MARKET COMMENTARY

ECB provides details on how it aims to decarbonise its corporate bond holdings

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- **The ECB published today the details of its decarbonisation process. It will be based on an issuer-specific climate score integrating both a backward-looking and forward-looking component as well as a data disclosure quality score.**
- **The central bank has not provided any information on the origin of the scores to be used.**
- **The corporate bond purchases will be tilted towards issuers with better scores starting 1 October 2022, not triggering any loss of eligibility for now. Still, the ECB will now impose maturity limits on bonds from lower-scoring issuers. The comparison versus the average portfolio score may penalise sectors with the heaviest emissions based on our analysis of Utilities, Materials, and Energy.**
- **While this is a crucial step for the ECB, the fact that the quantitative tightening is fast approaching, potentially reducing the reinvestments in the APP already in Q123, may reduce the market impact that could have been initially envisaged. That being said, as most private investors are concomitantly attempting to improve the carbon footprint of their portfolio, we are still expecting the "E" component of the ESG scores to further feed into credit market valuations.**

A three-step approach

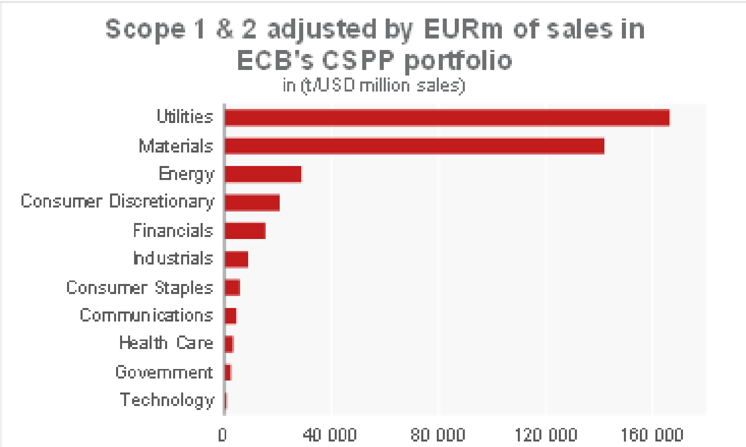
The ECB has announced today (see link) that it will tilt its corporate purchases starting 1 October according to the following three criteria:

1. A backward-looking sub-score is based on issuers' past carbon emissions. It will both compare companies carbon emissions versus peers their peers in a specific sector but also versus the central bank entire private portfolio.

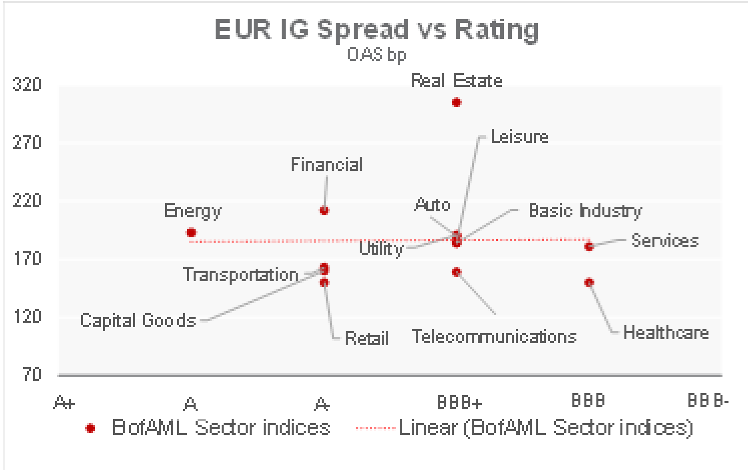
2. A forward-looking sub-score calculated according to the objectives set by issuers to reduce their greenhouse gas emissions in the coming years. Doing so the ECB hopes to further incentivize companies to improve their climate ambitions by contributing to linking their cost of issuance to their climate profile.

3. Finally a climate disclosure sub-score that will reflect the quality of issuers' reporting of greenhouse gas emissions. Here again the ECB is hoping to contribute to incentivizing bond issuers to improve their climate-related disclosures linking them potentially to their cost of funding. Scope 3 emissions data are still lacking exhaustiveness and consistency.

In the communique, there is no mention of who will provide the data for the scores underpinning the carbon score assessment.



Source ECB, Bloomberg, GIAM own calculations



No sales for now but a cap on maturities :

The tilted corporate bond purchases will not be triggering any loss of eligibility for now, meaning bonds of low score issuers will not be sold. However, the ECB will now impose maturity limits on bonds from lower-scoring issuers, which could also encourage private sector investors to mimic the central bank, making long-dated funding even more complicated.

No specific sector carbon reduction target, but still a possible sectoral rebalancing could occur :

According to our analysis, within the ECB private bond portfolio based on scopes 1 and 2 emissions normalised by sales, the sectors with the heaviest carbon issuances are 1/ Utilities, 2/ Materials, and 3/ Energy. The fact that the ECB scores are not only discriminating among peers within sectors but also across the entire portfolio may eventually penalise 'dirty' sectors and relatively favour clean ones.

QT will limit the direct market impact from the ECB policy, but the "E" premium" should increase anyway :

This is an essential step for the ECB. Yet quantitative tightening (QT) is fast approaching, potentially reducing the reinvestments in the APP already in Q123. This may reduce the market impact that could have been initially envisaged. Indeed the bulk of the corporate reinvestments are being made within the APP, circa EUR2bn per month currently, while PEPP reinvestments that will last for longer will amount to much less than EUR1bn per month.

That being said, as most private investors are concomitantly attempting to improve the carbon footprint of their portfolio, we are still expecting the "E" component of the ESG scores to feed into credit market valuations gradually.