Truist Advisory Services, Inc.

Global Perspective from the Investment Advisory Group

Climate Change – Europe is leading the charge

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Summary

The landmark report from the United Nations (UN) Intergovernmental Panel on Climate Change depicted a dire future for the Earth's climate, highlighting that each of the last four decades has been successively warmer than any decade that preceded it since 1850. Policymakers around the world have started to incorporate climate into their policymaking. Intra-government organizations, like central banks, also started introducing strategies to mitigate the risks global economies face from climate change. Major central banks' quantitative easing (QE) programs, deployed to stabilize economic activities and financial markets, are projected to be increasingly aimed towards de-carbonization efforts. In short, QE is becoming QE"D", with D referring to de-carbonization efforts. In the meantime, investors are deploying more and more resources towards the Environmental, Social, and Governance (ESG) aspects of their investments, stressing the Environment component. In short, ESG is becoming "E"SG, with an emphasis on E.

Europe is leading the charge

Europe is the leader in policymaking for climate change

The European Union (EU) is on track to meet its greenhouse gas emissions reduction target for 2020 and has a plan to further cut emissions by at least 55% by 2030. By 2050, Europe has the aspiration to become the world's first climate-neutral continent. This ultimate goal is at the heart of the European Green Deal, a set of policy initiatives aimed at achieving carbon neutrality. It's also in line with the EU's commitment to the Paris Agreement. Ultimately, while dealing with climate change, the EU aims to promote sustainable economic growth, create jobs, and deliver environmental benefits for its citizens. Investing in green technologies could also bolster the long-term global competitiveness of the EU economy. Policymaking in major political institutions, as well as the establishment in the EU, is concentrated on achieving climate-related goals, especially the influential monetary authority, the European Central Bank (ECB).

The ECB is trying to kill two birds with one stone

In July of this year, the ECB showed a solid commitment to incorporating climate change considerations into its monetary policy framework. Including climate change considerations in monetary policy operations for disclosure and risk assessment is one thing, but implementing a new collateral framework and shifting corporate sector asset purchases according to climate change is another thing. The ECB's goals could have a profound shift in how future investments are allocated between alternative opportunities. Under its authority to fight with the pandemic-related economic slowdown, the ECB has been buying on average €120 billion worth of bonds issued by European sovereigns and corporates per month. Rules on how these purchases are allocated are currently being rewritten.

Targeted longer-term refinancing operations (TLTROs) for climate change

More importantly, the central bank offers long-term funding with attractive conditions to banks, called targeted longer-term refinancing operations (TLTRO), to stimulate bank lending. Borrowing rates in these operations can be as low as half a percentage point below the average interest rate on the deposit facility, close to negative half a percent already. The more loans participating banks issue to non-financial corporations and households, the more attractive the interest rate on their TLTRO-eligible borrowings becomes. Multiple series of TLTROs were issued in 2014, 2016, and 2019. The ECB is planning to issue more TLTROs in the future, but the new ones could have constraints attached to climate change and sustainability initiates. In theory, this would allow the ECB to give free money to participating banks for their new loan commitments at interest rates as low as negative one percent, as long as the new loans match with any climate change-related criteria that the ECB deems appropriate.

Stress tests including climate change risk could shape bank balance sheets rapidly

The ECB also plans to conduct an economy-wide climate stress test and a supervisory climate stress test for individual banks in the Euro system. This could lead to a significant change in how future loans are created in the banking system. As expected, the loans helping to mitigate climate risks could be rated favorably in the ECB's stress tests. With this new framework, a new risk profile of the assets held on the Eurosystem's balance sheet could potentially reduce the undesirable accumulation of climate-related financial risks.

It's not just the ECB, the Bank of Japan (BoJ) and Bank of England (BoE) join the foray

Like the ECB, the BoJ started to offer numerous incentives to lenders providing loans to businesses working on greener economy projects. The BoJ aims to finance projects both inside and outside of Japan via green bonds denominated in foreign currency. Another motive of this move is to keep the Japanese currency readily available to overseas markets and control the currency's value. The bank also started a series of internal discussions to make environmental issues part of the bank's mission.

As a bank supervisor, the BoE conducts stress tests on banks. As part of the 2021 Biennial Exploratory Scenario, the BoE will run a stress test to evaluate a wide range of risks to the UK financial system, including climate change. The inaugural stress test results will not change capital requirements for the banks or insurers. Still, the BoE could eventually incorporate changes based on these tests, resulting in a significant change on where future loans diverted.

Environmental, Social, and Governance (ESG) to the rescue

Over the last two decades, the investment industry has seen rapid development in the evaluation of a firm's collective conscientiousness for social and environmental factors. Corporate governance has always been a significant factor for minority investors since the dawn of investing. Still, the intangible assets and liabilities related to the environment and social factors recently took the spotlight. ESG-related indices are estimated to grow to over $1 trillion by 2030. European investors were leading the charge in demand for these indices, and interest started to resonate with U.S. investors as well.

Without "E", there will be no "S" or "G"

This August is on target to be the hottest month on record for many parts of the world. The Mediterranean region and some parts of California are experiencing climate change risks first hand, with an unprecedented amount of wildfires threatening human life, wildlife, and vulnerable ecosystems. Investors are quickly realizing that without a sustainable environment for people and companies to flourish in, there could be no platform left for social and corporate governance. In short, "E" became a prerequisite in ESG investing.

Successes in the ozone layer need to be replicated for greenhouses gasses, but much more capital is needed

Research suggests that, with the help of the 1987 Montreal Protocol, the global ban on chlorofluorocarbons (CFCs) helped the planet avoid 2.5^{o} C of potential warming. A similar success is needed to reduce carbon dioxide (CO_2) and other greenhouse gases. The reduction of CO_2 could be more complicated as other chemicals could be easily substituted for the use of CFCs. On the other hand, CO_2 is primarily a byproduct that usually requires a major shift in production and consumption. Reallocating and redesigning production lines requires capital and a significant portion of the cost of capital is controlled by central banks, regulatory bodies, and related government entities. Therefore, the allocation of capital will play a significant role in fighting climate change.

Bottom Line

European policymakers and central banks are leading the charge in climate change initiatives. As a result, Europe has made good progress towards some of their emissions-related goals. The ECB has already started making changes to their asset purchase program and collateral framework to incorporate sustainability and climate change, and more could be on the way. Additionally, the BoJ and BoE have started to place an emphasis on climate change risks. As a result, this could dramatically change where capital is allocated in the EU, UK, and Japan as focus on climate change continues to heighten, and we're starting to see a greater focus in the U.S. as well; this will increasingly influence global investing.

Because of their narrow focus, environmental, social and governance investments tend to be more volatile than investments that diversify across many sectors and companies.

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