are going to look at everything through the lens of Climate as Capital Strategy, because early recognition creates investor advantage. With that as context...

Market Signal

Three Spread Signals Moving Simultaneously

Spread data is the most honest signal in real estate capital markets. It cannot be massaged by narrative or marketing. When lenders demand a higher yield spread for a loan category, it means the credit market has quantified a risk that the equity market may not have fully priced in yet. In 2024 and 2025, three spread signals are emerging simultaneously across commercial real estate credit markets — all three tied to climate risk.

- **Signal 1 — CMBS spread differentiation by climate exposure:** Trepp and MSCI research documents an emerging spread differential between CMBS pools with high concentrations of climate-exposed collateral and those with lower climate exposure. The differential is currently small — approximately 10 to 30 basis points at the pool level — but it is directional, consistent, and growing. In the 2007-2008 cycle, the widening of CMBS spreads preceded the equity repricing of commercial real estate by approximately 12 to 18 months. The signal is worth reading early.

- **Signal 2 — Green bond greenium in real estate debt:** Green-labeled real estate debt instruments are achieving lower spreads than conventional equivalents across Europe and, increasingly, in Asia-Pacific. The greenium — the pricing advantage for green classification — ranges from 10 to 30 basis points in mature markets such as the Netherlands, Germany, and France, and from 40 to 80 basis points in specific emerging markets, including Brazil and India. This is Signal 2 operating as a direct financing cost bifurcation. The assets that can access the green market finance at a structurally lower cost than those that cannot. That differential compounds over a multi-year hold.
- **Signal 3 — Lender overlay tightening in climate-sensitive markets:** Institutional lenders in Australia, the UK, and parts of continental Europe are applying climate overlays — LTV adjustments, additional covenant requirements, physical risk certification prerequisites — to originations in identified high-risk markets and postcodes. These overlays are rarely announced formally. They surface in the approval process. The result is a de facto spread widening for climate-exposed assets, even when the nominal rate is not explicitly labeled as a climate adjustment.

Case Study

The UK Commercial Mortgage Market and EPC Covenant Language

The United Kingdom has the most advanced publicly documented climate-related lending overlay in any major English-language market. Beginning in late 2023 and accelerating through 2024 and 2025, a growing number of UK institutional commercial mortgage lenders have incorporated EPC (Energy Performance Certificate) covenant language into standard commercial property loan documents. The covenant structure takes one of three forms:

- **Maintenance covenant:** The borrower must maintain a minimum EPC rating — typically C or above — throughout the loan term. Failure triggers a margin step-up, typically ranging from 25 to 50 basis points per annum.
- **Improvement covenant:** If the property is currently rated D or below at origination, the borrower must provide a documented improvement plan to reach C by a defined date — typically before the MEES 2028 deadline — with drawdown conditions or compliance milestones tied to progress.
- **Refinancing condition:** For loans maturing after 2028, some lenders are requiring that the asset achieve a minimum EPC C rating as a condition of refinancing. The climate compliance requirement is embedded in the loan's exit, not just its origination.

Here is what this looks like in practice. A commercial mortgage on a Bristol mixed-use retail and office building — EPC rating D at origination in 2023 — includes a covenant requiring achievement of EPC C by January 2028 or a margin step-up of 35 basis points per annum. The borrower's rate is 5.75 percent for years one through five. If the EPC upgrade is not achieved by 2028, the rate steps to 6.10 percent for the remaining term.

The financial logic is direct. A 35-basis-point margin step-up on a £20 million commercial loan costs approximately £70,000 per year in additional interest. Over five years at a 5.75 percent discount rate, the net present value of that step-up is approximately £297,000, which is comparable to the cost of a

meaningful EPC improvement program for a building of that size. The lender has effectively told the borrower: upgrade the asset or pay a cost roughly equivalent to the upgrade over the remaining loan term. This is climate risk priced into the capital structure.

For comparison, Germany's KfW — the federal development bank — has long offered energy-efficiency-conditioned financing for commercial real estate, providing materially lower rates for buildings that meet defined energy performance thresholds. The KfW approach is a positive incentive structure; the UK covenant approach is a penalty structure. The two create a 50 to 100 basis point spread differential between certified and uncertified assets in the same market — accessed through different mechanisms but producing the same market signal.

Strategic Implications

Implication 1: Read every loan document before you sign. EPC covenant language and climate-related margin step-up provisions are now appearing in standard UK institutional commercial mortgage documents. Before any commercial mortgage closing in the UK, the EU, or Australia, conduct a specific covenant review covering: any EPC or energy performance maintenance covenant, any climate certification conditions attached to refinancing, and any physical risk insurance maintenance requirements with carrier count floors. The language is changing. The standard review checklist has not yet caught up.

Implication 2: Refinancing risk has a climate component. For assets with loans maturing after 2027 in the UK, after 2025 in Australia, or after 2028 in markets implementing EU-equivalent building performance standards, the refinancing assumption must now include a climate compliance condition. An asset that cannot achieve the required certification by the loan maturity date may not qualify for refinancing from its existing lender — or from any institutional lender in that market. This is a new category of refinancing risk that does not appear in standard DSCR-based covenant analysis.

Implication 3: Access to green financing is a compounding return multiplier. The spread differential between green and conventional commercial real estate debt — currently 10 to 80 basis points depending on market and instrument — compounds over a multi-year hold. On a £20 million loan at a 50 basis point greenium, the cumulative interest saving over seven years is approximately £700,000. That is before accounting for the higher exit value of the certified asset and the broader pool of exit buyers. Access to green financing is not a marginal benefit. It belongs in the acquisition underwriting.

Implication 4: CMBS spread signals lead equity repricing. In the 2007-2008 cycle, the widening of CMBS spreads preceded the equity repricing of commercial real estate by 12 to 18 months. The mechanism is consistent: lenders quantify tail risks before equity buyers do, because debt is first in line for losses. If CMBS spreads for climate-exposed collateral pools are widening now — and they are, at 10 to 30 basis points at the pool level and growing — the equity repricing of those assets is likely 12 to 18 months behind. That is the predictive window Signal 2 gives you.

Implication 5: Private credit is the next frontier. The EPC covenant and green bond developments described above are occurring primarily in institutional mortgage and CMBS markets. The approximately 2 trillion dollar global private real estate debt market has been slower to incorporate climate terms. As institutional LP standards cascade to private credit managers — following the pattern described in Episode 16 — climate-conditioned private credit terms will become the norm

within 24 to 36 months. Operators who build green financing relationships now will have access to cheaper private credit capital when the broader market begins requiring it.

Future Signal

- **Formal climate tranching in CMBS is the next step.** The current spread differential between climate-exposed and climate-resilient CMBS pools is an informal market signal. Within three years, expect commercial mortgage-backed securities to explicitly tranche by climate exposure — senior tranches limited to climate-resilient collateral, junior tranches absorbing climate-exposed pools. The assets that end up in junior tranches will carry that label for the life of the instrument. The pricing is permanent once it is structural.
- **Central bank stress testing will specifically include commercial real estate.** The ECB, Bank of England, and APRA have all run climate stress tests on bank loan books. The next iteration — under discussion at the Financial Stability Board — will include commercial real estate as a specific asset class with standardized physical risk scoring. When regulators require banks to hold additional capital against climate-exposed CRE loans, the cost of that capital is passed on to borrowers as a spread. This is the structural mechanism that permanently embeds climate spread differentiation.
- **Green mortgage products will reach mid-market borrowers.** The current green bond and green mortgage market is concentrated in institutional-scale transactions. As green certification becomes more accessible for mid-market assets and as lenders standardize green underwriting criteria, green loan products will reach the sub-twenty-million-dollar market. Operators who have already built green certification pathways for their portfolios will benefit from this pricing first.

Stakeholder Takeaway

The CRDF Signal Tracker™ for this episode maps the three debt market signals — CMBS spread differentiation, green bond greenium, and lender climate overlays — against your current financing relationships and existing loan documentation. Pull your last three loan documents. Search for the words "EPC," "energy performance," "climate," and "sustainability" in the covenant language. Whatever you find — or do not find — is your Signal 2 baseline today. The underlying framework doesn't expire with the data. The Signal Tracker™ is designed to be populated with your current relationships. Download it free at climatereadyre.com.

We've seen what the debt markets are pricing. On Wednesday, we build the capital stack for climate-exposed deals — because the financing structure of a climate-exposed acquisition differs from that of a climate-resilient one, and getting it wrong is expensive. Episode 23 — *Capital Stack Design for Climate-Exposed Deals*.

I ask the same question at the end of every show, because if you could avail yourself of 20/20 hindsight before you feel the pain of "If I knew then what I know now," how would that inform your decisions process today? That's what the Signal Tracker™ is there for.

That wraps it up for today. Be sure to subscribe to *Climate-Ready Real Estate Investing* to receive free downloads for our Market Intelligence and Strategy & Underwriting briefs. Listen to the [podcast](#) and

find us on [Twitter](#) and [LinkedIn](#). If you'd like to be a guest on the show, you can register at www.climatereadyre.com, the place where resilient returns and resilient communities meet. Until next time, I'm your host, Jamie Wolf — be good and do better for today, tomorrow, for you, and for all. KNOW YOUR SIGNALS AND BE CLIMATE-READY!