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EU Green Deal and Investing in European Banks

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The EU Commission is aiming to be a leader in tackling climate and environmental-related challenges and has set out ambitious plans in its so-called EU Green Deal to enable this.

The commitment is to be climate neutral by 2050 and the plans are to reduce greenhouse gas emissions by at least 55% in 2030 compared with 1990. The EU Commission is due to publish its legal proposals for the EU Green Deal in mid-July. The commission has estimated that achieving the current 2030 climate and energy targets will require €260 bn in additional annual investments. This is equivalent to approximately 1.5% of GDP compared with the nominal GDP of 2018.[1]

In Europe, where bank lending and debt markets have a greater role in financing economies, banks will play a critical role in the development of sustainable finance, which in turn will be key to the success of the EU Green Deal. The banks will lead capital markets' financing and innovative structured solutions to manage the transition risk. The commission is also aware that long-term incentives will be needed to direct financial and capital flows to green investments and to avoid stranded assets.

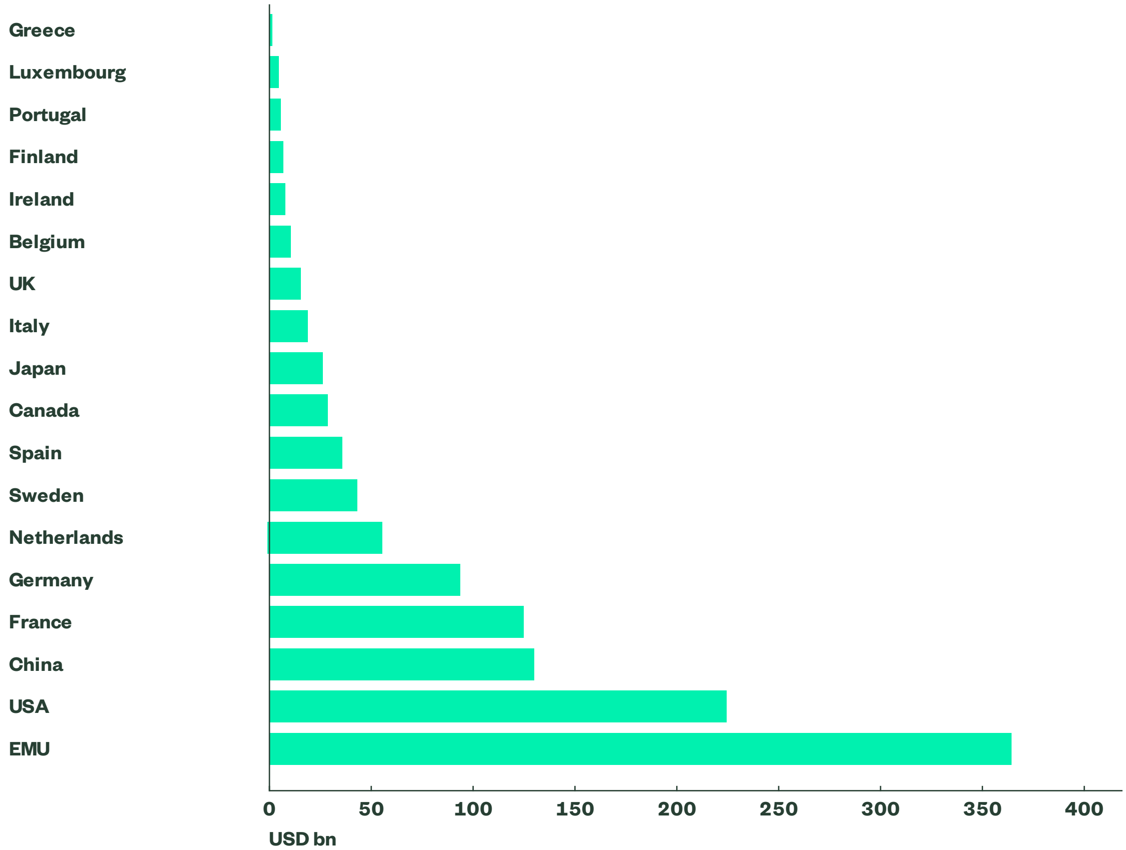
Green Bond Issuance Rises Across the Board

Climate-linked or green bond issuance has been growing quickly including both at the sovereign and corporate issuance levels. In this context, it should be noted that eurozone green bonds issuers are amongst the largest global issuers (Figure 1).

The other key players in the EU Green Deal will be asset owners, asset managers and insurance companies that seek to align their portfolios to meet sustainability objectives.

The 2021 United Nations Climate Change Conference (COP26) will play a critical role in moving toward mandatory carbon emissions disclosure, which will provide the transparency needed for all players to step up efforts in the development of sustainable finance. A key first step in this process has been for the European Parliament and the European Council to adapt the taxonomy for classifying environmentally sustainable activities.

Figure 1
Green Bonds Issued



Source: Climate Bond Initiative, State Street Global Advisors, as at December 2020.

Banks and ESG

Based on this taxonomy, banks would need to increase their own disclosure to offer investors and companies the opportunity to identify 'green' investments and ensure that they are credible (Figure 2).

Figure 2
Key Considerations for Investing in Banks as Part of the Green Deal

- Climate Strategy and Management/Board Commitment
- Disclosure Standards
- Credit Exposure to Transition and Physical Risks
- Green Versus Brown Financing
  - — Fossil Fuel Financing
  - — Greenhouse Gas Intensity of Lending
  - — Sustainable Bond Financing

Source: State Street Global Advisors.

Banks also need to address the systemic risks of climate change and will be required to address climate and environmental risks as part of the EU prudential framework. The suitability of existing capital requirements as applied to green assets is being reviewed as part of the commission's action plan on financing sustainable growth.

The European Parliament and the European Council have mandated the European Banking Authority (EBA) to identify the principles and methodologies for the inclusion of environmental, social and corporate governance (ESG) risks in this review. The evaluation performed by the EBA supervisors will also explore the prudential soundness of introducing a more favorable risk sensitive treatment for green assets — the so called green supporting factor.

Investing in Banks as Part of the EU Green Deal: Risks and Opportunities

The key risks to consider would be the transition and physical risks in credit exposures. The banks will also face increased scrutiny as highlighted above for their capital adequacy and will have to address both regulatory and political pressures as countries move forward to meet their own sustainability goals under the Green Deal.

But the Green Deal also presents opportunities for banks to participate in the financing and advisory activity that will be part of the development of sustainable finance needed to achieve the objectives set out by the commission (Figure 3).

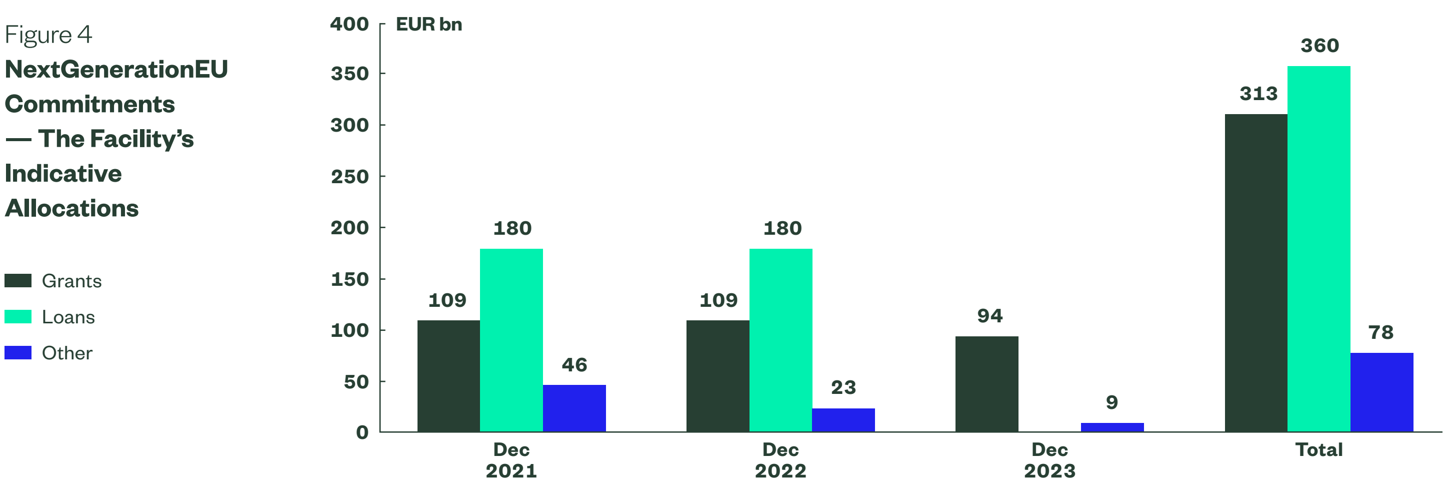
Figure 3
Investing in Banks — Risks and Opportunities

Risks	Opportunities
Transition and Physical Risks in Credit Exposures	Finance Green Bonds/Projects
Increased Capital Requirements	Advise on and Structure Innovative Solutions for Clients to Address Transition Risks
Changing Regulatory Environment	Develop Liquidity for Carbon Market Trading
Reputational Damage	Corporates Improve Brand Image and Stock Valuation
	Access to More Investors

Source: State Street Global Advisors.

The Green Deal will be financed via a number of EU programs, including the Recovery and Resilience Facility (the Facility). Issuance for the Facility's funding or "pre-financing" for EU countries' programs begins in June 2021 and funding will be made available to national governments after the approval of their recovery and resilience plans. Countries will obtain a mix of grants and loans (Figure 4).

Figure 4
NextGenerationEU Commitments — The Facility's Indicative Allocations



Note: Euro billions in 2018 prices; the Multiannual Financial Framework runs until 2027; other includes research and innovation, strategic investments, agriculture, etc. Source: The European Commission, as at April 2021.

The funding will make the EU one of the largest issuers in euro with an average of around €150 bn per annum between mid-2021 and 2026. NextGenerationEU green bonds will make up part of this issuance where €80 bn in bond issuance is likely to come to the market this year. What remains of the funding will come from Treasury bill auctions, which should start in September. Overall funding needs will also be reviewed in September.

A mix of syndication and auctions is to be used to issue bonds and banks will be arranging to finance this issuance as well as structuring finance for corporates, which have the capability to invest in green projects. National recovery and resilience plans that apply for funding from the Facility will have to make a minimum 37% allocation for spending on climate-linked investments (Figure 5).

Figure 5
The Recovery and Resilience Facility

Twin Transitions: Green and Digital

Each recovery and resilience plan will have to include

a minimum of

37%
of expenditure

for *climate* investments and reforms

a minimum of

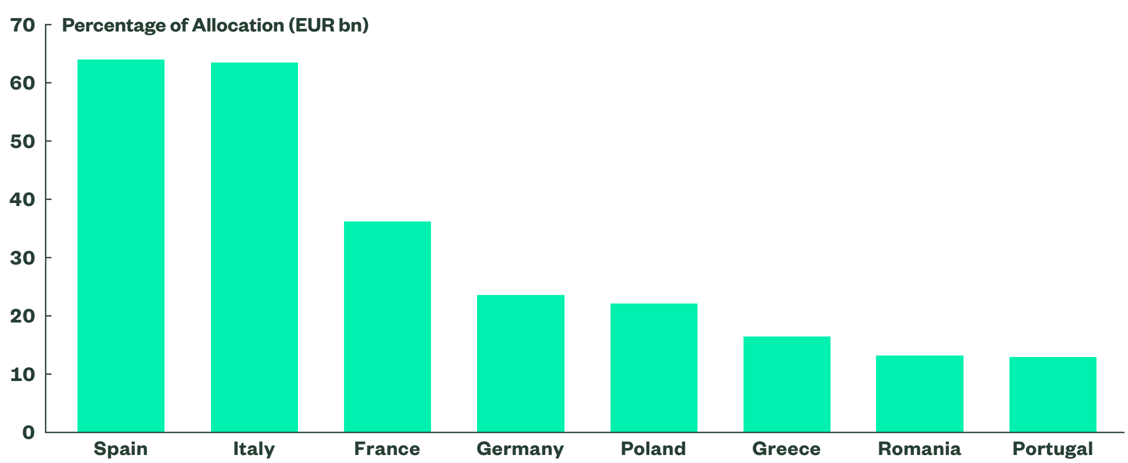
20%
of expenditure

to foster the *digital* transition

The commission will assess national plans against these targets.

Source: The European Commission, as at 12 February 2021.

Figure 6
NextGenerationEU Grant Allocations



Note: Euro billions in 2018 prices. Source: The European Commission, as at April 2021.

In Conclusion

Better defined climate strategies should result from the implementation of the EU Green Deal and provide banks with opportunities to improve the E, S and G elements of their ESG scores. In our Fundamental Growth & Core Equity team, we have incorporated ESG analysis within our research process framework.

Amongst the key considerations for investing in banks in light of the Green Deal are therefore banks' climate strategy and management/board commitment, disclosure standards with regards to credit exposure to transition and physical risks and green versus brown financing. We look for banks that have taken a lead in addressing these considerations and can capture the opportunities the Green Deal will present.

Appendix — EU Green Deal Summary

Objective	Seeks to achieve climate neutrality by 2050 and decrease emissions by 55% in 2030 compared with 1990 levels.
Member State Requirements	All national recovery and resilience plans will need to focus strongly on both reforms and investments supporting the green transition. Each recovery plan will have to include a minimum of 37% of expenditure related to climate. Member states should present reforms and investments to support green transition in energy, transport, de-carbonizing industry, circular economy, water management and biodiversity. These need to be implemented over the 2021–2030 period. Member states will need to factor in the need to ensure a just and socially fair transition across green policy areas.
Types of Green Investments	Fast deployment of renewable energy and hydrogen and increased action on energy efficiency of buildings. Enhance building renovation to at least double the annual renovation rate of existing building stock. Investment in public transport and in infrastructure that supports a shift toward more sustainable and smart mobility, including upgrading the Trans-European Transport Network. Investments aimed at boosting demand for zero- and low-emission vehicles and accelerating rollout of recharging and refueling technologies and value chains. Improving environmental infrastructure, in particular for waste and water management.
Size	The Green Deal is estimated to require €260 bn of additional annual investment or 1.5% of GDP as estimated using 2018 nominal GDP. Both public and private sectors to be involved. The commission will provide funds through its current budget and the Recovery and Resilience Facility to be funded by the NextGenerationEU.
Funding	37% of Recovery and Resilience Facility (€672.5 bn), which equates to €249 bn, will go to climate investments and reforms. 30% of budget to be allocated to climate mainstreaming across all EU programs. A Just Transition Mechanism has been set up to help mobilize €65–75 bn over 2021–2027, which is targeted to support those most affected by the transition toward a climate-neutral economy. The commission has proposed new revenue streams (own resources), one of which is based on the taxation of non-recycled plastic packaging waste. A second revenue stream could involve allocating 20% of the revenue from the auctioning of EU Emissions Trading System to the EU Budget.
Funding Strategy	The Recovery and Resilience Facility will receive 90% of the NextGenerationEU funds, which will be funded by borrowing on the capital markets using a diversified funding strategy including both medium and long-term bonds, some of which will be issued as NextGenerationEU green bonds and EU Bills to maintain flexibility in terms of market access and to manage liquidity needs and the maturity profile. The commission will continue to coordinate with other issuers, including EU member states and supranational organizations.
NextGenerationEU	Under the NextGenerationEU, the commission will raise up to around €800 bn, 5% of EU GDP, through funding operations on the international capital markets during the 2021–2026 period. Budget sometimes stated in 2018 prices or €750 bn equating to around €800 bn in current prices.
Fund Disbursement Mechanism	Financing of the NextGenerationEU set to start by June 2021. First disbursements to member states will take place in 2021 representing 9.5% of the total allocation, with 20% in 2022, 24% in 2023 and peaking at 25% in 2024.
Action Plan	In May 2021, EU ambassadors approved the EU Climate Law. New EU Strategy on Climate Adaptation to make Europe a climate-resilient society by 2050 will be presented in July 2021.

Note: The above estimates are based on certain assumptions and analysis made by the European Commission. There is no guarantee that the estimates will be achieved. Source: The European Commission, as at 14 June 2021.

Endnote

1 The European Green Deal. (2019, December 11). Communication From the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions. The European Commission.

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