GENERALI INVESTMENTS

# Focal Point
## ECB greening of the credit market to start in 2022

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- The ECB's new strategy puts climate action into the focus. Climate change will be incorporated in economic forecasts and stress tests. The ECB targets to abandon its market neutrality with respect to CSPP purchases by 2022 and to include climate risks into the collateral framework.
- While these measures are in line with expectations but disappointed with the late application of carbon filters.
- On credit markets, the climate strategy of the ECB will start with enhanced disclosures before including climate related rules on risk assessment, collateral rules and CSPP purchases starting in H2 2022.
- With the ECB being the largest investor in the European credit market, such shifts in policy will undoubtedly impact valuations, amplified by private investors that are trying to minimize the carbon footprint in their credit portfolios.
- We expect the move to be the strongest within Utilities, Energy and "Dirty Manufacturing".

Climate change and the need for greening the economy has become a top priority issue in politics. The EU addressed it in the NextGenerationEU Recovery Plan and the latest European Green Deal proposals. The ECB also explicitly takes into account climate change in the design of its new strategy. This comes close to an industrial revolution, with the transformation of the European economy has just started. In what follows we take a closer look into the details of the ECB's climate change agenda and the implications for capital markets.

### New ECB strategy focuses on climate change

Climate change is the dominant topic for the coming decade and increasingly impacts the agenda of monetary policymakers. A survey among central banks from December 2020 reveals increased awareness of climate-related risks while concrete actions have been limited so far. Only about tone quarter of the reviewed 107 central banks had included sustainability aspects in their objectives.

Among central banks, the ECB had made very clear for longer that it will actively address climate change. With the update of its strategy released on July 8 it moves towards a symmetric inflation target, allows some moderate inflation overshooting under certain conditions, looks at house prices and also regularly conducts a financial analysis. While this are largely adjustment that evolved from the past decade's experience, the inclusion of a climate action plan as a policy objective is new.

Through its climate action plan (see annex for more details) the ECB adopts a comprehensive approach. On the analytical side, it will extend its macroeconomic projections and scenario analyses by climate-related factors and specific statistical data will be developed and incorporated. On the supervisory side, regular bank stress tests will include climate-stress tests.

**Key elements of the ECB 2021 new strategy**

**Inflation target**
- Symmetric around 2% yoy
- Medium term: inclusion of house prices in HICP
- Moderate overshooting if economy is at lower bound

**Complex analysis**
- Economic analysis complemented by a financial
- Analysis of side effects of unconventional policy measures, e.g. on the financial sector, inequality

**Augmented policy tool box**
Close to the effective lower bound forceful and persistent action is needed, suggesting that 'unconventional' measures like QE and TLTROs are now part of the regular toolbox.

**Communication**
- Different form of policy statement, better communication to wider public
- Next strategy review scheduled for 2025

**Climate action plan**
- Extension of macro projections and scenario analysis by climate factors
- Bank tests to include climate factors
- Departure from market neutrality
- Discrimination between ‚brown' and ‚green' firms regarding rating

Regarding monetary policy operations, significant changes are about to come. So far, the ECB had stuck to the principle of market neutrality which entails the ECB purchasing securities in proportion to their relative market capitalisation. However, recently Governing Council members changed course and for instance Schnabel argued that it "*seems appropriate to replace the market neutrality principle by a market efficiency principle*". Following an assessment of market inefficiencies, proposals on how to adjust the Corporate

Sector Purchase Programme (CSPP) will be made throughout 2022 and implemented in 2023. Moreover, the ECB will include climate change risks in the credit rating and by the end of 2024 in the credit assessment suggesting climate-related haircuts in repo operations. More generally, eligibility criteria for asset purchases will be developed and come into force in 2024.

That said, it seems that the ECB is still working on the details. ECB President Lagarde merely stated when presenting the ECB's new strategy that it was too early to say whether for some companies haircuts would be applied or whether purchases would be tilted towards the most virtuous players. A reference point is a recent speech by Isabel Schnabel, referring to the climate strategy of the Bank of England according to which three main pillars would apply:

- First, the weighted average carbon intensity of the portfolio (tonnes of CO2 equivalent emitted per EURm of revenue generated).
- Second, the implied temperature rise metric – an estimate of the temperature increase over preindustrial times that the portfolio is aligned to.
- Third, the proportion of company portfolio that is aligned with a full transition to net-zero by 2050.

Still, the implementation is not straightforward. The first criterion on carbon emissions is the easiest to implement. The two other requirements are more challenging in terms of data availability. The ECB could rely on science-based targets.

## Gradual focus on corporates until 2025

Content-wise, the ECB climate action plan was not particularly surprising. The experience with ECB policy measures like QE suggests that it takes an evolutionary step-by-step approach rather than a big bang solution. However, regarding the timeframe for implementing the market-specific actions, it fell behind expectations. Regarding the CSPP framework, we expect the ECB starting with carbon emissions having a significant weight and then gradually turning to a forward-looking stance taking climate as a broader concept than purely focusing on carbon. We therefore see the climate action plan as the first step towards a greener policy. By the Treaty the ECB shall support the economic policies in the Union, e.g. the goal to become climate-neutral by 2050.

The measures outlined in the action plan focus on corporates. The ECB has already declared step-up (variable coupons) sustainability-linked bonds (SLBs) as eligible collateral from 2021 onwards and included them in its asset purchase programmes. We also see a good chance for green Targeted Long Term Repo Operations (TLTROs). The lending conditions would then depend on green characteristics either of the lender or the project that is going to be financed. TLTROs that will complement the different haircuts in repo operations for 'brown' versus 'green' collateral already outlined.

## No green or labelled QE but…

However, more far-reaching measures like green QE (comprising only green eligible bonds) will not come on the table in our view. First of all, potential conflicts with the ECB's primary objective of price stability could emerge. Also, the green bond universe is small compared to the overall eligible space and the green bond market remains dominated by financials and utilities. Demand for green bonds is already outpacing supply leading to materially tighter spreads for green bonds compared to their conventional counterparts, also called greenium. Against this backdrop, it is not surprising that comments from ECB officials suggest that the ECB will rather look at the climate profile of the issuer than at the characteristics of the specific bond. A study by the Bank of International Settlements (BIS) is also underpinning this approach, showing the lack of additionality of green bonds, i.e. failing to make corporate strategies greener beyond the green bond issuance.

That said, the ECB's new green tilt will give an additional boost to the growing green bond market which will offer more possibilities for green monetary policy action. We expect such a 'virtuous circle' to evolve. The volume of the European green bond market is growing fast. It almost doubled from € 546 bn in January 2020 to € 999 bn currently. The ECB is already a big player in this market. It has actively invested in green bonds through its QE programs and, as of July 2020, owns 20% of the eligible PSPP and CSPP green bond universe. But given the so far binding principle of market neutrality, these purchases have probably been just in due proportion to the ECB's usual purchases. Tailwind from the PEPP as well as APP purchases will at least maintain this share. But once market neutrality is abandoned, ECB support through its various programs (which we largely expect to persist over the coming years) will additionally foster the further growth of the European green bond market, which may become the global key market.

The ECB announced the next overhaul of its strategy already for 2025 and we would expect that a larger green bond market then also gives leeway for additional policy action.

The ECB's climate agenda includes developing indicators on green financial instruments, allowing for more targeted actions at a later stage. In particular, green or labelled (green, social, transition or sustainability linked) bonds could remain eligible to collateral or asset purchases for issuers that do not match the overall climate objectives of the central bank.

## …enhanced climate disclosures as a first step

Yet the ECB will likely decide to focus its approach on issuers rather than individual bonds, labelled for instance. As ESG data availability is a challenge, the ECB starts to act as a catalyst in fostering enhanced disclosures. The first step of its roadmap of climate-related actions is dedicated to pushing corporates to improve their standard climate disclosures. From what was said during the strategy review press conference, they will be based on EU regulations but will be stricter than that. Those disclosures will serve as a requirement for eligibility as collateral and asset purchases. The ECB is forced to take this step because it has decided to take a forward-looking approach to companies' behaviours. Indeed, the dataset for temperature rise metrics for instance is far from complete at this stage on the overall European investment-grade universe.

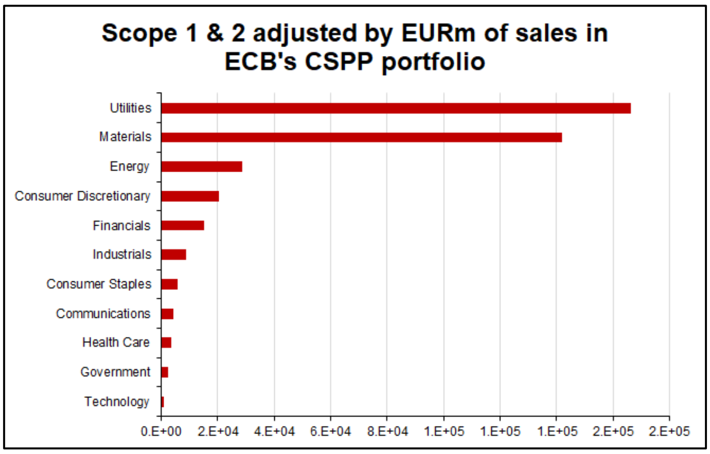
## Risk assessment will also integrate climate

The ECB also announced that it will start conducting climate stress tests of the European Banks in 2022 to assess the Eurosystem's risk exposure to climate change. According to

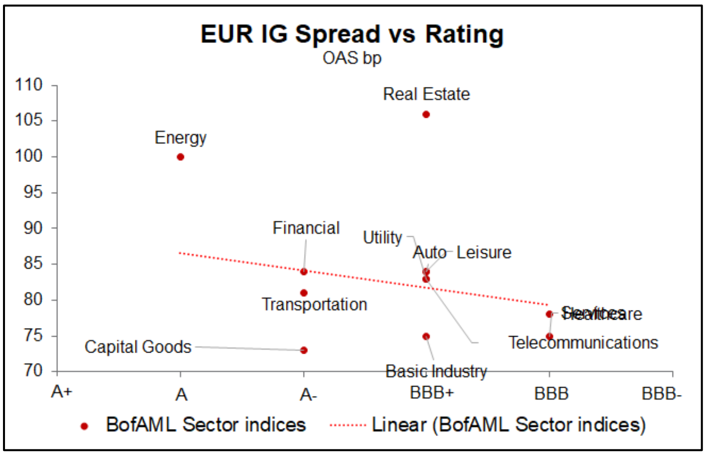
ECB sources, this first climate-related exercise will be an overall assessment of climate risks on banks' balance sheets at sector level, avoiding stigmatisation of single names. The ECB will also "*assess whether the credit rating agencies accepted by the Eurosystem Credit Assessment Framework have disclosed the necessary information to understand how they incorporate climate change risks into their credit ratings".* In addition, the ECB will consider developing minimum standards for the incorporation of climate change risks into its internal ratings. This can be viewed as a push to rating agencies to accelerate their inclusion of climate risks in ratings. It is maybe also a sign that the ECB could use external ESG ratings in the implementation of its climate strategy.

## What impact for credit markets?

The inclusion of climate risk in CSPP purchases will only start in the second half of 2022. This will undeniably affect the ecologically dirtiest sectors/players, as the ECB is the largest credit investor in the market. It holds nearly 25% of the CSPP eligible space. We believe that the sectors most affected by the new ECB strategy will be Utilities, Energy and Materials but ultimately it will lead to further discrimination between winners and losers of the climate change journey. However, the impact also critically depends on the measurement retained. For instance, the Auto sector would score very well when looking at direct emissions only, but it is among the worst when indirect emissions are also considered.




Nonetheless, private investors have not awaited the ECB to integrate climate goals into their investment strategy and we are already witnessing some impact on valuation from ESG criteria. The valuation of the Oil & Gas sector for instance is already much wider than its rating would suggest on the back of a very poor ESG profile - a trend that will likely amplify in the coming quarters.



# Annex

## ECB roadmap of climate change related action

| | | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|
| 1. | Eurosystem/ECB staff macroeconomic projections | Introduce technical assumptions on carbon pricing for forecasting and regularly evaluate the impact of climate-related fiscal policies on the Eurosystem/ECB staff macroeconomic projections baseline. | | | |
| 2. | Macroeconomic modelling and scenario analyses | | Integrate climate risks into the ECB's workhorse models and assess their impact on potential growth. Conduct scenario analyses regarding transition policies. Model implications of climate change for the transmission of monetary policy. | | |
| 3. | Statistical data for climate change risk analyses | Develop indicators on green financial instruments. | | Develop new statistical collections related to climate change. | |
| | | Construct indicators on exposures of financial institutions to climate-related physical risks through their portfolios. | | | |
| | | Derive indicators on the carbon footprint of portfolios of financial institutions. | | | |
| 4. | Market neutrality and efficiency concepts in monetary policy operations | Assess potential biases in the market allocation amid market inefficiencies and the pros/cons of alternative allocations. | Make concrete proposals for alternative benchmarks, in particular for the Corporate Sector Purchase Programme (CSPP). | | |
| 5. | Disclosures in line with EU policies as an eligibility requirement in collateral framework and asset purchases | Proposal and adoption of EU disclosure regulation. | | In force. | First regulatory disclosures covering 2023. |
| | | | Design adequate policies and conduct legal and operational preparations. | Adaptation period for issuers. | In force. |
| 6. | Climate stress-testing of the Eurosystem balance sheet | Prepare data and methodology. | Conduct pilot stress test based on the 2021 ECB economy-wide climate stress test and 2022 supervisory climate stress test of individual banks. | Build upon the pilot stress test and introduce regular climate stress-testing. | |
| 7. | Climate change risks in credit ratings for collateral and asset purchases | Assess rating agencies' disclosures and understand how they incorporate climate change risk in ratings. | Introduce requirements into the Eurosystem Credit Assessment Framework (ECAF) targeted to climate change risk, if warranted. | | |
| | | Develop minimum standards for internal credit ratings. | | | |

The pink areas represent external developments that the Eurosystem relies on for the implementation of measures. The blue areas represent Eurosystem actions.
source: https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210708_1~f104919225.en.html

# Imprint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**Sources for charts and tables:** Refinitiv/Datastream, Bloomberg, own calculations
Version completed: see front page


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