

White Paper

Climate Transition risk in Fixed Income Insurance Investment

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Investment White Paper

The GIAM's view on how to tackle climate Transition risk in Fixed Income Insurance Investment

SUMMARY

- **For insurance portfolios, for reducing the carbon footprint given the limited turnover possibilities, we adopt a gradial asset rotation approach, exiting from poor ESG-rated assets gradually while pushing for change in activist approach via our engagement activities.** From an insurance investment standpoint, the expectations in terms of transition risk will most probably result in heightened pressure on prices of high carbon footprint assets. This may therefore redesign the sectoral repartition of the economy, impairing carbon-intensive businesses while boosting the greenest ones. Looking at the EIOPA study between a run-off approach or a reallocation one, we conclude that starting to reduce transition risk is warranted as it has limited economic implications and will gradually imply regulatory benefits.
- **We expect Central Banks to intensify pressure on poor ESG-rated corporates over the coming months increasing de facto the ESG premium.** Climate change is not yet part of the mandate of major central banks, but the implied medium-term threat to price stability is leading them to start tackling this risk. We take a closer look at the implications expected from the climate strategy of the European Central Bank, in particular the greening of corporate bond purchases and banking regulations.
- **GIAM has a very strong commitment to tackle climate risk within portfolios and a unique multidimensional in-house approach .** GIAM has committed to achieving the Paris Agreement goals by cutting the Group's greenhouse gas (GHG) emissions attributable to (direct) investments in corporate bonds and equities by -25% from 2019 to 2025. We explain our approach to reaching this goal, going from a prudent exclusion policy, to a strong engagement activity and a detailed methodology to decarbonise portfolio.

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1. Transition Risk: key facts from the EC and EIOPA

Climate change is posing several threats to our modern society. The severe and broad-based environmental and social consequences we are already witnessing will only worsen if no coordinated actions are taken. From an economic point of view, global warming and the associated physical phenomena expose insurance companies and asset values to evolving risks and pose material challenges to companies' business models and solidity.

To prevent a spiral and secure a better future, the Paris Agreement on climate change calls for a reduction of greenhouse gas emissions aiming to contain the global temperature increase to well below 2°C., preferably to 1.5°C compared to pre-industrial levels.

Achieving such thresholds would entail considerable and unprecedented reductions in carbon emissions, hence discouraging investments in carbon-intensive businesses. Companies failing to comply with green standards will face additional risk as new regulations and legal claims come forth.

A Pigouvian tax on carbon emission to reflect for negative externalities, where fossil energy dependency falls due to technological discontinuity, would also introduce a detrimental factor for the value of carbon-intensive assets.

In this context, investors may revise their expectations on transition risk, resulting in heightened pressure on prices of high carbon footprint assets.

The materialisation of transition risk has the potential to completely reshape the sectoral landscape of the economy, jeopardising the viability of carbon-intensive businesses while boosting the greenest ones.

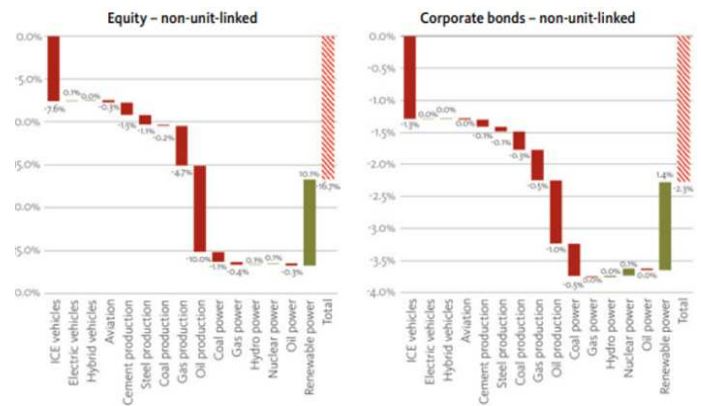
In a [recent statement](#), the European Insurance and Occupational Pensions Authority (EIOPA) clarified the main streams of climate risk, defining, alongside policy risk, the key sources of transition risks:

- I. "Legal risks, for example the risk of litigation for failing to avoid or minimise adverse impacts on the climate or failing to adapt to climate change.
- II. Technology risks, for example if a technology with a less damaging impact on the climate replaces a technology that is more damaging to the climate.
- III. Market sentiment risks, for example if the choices of consumers and business customers shift towards products and services that are less damaging to the climate.

IV. Reputational risks, for example the difficulty of attracting and retaining customers, employees, business partners and investors if a company has a reputation for damaging the climate."

In the perspective provided by EIOPA, these dimensions

Change in value of investments when compared to their initial value in the "what if" scenario for equity and corporate bonds



Source : EIOPA

of transition risk reach different severities in various climate scenarios. In its recent [sensitivity analysis](#) of climate-change related risks, EIOPA considered two main scenarios:

- I. In line with EU commitments where the global temperature increase remains below 2°C, preferably no more than 1.5°C
- II. Out of line with EU commitments where the global temperature increase exceeds 2°C and a late and sudden policy requires economies to re-align and dramatically reduce the CO2 footprint.

Nonetheless, in its more recent opinion, EIOPA introduced an ampler degree of freedom in the definition of the long-term climate scenarios whereby insurance companies may develop their own scenarios or elaborate on the existing ones, depending on their expertise and resources. While no precise and binding guidance has been given, EIOPA refers to a set of climate scenarios released by the Network for Greening the Financial System (NGFS) in June 2020, which generally falls into three main categories:

- I. Orderly transition;
- II. Disorderly transition; and
- III. "Hot house" world, leading to severe physical risks.

The first two transition scenarios are consistent with limiting global warming to below 2°C by 2070. On the contrary, growing emissions in the "hot house" scenario leads to a temperature rise of over 3°C within the same horizon. The representative scenarios in each of the

three quadrants are supplemented with five alternate scenarios with different assumptions on policy responses, temperature targets and technological progress. As climate change poses long-term risk, in its recent proposal the EC has initially envisaged the inclusion of climate related scenario analysis only in Pillar 2 (ORSA). Such scenario will have to be assessed at least every 3 years. On the contrary, no amendments to Pillar 1 (common risk assessment framework) are expected yet; at this stage, EC has simply given EIOPA a mandate on potential Pillar I adjustments. EIOPA will have to consider:

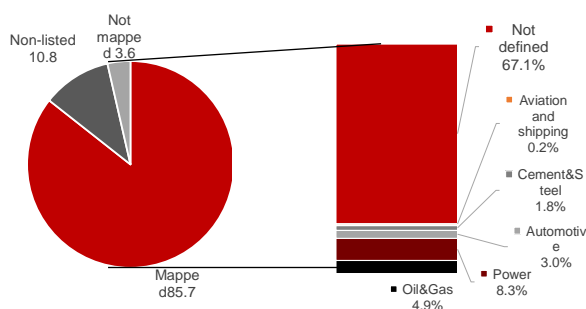
- I. Potential differential in capital charges based on climate related factors;
- II. More stringent capital requirements for certain assets reflecting the risk of stranded assets as part of the move to a green economy; and
- III. Reduced capital requirements for 'Green' investments to encourage further investment by the insurance sector

A concept of materiality applies to the identification of climate change risks for insurance business under EIOPA indications, e.g those risks that could influence the decision-making or judgment process of a company's decision-makers. To assess such degree of materiality of a climate change risk, both qualitative and quantitative analysis should be used (with the latter including, inter alia, an analysis of the asset portfolio exposure to transition risk e.g., considering the carbon footprint dimension). Importantly, such analysis will require examination of the future impact of climate change on the incidence of those risks, thereby not confining the materiality concept to the overview only of present current climate conditions

1.1 Climate risk in insurance portfolios: Run-off approach vs. reallocation

Managing climate risk for insurance portfolios requires defining sustainable carbon exposure limits and a

Share of corporate bonds climate-policy relevant

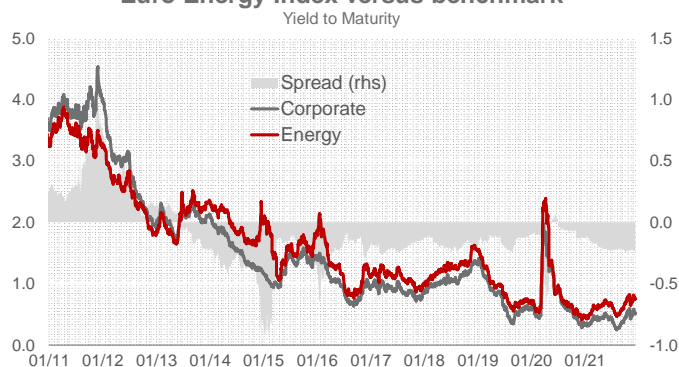


Source: EIOPA

realistic pathway to the target. While, from a mere economic standpoint, strategies can vary from a runoff approach to a more abrupt portfolio reallocation (or activist approach), the economics of the two options cannot be fully defined in advance. In fact, not only are reinvestment yields and unrealized gains and losses market dependent, but also the materialisation of the transition risk cannot be anticipated in magnitude and timing (rough anticipation of these should be investors' ambitions).

As such, a trade-off between a runoff approach and a quicker portfolio reallocation may arise from a prolonged exposure to an undesirable portfolio carbon footprint on one hand, and the yield dilution implied by rapid divestments of derated assets generated by a reduction technique on the other hand. Given the potential extent of the reallocation, frontloading actions will not come without implications.

Euro Energy Index versus benchmark



Source: Bloomberg, ICE BofA Euro Indices, GIAM own calculations

In fact, while reinvestment yields of carbon intensive sectors like the energy sector do not differ materially from the average yield of the broad investment grade market, book yields of legacy high carbon exposures can be materially higher as shown in the chart below. Scaling down legacy holdings can therefore lead to yield dilution and suboptimal profit realizations.

From a more holistic perspective, reduction techniques may even conflict with engagement strategies (would need to be introduced as concept for greening, would do this in earlier part above) which, in the longer run, can prove equally effective. In that spirit, the Net Zero Asset Owner Alliance promotes a gradual convergence based on selective reinvestment of maturing fixed income carbon intense exposures. Active reductions, although not prohibited, are not a lever of the agreement, the spirit of which is to gradually redirect investments while retaining the possibility of pressuring and engaging with carbon intense issuers to benefit from organic decarbonisation strategies.

This long-term approach is also consistent with the final

aim of “decarbonising” high carbon footprint sectors/markets. The risk of just dumping high carbon footprint sectors or securities lies in those businesses progressively going in the hand of private equity businesses that are not exposed to the same level of attention and transparency. This perpetuates the activity for longer as the pure market-based mechanism gets diluted, hence reduces the economic decarbonisation achievement of the radical reallocation strategy. Instead, we argue that issuers with a high current level of emissions but having a credible decarbonisation plan will positively contribute to net zero emissions by 2050. From an investor perspective, the advantage of this approach can be recognised by maintaining exposure to, and not simply excluding, those issuers/sectors that today are characterised by higher margins of improvement in terms of carbon emission reductions. This should allow exposure to these issuers to benefit from a potential and gradual reduction in their cost of capital, thereby increasing valuations of the related assets.

In the fixed income space we consider the primary market to be the ideal area for investors to deliver the message, when issuers seek new capital, rather than secondary market transactions to optimises portfolio allocation.

1.2 Transition risk and investment in green bonds: Is there a trade-off between an instrument and a borrower-based approach?

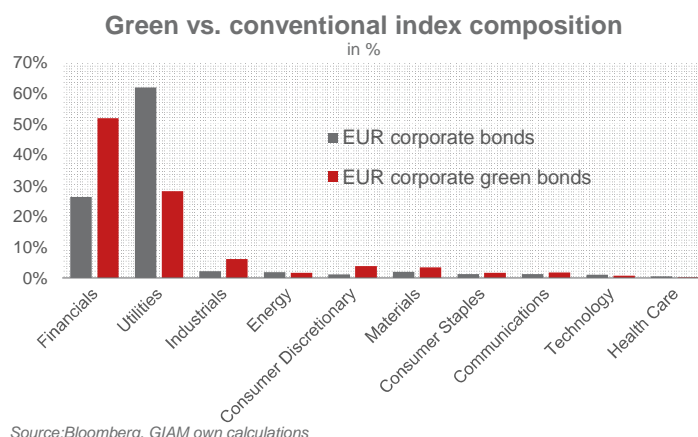
Greening the global economy requires resources, incentives, and effective policy actions. While all these variables are often in synergy, there might be seldom cases of partial misalignment Crucially, greening the economy would also entail funding green projects for dirty business and setting effective incentives for this to come to fruition.

When it comes to resources, the rapid development of the green bond market plays a major role within the private sector. The definition of a European Taxonomy and the creation of an EU Green Bond Standard will further contain reputational and greenwashing risks, boosting demand for green assets.

Nonetheless, a green label at instrument level can sometimes conflict with the aim of managing the transition risks, which, on the contrary, arise from the carbon intensity of an issuer’s whole perimeter of business. A label at instrument level might not provide a sufficient incentive for investors when the transition risk for the issuer is perceived as substantial. The investor’s desire to support the transition while avoiding transition risk can create a “prisoner’s dilemma” in which individual investors face high individual costs associated with

mutually shared benefits, leading to a suboptimal contribution to the decarbonisation objective.

Looking at the composition of the green bonds market versus the standard one, we see that green bonds issued by carbon intense issuers amount to a lower share of the former compared to the latter.



In this context, while a Pillar 2 (issuer specific risk assessment framework) sensitivity analysis on climate risk will be a further push for the decarbonisation of insurance portfolios, the introduction in Pillar 1 (common risk assessment framework) of capital mitigants for green instruments might help high carbon footprint companies to access green funds.

From a pure carbon footprint portfolio calculation perspective, assigning lower CO2 emission shares to green bonds, on the basis that they should finance cleaner projects/assets compared to the asset mix of the issuer, can be debated. Assuming that emissions generated by a single issuer can be split and apportioned on existing related securities and considering aggregate emissions at issuer level, there must be an offsetting emissions’ reallocation penalising other conventional (non-green) securities. Consequently, this approach, whenever adopted, should consider such adjustment to maintain the zero-sum principle.

2. ECB a green catalyst in 2022

The ECB walked its talk. The overhaul of the ECB's strategy finalised in July 2021 contains green objectives for the first time. By means of the so-called climate action plan it seeks to support the transition towards a greener economy.

2.1 Further policy greening likely

'- 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.

- Regarding monetary policy, the ECB gave up the principle of market neutrality. Following an assessment of market inefficiencies, proposals on how to adjust the Corporate Sector Purchase Programme (CSPP) will be made in the second half of 2022. Moreover, the ECB will include climate change risks in credit ratings and by the end of 2024 it will suggest climate-related haircuts in the credit assessments of repo operations. More generally, eligibility criteria for asset purchases will be developed and come into force in 2024.

In a background paper, potential actions are discussed in greater detail. It suggests climate-related disclosure requirements for private sector assets as a new eligibility criterion or as a basis for differentiated treatment of collateral and asset purchases. The green market is growing rapidly, additionally fostered by the EC's plan to issue up to € 250 bn of green bonds between mid- 2021 and 2026. Under the CSPP and the Pandemic Emergency Purchase Programme (PEPP), the Eurosystem held by November 2020 around 20% of the eligible green bond universe. However, the effectiveness of the policy tools to support the green transition crucially hinges on the ability to properly define green assets. As the ECB recently pointed out this

requires both "clearer standards on green versus ESG products" and the establishment of a (green) capital market union. Here, the European Commission's taxonomy on green bond standards and the announced expansion of the EU Ecolabel to ESG funds will be important.

Looking further ahead, we expect the ECB to intensify its green policy support. With the eligible universe continuously expanding it could for instance increase the share of green bonds when reinvesting some of its (corporate) stock of asset purchases. Moreover, the ECB pointed out that "green equity markets may be particularly valuable given that countries with a higher share of equity funding tend to reduce their carbon footprint more rapidly". With a clear definition of what 'green' means segmentation between the green and the 'brown' sectors will become operational. All in all, the ECB will in our view increasingly support green companies and assets. However, the impact of such climate policy may be lighter than initially expected now that the higher inflation landscape will lead the ECB to end its net corporate purchases in the third quarter of 2022. Still, the central bank will continue to be active on the corporate bond market via the reinvestment policy amounting more than EUR2bn per month over the coming years.

2.2 ECB to further green credit markets

As the largest player in the European credit market, the ECB's implementation of its climate strategy in 2022 should be highly scrutinised as it will very likely be a catalyst for climate-related dispersion.

Content-wise, the ECB climate action plan was shy of details regarding the way it could tilt CSPP purchases in 2022.

The BoE has shouted first

A natural source of inspiration for the ECB will likely be the Bank of England (BoE), which recently disclosed the details of its own climate strategy applied to private purchases.

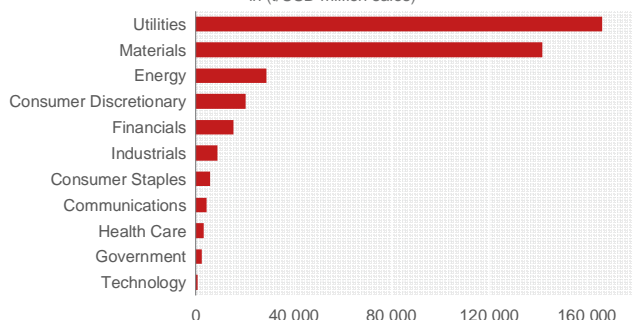
As a reminder, the BoE aims for a 25% decrease in emissions from corporates included in its portfolio by 2025 and net-zero by 2050, both via new eligibility requirements and tilting criteria.

The BoE will tilt purchases towards stronger climate performers within its corporate credit program (CBPS), and away from weaker performers, using a multifactorial scorecard incorporating:

- The level of emissions intensity based on the company revenues;
- Past reductions in absolute emissions (relative to

Scope 1 & 2 adjusted by EURm of sales in ECB's CSPP portfolio

in (t/USD million sales)



Source: ECB, Bloomberg, GIAM own calculations

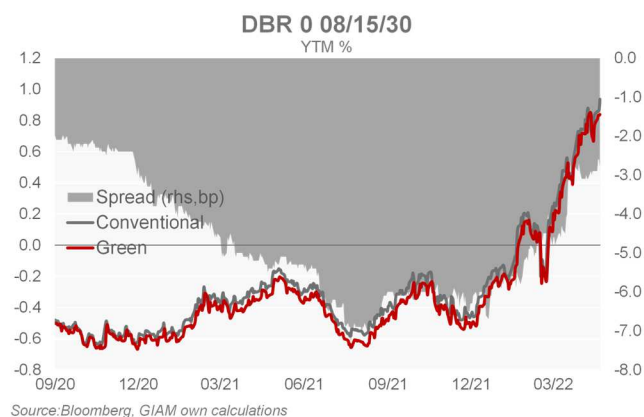
sector-specific pathways for high emitters);

- Publication of climate disclosure;
- Publication and third-party verification of an emission reduction target.

We suspect that similarly to the BoE, the ECB’s strategy should apply to future purchases and not immediately to the stock. It should also be based for now only on Scope 1 and 2 (direct and indirect carbon emissions) data for the moment while Scope 3 will be incorporated at a later stage.

No “green bond QE” expected

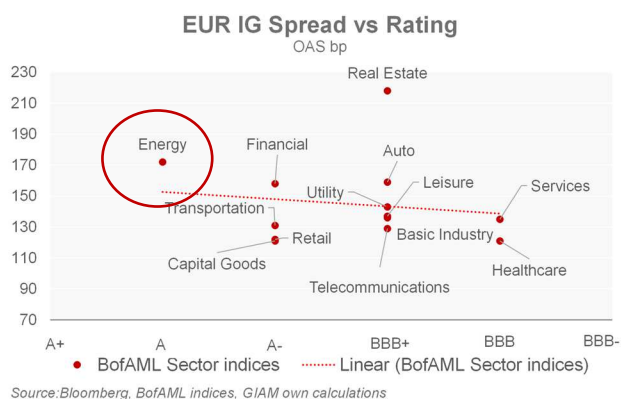
The ECB has already declared step-up (variable coupons) sustainability-linked bonds (SLBs) as eligible collateral from 2021 onwards and has included them in its asset purchase programs. Green bonds are also purchased in size by the ECB alongside its overall private bond purchases. The communication has been regular over those green bonds purchases but it is nearly impossible to know whether they have been overweighted, and the market neutrality principle in place up until now would rather suggest the opposite. Yet the question of a specific status for green bonds remains. We are of the view that supply struggles to satisfy demand in the green bond space, and we doubt the ECB would be happy to further grow those imbalances.



The ESG premium is set to grow

We now expect the ECB to remain a net purchaser of credit until Q3 2022, while the actual inclusion of climate risk in CSPP purchases will only start in the second half of 2022. Beyond that it will only apply to reinvestments, but we still expect this to be a strong catalyst for further integration of “E” factors in credit market valuations. This will undeniably affect the ecologically dirtiest sectors and players, as the ECB is the largest credit investor in the EUR 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 dispersion 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 is among the worst when indirect emissions are also considered.



2.3 The ECB as a regulator: The impact of transition risk on banks, climate buffer

As jurisdictions seek to address climate change, economic disruption (transition risk) could stem from the cumulative effects of changes in government policies, technology, and consumer and investor behaviour.

The banking sector plays a pivotal role in intermediating funds to corporates and is thereby exposed to the transition risk of firms via credit, market and liquidity risk. In addition, climate-related developments may increase operational risks by affecting business continuity as well as giving rise to litigation and reputational losses.

According to the ECB (footnote: Climate-related risk and financial stability, July 2021), the extent to which credit and market risk affect a bank’s solvency or liquidity risks and wider financial stability depends on the clustering of exposures together with the specific transmission of risks via either firm defaults or asset valuations. Bank domestic loan exposures to climate policy-relevant sectors (CPRS) in the euro area amount to €1.9 trillion, representing 52% of the euro area total domestic NFC loan portfolio (Source ECB). Recent stress test results point towards transition risks more than physical risks having a significant and concentrated impact on the banking system.

There is growing evidence that the current banking capital framework may not sufficiently capture the special features of climate risks. A range of initiatives to incentivise appropriate changes to banks’ risk

management and increase supervisory scrutiny are already well underway.

Last November, the ECB welcomed [EU banks' initial steps](#) towards incorporating climate-related risks, but none were close to meeting all supervisory expectations. Only one-third of banks have plans in place that are at least broadly adequate, and half won't have completed implementation of their plans by the end of 2022. Banks have made progress in meeting ECB expectations regarding management bodies, risk appetite and operational risk management but are failing in areas like internal reporting, market and liquidity risk management. Less than one-fifth have developed key risk indicators to monitor.

In this context, according to BIS, in a speech held in October 2021 addressing the role of prudential policy in addressing climate change, regulators would need to consider supplementary actions through requirements (e.g. supervisory review processes and capital add-ons) or Pillar 3 disclosure obligations. The imposition of capital add-ons under Pillar 2, based on suitable scenario analysis and stress testing, could be more effective than upward adjustments in risk weights under Pillar 1. Climate-stress tests allow, at least theoretically, the potential impact on banks to be considered in the light of different scenarios that combine specific climate developments and actions taken by policymakers and the banks themselves. Supervisors can then use those exercises to require either management actions or additional loss-absorption capacity or both.

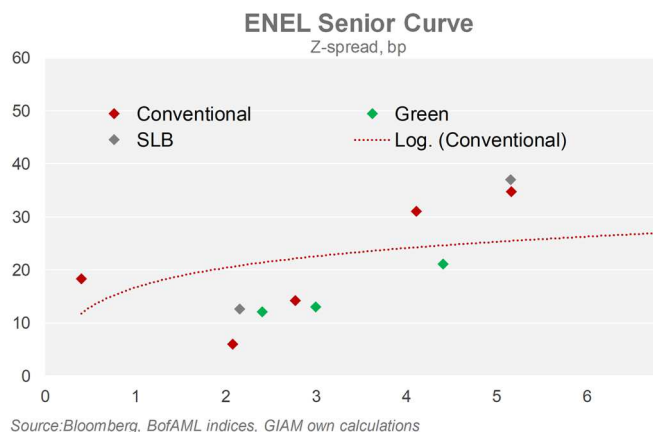
Potential changes in the calculation of banks' capital requirements would provide the market with more data to better compare and differentiate among banks. However, it is important that these parameters be calibrated on the probability of default associated with such exposures, not just against the "greenness" or "brownness" of the assets. This is key to avoid mixing policy and prudential objectives, because an asset's "greenness" is not necessarily an indicator of lower credit risk for instance.

It will take some time for the authorities to introduce these regulatory capital changes – not only because it would require an improvement of data availability and consistency, but also because of the consequences these changes might have on some economic sectors that need to fund their transition to a greener economy.

3. Transition Risk: key facts from the EC and EIOPA

The latest assessment [report](#) has made it clear that immediate, rapid and large-scale reductions of greenhouse gas (GHG) emissions will be required to stabilise global temperatures in line with the targets of the Paris Agreement.

In the financial service industry, there has been a growing recognition of the significant climate-related impacts of asset managers' portfolios and the effort needed to achieve significant emission reductions by 2025. While a multitude of commitments and strategies have emerged in the fund management industry, there is less clarity on how asset managers can achieve this goal. The growing need for consistent, comparable, and practical information is a key challenge associated with



climate integration. The procedural steps and organisational requirements that are essential to transform any climate ambition into real action are still under discussion within the industry.

3.1 Achieving the Paris Agreement goals

GIAM has committed to achieving the Paris Agreement goals by transitioning the Group's direct investment in equities and corporate bonds to -25% greenhouse gas (GHG) emissions from 2019 to 2025. By supporting the reduction of GHG emissions in the real economy and engaging with portfolio companies to pursue a carbon neutrality strategy, Generali Group became part of the Net Zero Asset Owner Alliance (NZ AOA) to join forces with a global transition and play an active role in kicking off a domino effect on other market participants.

Setting targets was the starting point to begin monitoring and understanding where the Group stands on the transition journey. Contextually, GIAM supports the Group by developing a proprietary approach for road testing and implementation based on the highest quality of available data. Consulting the NZ AOA protocol and the EU TEG benchmark regulation [guidance](#), we selected carbon footprint as the target metric to be used as a reference, within listed equities and corporate credit being asset classes included in the analysis' scope.

With the aim of achieving the pre-committed targets, we designed a decarbonisation roadmap built on a spectrum of layers combining environmental considerations with conventional investment strategies and financial returns. In line with the NZ AOA targets, GIAM framework leverages on a coal exclusion strategy,

engagement efforts linked to an active management/security selection strategy and estimated organic decarbonisation trends.

Since 2008, the main priority has been divesting from the single largest source of carbon emissions – coal, through the application of the “coal exclusion strategy”. Recognized as the main factor responsible for climate change and attributable to human activity, coal production and usage needs a steep reduction. In fact, according to the IPCC, coal-fired electricity generation must be reduced to near-zero in all climate scenarios consistent with limiting warming to 1.5° and thermal coal combustion needs to be reduced by 75% from 2010 to 2030, and by 98-100% by 2050.

According to the [Science-Based-Targets initiative](#), for financial institutions to be compliant with a full phase-out of coal by 2030 globally, across all their activities, they would need to immediately cease all financial or other type of support to coal-exposed companies, that are building new coal infrastructure or investing in new or additional thermal coal expansion, mining, production, utilisation (i.e., combustion), retrofitting, or acquiring coal assets. According to [Climate Analytics](#), between 2030 and 2040 all global regions need to phase out coal: the first regions expected to phase out are the OECD, Eastern Europe and former Soviet Union countries Germany e.g. committed only by 2037, Poland 2049, followed by Latin America by 2032, Middle East and Africa by 2034, and finally non-OECD Asia by 2037, completing a global coal phase-out before 2040 multiple sources [1](#) [2](#) [3](#)

Finally, according to the [IEA](#) (International Energy Agency), under a new scenario to reach net-zero emissions by 2050 (called Net Zero Emissions by 2050 – NZE2050), the share provided by coal plants without

Carbon Capture Usage and Storage CCUS technologies will need to fall sharply from 37% in 2019 to 6% in 2030, with the share of renewables in global electricity supply rising from 27% in 2019 to 60% in 2030.

3.2 A prudent approach to exclusion

In line with scientist recommendations, Generali has been applying restrictions to the financing of coal issuers since the launch of the Group Climate Change Strategy in 2018. With a long-term approach, and according to the pathways required to drive real economy towards 1.5°C, we at GIAM support the Group in reaching the complete exclusion of investments in utilities and mining companies which – even marginally – generate revenues from coal, produce power from coal or extract coal by 2030 for issuers located in the OECD area and by 2040 for issuers in the rest of the world.

The coal exclusionary approach allows a disciplined

stance towards portfolio emissions, avoiding critical positions from a carbon footprint perspective, and contributing to the global removal of coal energy sources in a stricter timeframe. However, although simple and transparent, an extended exclusionary approach across all sectors would force absolute “yes or no” decisions, which can often mask the subtleties of some corporate activities. GIAM recognises several caveats in pursuing a divestment strategy, such as

- the limit on investors’ impact – giving no contribution to the transition to a low carbon 2°C economy and missing the opportunity to drive companies in changing their business models and products

- or ignoring grey areas for exclusion decisions in companies with heterogeneous business activities, rather than pure play businesses.

For example, energy companies are among the biggest polluters but also some of the biggest investors in renewable energies. For these companies, GIAM looks for a very clear transition pathway, interrogating companies’ decarbonisation commitments to see if carbon reduction targets and investments are in line with the Paris Agreement. According to the [IEA](#), oil major leaders need to start exiting from fossil fuel production, making no incremental investment in fossil fuels. Energy companies should be dedicating most and soon all their additional capital expenditures into the renewables or the non-hydrocarbon economy. As an investor, the most important thing that GIAM can do is to support the transition and drive investment efforts in this direction. This means encouraging oil major leaders to increase investments into renewable energy and associated infrastructures, interconnected grids, hydrogen ingredients and in the different forms of carbon capture. A divestment strategy would penalise energy companies which, in the short term, are not the only ones carrying the burden, given that around 85% of the world’s primary energy currently comes from fossil fuels and there is still growing demand.

Aside from the energy sector and the supply perspective, there is an equally important demand issue about how we move away from a fossil fuel addicted economy evolving towards an entire new system, with different purchasing behaviours. Effort from policy makers is required to give a clear signal on commitments to rapidly scale up the clean and resilient technologies we need for the future and incentivising their employment.

Another example of a sector that has been struggling with both how its companies operate and what product they create is the mining sector. Like the energy sector, in addition to significant improvements to reducing carbon footprint, miners are questioned on the product they produce. At GIAM, we distinguish between miners that produce and explore for coal, from miners involved in types of minerals that are needed for the renewable energy transition. As of today, for example, the use of electric

vehicles requires a large amount of copper, nickel, and cobalt, the extraction of which results in negative long-term impacts for environmental and biodiversity. The mining sector needs to better consider the massive need for raw materials and, at the same time, their difficult broader ESG history, including social issues emerging with local communities, human rights violation, and work safety standards. In Generali, extraction standards play a role to the extent in which companies with virtuous environmental standards and which products contribute to the energy transition would not be automatically restricted/penalized

3.3 Engagement is of the essence

At GIAM we believe that a “one-fits-all approach” across companies and sectors is not realistic, which is why we engage directly with oil and gas, utilities, materials companies with the aim of supporting them in their transition path towards net zero. More specifically, GIAM engages companies in setting targets defined in periodic committee meetings and allocating efforts in the most cost-effective way by selecting issuers with the highest probability of engagement success.

3.4 Our decarbonisation strategy

Through the development of a common bank between the research and active ownership teams, the ESG analysts identify the areas to investigate and provides feedback to the engagement specialist, with the goal of turning the conversation toward specific strategic changes, such as moving away from fossil fuels, improving climate-related governance by integrating carbon-related KPI to remuneration policies and others, rather than broad commitments to change. The ESG analyst also includes engagement outputs into single security analyses. As such, while selling is still potentially accepted when engagement targets are missed, GIAM does not pursue a divestment strategy (apart from coal). Our approach instead focuses on reinvestment and capital reallocation in line with research and engagement assessments, all as part of a unique portfolio decarbonization strategy. Portfolio managers can leverage on the ESG analysts’ work in their funds by pursuing carbon reduction goals, adopting an optimized allocation strategy that we call “the active lever”.

3.5 GIAM’s model

To support investment decision-making and rebalancing, GIAM is developing a proprietary quantitative model applicable to multi-asset portfolios. It is based on a multi-criterion ranking model.

GIAM analysts continuously support portfolio managers providing climate assessments on single names, hence recommending investments migration from identified

climate laggards towards the leaders. Essentially, the rebalancing solutions that can be implemented are numerous and can vary depending on the asset class. For instance, on the fixed income side a possible strategy is to bring to expiration corporate bonds issued by laggards and reinvesting the generated proceeds into leading companies. On the equity side, however, a comparative approach of portfolio emissions versus a predefined benchmark can be adopted, with assessment and reallocation strategies aimed at reshaping exposure to reduce overweights to higher carbon issuers, while favouring more virtuous companies.

Overall, GIAM believes that picking companies best positioned to face the climate transition will not only result in a lower aggregated carbon footprint but will also accelerate the portfolio’s decarbonization trend through the so-called “organic effect”. Based on the adaptive capacity of companies to decarbonize at a faster pace than expected, the organic lever considers how a single

GIAM Decarbonisation Framework



Source: GIAM

company’s reduction trend contributes to the overall portfolio pathway. Betting on their target achievement, we select companies where we expect the highest carbon reduction percentage, and we engage with the less green companies to help them improve their emissions trajectory.

In conclusion, the implementation of the above-described levers and the whole climate transition management framework is instrumental to achieving the carbon emissions reduction targets within GIAM’s investment portfolios. All functions at GIAM are involved in this activity and the above-mentioned climate frameworks, which ensures integration across pre-existing financial data systems and investment processes, ESG analysts, research, and portfolio managers together with the engagement and voting functions. In this way, all functions aim to constantly improve the integration of climate transition information and data within the traditional business and investment decisions.

IMPRINT

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