GENERALI INVESTMENTS

Core Matters
European Green Deal: A game changer?

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- The European Green Deal is the EU Commission's new growth strategy. It aims to turn the climate and environmental challenges into an opportunity to modernise the EU economy, endorsing a large investment program. The plan targets emissions reduction of at least 55% by 2030 and climate neutrality by 2050.
- To foster the change the EU will deploy its budget aiming to mobilise about 0.7% of GDP annually. Overall, investment needs are estimated at about 2% of EU GDP annually until 2050. The deal implies substantial structural changes. The most involved sector is Energy but the plan basically cuts across the whole economy.
- The Green and sustainable bond market is now at a turning point. Forthcoming sizeable green issuance in the EU will help growing and greening European finance in a more balanced and standardised way. Meanwhile the ECB will likely add green layers to both its monetary policy and regulatory objectives.
- Among sectors, building and materials are the main beneficiaries while Utilities and Autos will have to adapt.

European Green Deal – A new growth strategy

The European Green Deal (EGD) is the EU Commission's new growth strategy. It tries to turn the climate and environmental challenges, that the Commission sees as "*this generation's defining task*", into an opportunity to modernise the economy. It thereby embeds a large investment program that some compare to the US New Deal (1933) or the Marshall plan (1947). Quite ambitiously, the EU Commission aims:

- to transform the EU into a fair and prosperous society,
- with a modern, resource-efficient and competitive economy,
- where there are no net emissions of greenhouse gases from 2050 on,
- and economic growth is decoupled from resource use.

While the deal intends to protect the environment in the first place, it tries to "*put people first, and pay attention to the regions, industries and workers who will face the greatest challenges*".

I. Dimensions of the Deal

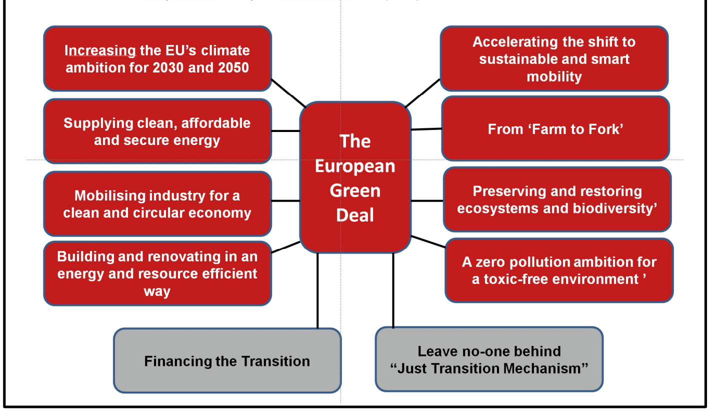
The EGD is a complex endeavour. Policies for clean energy comprise the whole economy ranging from industry and production to consumption, construction, infrastructure, transport, food and agriculture, taxation and social benefits. These policies must be formulated, coordinated with member states and internationally, put into law, be implemented and updated as well as financed.

1. Aims and policies

The EGD explicitly lists eight goals and policy areas. It details the climate ambition – which we will see in more detail in the statistics chapter – and outlines the sectors most affected, i.e. energy production, industry, buildings and traffic It covers broader environmental and health goals such as agriculture, biodiversity and pollution. In more detail the deal specifies:

Transforming the EU's economy for a sustainable future

Adopted from: European Commission, COM(2019) 640 final, 11.12.2019



- **EU's climate ambition for 2030 and 2050**

The EU aims at climate neutrality, i.e. no net greenhouse gas (GHG) emissions by 2050. Current policies will not be sufficient. Thus, the Commission proposed on Sept. 17, 2020, to cut GHG emissions by 55% by 2030, up from the previously proposed 40% (all compared to 1990).

- **Supplying clean, affordable and secure energy**

To reach the 2030/2050 climate objectives, the production and use of energy must be largely de-carbonised. It implies that the power sector must strongly rely on renewables.

- **Mobilising industry for a clean and circular economy**

To decouple growth from resource use, the EGD aims to transform this linear "*extraction to consumption to waste/pollution*" economy into a clean and circular economy. The transition is expected to last a generation but must be set on track within the next five years.

- **Building and renovating in an energy and resource-efficient way**

Buildings (new and existing ones) need to become more energy efficient. Today, the annual renovation rate varies from 0.4 to 1.2% across EU members. This rate will need at least to double to reach the EU's energy efficiency and climate objectives (old goal).

- **Accelerating the shift to sustainable and smart mobility**

Transport is a large GHG polluter. To achieve climate neutrality, a 90% reduction in these emissions is needed, incl. road, rail, aviation and ships. 75% of inland road freight should shift onto rail and inland waterways. Fossil-fuel subsidies (air transport, shipping) should end.

- **From 'Farm to Fork': designing a fair, healthy and environmentally friendly food system**

Food production needs to become much more sustainable. Strategies will aim at significantly reducing the use and risk of chemical pesticides, as well as the use of fertilisers and antibiotics. Organic farming will also need to increase. The Farm to Fork Strategy will also foster a circular economy by taking action on transport, storage, packaging and food waste.

- **Preserving and restoring ecosystems and biodiversity**

The EU is not meeting important environmental objectives such as the Aichi targets under the Convention on Biological Diversity. To ensure that the EU plays a key role, the EC presented a Biodiversity Strategy in May 2020, to be followed up by specific action in 2021.

- **A zero pollution ambition for a toxic-free environment**

Creating a toxic-free environment requires more action to prevent pollution from being generated as well as measures to clean and remedy it. The Commission will adopt in 2021 a zero pollution action plan for air, water and soil. It will also present a chemicals strategy.

2. EU timeline

The EGD is not yet a complete set of defined policies but instead under development and discussion. The Commission sets "milestones" by publishing strategies and action plans. The EU political process than applies. The ambition to cut GHG by 55% until 2030 was officially announced in September 2020. The consent of the Council has recently been put off to December. By June 2021, the Commission will review and revise the EU carbon emissions trading scheme (ETS). In 2023 the member states are due to update their national climate and energy plans.

3. European Green Deal Investment Plan (EGDIP)

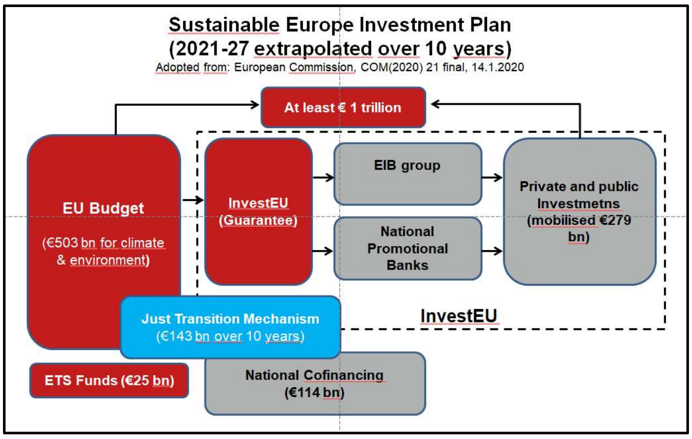
The transition of the EU to a climate-neutral, resource-efficient and competitive economy entails huge investment needs. In mid-January 2020, the Commission laid out its ideas regarding the investment side in the European Green Deal Investment Plan (also called the Sustainable Europe Investment Plan). The EU will deploy its budget to promote investments but total investment needs are much larger. The plan specifies three objectives:

- First, it intends to mobilise at least EUR 1 trillion of sustainable investments over the next decade through the EU budget and associated instruments
- Second, it will create an enabling framework for private investors and the public sector to facilitate sustainable investments (see below EU taxonomy)
- Third, it will provide support to public administrations and project promoters in identifying, structuring and executing sustainable projects.

The plan also includes the so-called Just Transition mechanism, which is especially geared towards facilitating public sector investments in the regions most negatively affected by the structural change.

How can this €1 bn over ten years be mobilised?

As the graph below shows, the EU plans to mobilise the sum by a combination of the EU budget (about €500bn), national co-financing, leveraged InvestEU funds, Just Transition and other resources (in sum €540 bn):



EU budget and Recovery Fund: The EU budget will play an important role. EU member states just agreed on a new long-term budget for 2021-2027 worth €1.074 tr. The European Parliament and the Council have reached a compromise. The EU Council has also agreed to a €750 bn recovery fund, intended to support the member countries most affected from the Covid-19 crisis. The EU budget is also intended to contribute to the climate objectives on the revenue side. The EU could be given own via environmentally geared levies or from auctioning rights in the Emissions Trading System. The topic is still under negotiation with the EU Parliament.

II. Growing and Greening European Finance

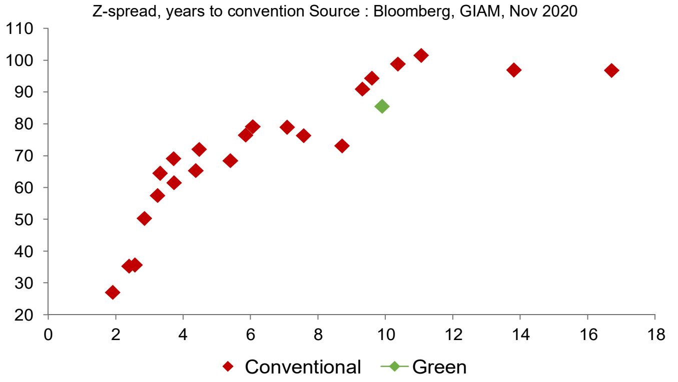
The transition towards a green economy is not only a political matter; it has also become an unavoidable trend in financial markets.

1. Green assets: A widening supply-demand gap

Institutional investors are incentivized for commercial reasons to substantially raise their green holdings. Thus, the supply, not demand is the bottleneck. As a result, both on the primary and secondary markets green assets are trading at a premium relative to conventional assets. Moreover, even during the corona virus-induced market sell-off, ESG funds proved more resilient than conventional ones.

Daimler EUR senior curve

Z-spread, years to convention Source : Bloomberg, GIAM, Nov 2020



2. The Green deal will likely reinforce European dominance of the green bond market

As a direct result of the increasing focus on climate change and sustainable finance, the green bond market has been growing rapidly, reaching around €350bn in 2020mostly in euros. Hence, the Green deal may help Europe to consolidate its top position in terms of sustainable finance, which may prove a strategic economic advantage.

3. EU will become the largest green bond issuer

The EU generally wants to support ESG markets. For instance, it announced that EUR100bn issuance for SURE will be made via social bonds. The EU is set to become a big issuer in the green bond space. €260 bn of its €750 bn Recovery Fund will be issued as green EU bonds, largely relying on the European Commission's work on EU Taxonomy and EU Green Bond Standards.

4. A standardization of green standards is a necessary step for a proper asset class to emerge

The EU is also doing its part to help achieve climate targets by publishing the EU Taxonomy for companies engaging in sustainable activity (which will be fully operational in 2022 after the adoption of its delegated acts).The EU Green Bond Standards are still being discussed. The emergence of the EU Green Bond Standards could be an game-changer, in particular for sovereign issuances, and possibly act as a standard for other regions.

5. Climate change is high on the agenda of the ECB's strategic policy review

President Lagarde (and other Governing Council members) have made clear that climate change initiatives will be high on the ECB's agendaThere are several options on the table and the key challenge for the ECB will be not to not to crowd out private investors in a structurally overcrowded market.

a. Greening both Banks and Insurance Prudential supervision

On the banking supervision side, the ECB could ensure that banks properly assess climate risk, which could lead green assets to receive preferential treatment.The European Banking Authority (EBA) could also possibly include this approach into its stress test exercises. Similarly, the European Insurance and Occupational Pensions Authority (EIOPA) has recently launched a consultation on the supervision of the use of climate change scenarios in ORSA.

b. New TLTROs with green objectives could be launched

Green TLTROs, as recently suggested by ECB President Lagarde could be launched. Under the current framework for the TLTROs, banks can borrow from the ECB at a rate linked to their credit extension. A green TLTRO could be based on bank lending activities that are compliant with the EU Taxonomy, supporting green activities.

c. Collateral rules are also starting to evolve towards more favourable rules for green assets

Recently the ECB took another measure to support green financing by making step-up (variable coupons) sustainability-linked bonds (SLBs) eligible collateral from 2021 onwards. Unlike traditional green bonds, SLBs' coupons are linked to sustainability performance targets. Further adjustments on collateral rules will also likely be considered. Applying more favourable haircuts for green bonds could be easily envisaged, which would encourage banks to hold more green assets than conventional ones.

d. The ECB has shown a desire to address climate issues via its monetary policy which is not trivial

The ECB has been an active investor in (eligible) green bonds through its QE programs. The ECB mandates do not encompass yet an outright climate objective. The decision will come with the ECB's policy review but we expect some incorporation of green criteria. It could either apply new criteria to the current QE program or whether to launch a specific one dedicated to green assets. The ECB also could use its non-monetary policy portfolio to support environmental-friendly investments. A crucial question is also whether the ECB would apply its criteria to the issuer or each bond. A recent study by the Bank of International Settlements (BIS) would in our view rather suggest that the ECB would favour the first option. In terms of which criteria could be applied, recent comments from Pascal Canfin, chair at the European Parliament Environment Committee, are also pointing towards carbon filters for ECB purchases.

6. Sector implications

Among sectors the most affected ones will be building and materials which will be the main beneficiaries through the objective of Building and renovating in an energy and resource-efficient way, while on Utilities and Autos the impact will be sector neutral but winners and losers will emerge within sectors. Among Utilities there will be even a greater rotation between conventional energy producers versus renewable specialists, while in the Auto sector the Green deak is providing the sector with subsidies to cope with the very ambitious coarbon issuance reduction plan.

Conclusion

To conclude, the green deal is a unique opportunity for European finance to become greener, not only on the private market but also on the public side. The plan is likely to boost short-term GDP across the EU through a major investment plan in power production capabilities, buildings renovation, automotive and industrials. Moreover, the EU Green deal aims at protecting long-term wealth, by fighting climate change and reaching net-zero emissions by 2050. But it could also reshuffle the cards of the European geopolitical landscape as by shifting away from hydrocarbons Europe will gradually source its electricity domestically.

On financial markets, as the EU will become the biggest green bond issuer it will likely facilitate some standardisation and will force all stakeholders from issuers to intermediaries intermediaries and investors to set a clear target in terms of environmental impact. The supply of green bonds is set to keep growing over the coming years but the demand will potentially grow even faster as regulation will gradually encourage institutional investors to hold more and more green assets. EU institutions are looking to play a role in this transition, e.g. the ECB will likely add a green layer to its various mandates; most importantly it may add a green layer to its asset purchases. This could have an impact on the relative valuation of green assets versus conventional ones.

Imprint

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