ECB: CLIMATE PROTECTION TO BE GIVEN A BIG BOOST

A GREEN PRESIDENCY FOR CHRISTINE LAGARDE

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IN A NUTSHELL

_ The ECB has decided on a comprehensive plan to further incorporate climate change considerations into its monetary policy. A package of measures is to be implemented by 2024
_ Companies are required to disclose their climate risks in order to qualify for corporate asset purchases. For its own corporate bond portfolio, the ECB is likely to define criteria in the medium term that take climate protection aspects into account
_ The climate agenda is not taking over monetary policy completely; rather an appropriate mix of measures are being adopted to address climate policy challenges

1 / Climate-change monetary policy

1.1 To what extent is climate protection covered by the ECB's mandate?

Sooner than expected the European Central Bank (ECB) presented the results of its monetary policy strategy review on July 8, 2021. In addition to adopting a new inflation target of 2%, rather than its previous "below but close to 2%," the ECB has made an effort to integrate the consequences of climate change into its policy-making – whether monetary policy or financial supervision. In doing so the central bank has confirmed the stance that has emerged from speeches and essays by many members of the Governing Council since the beginning of Christine Lagarde's ECB presidency. As a major central bank, it is thus sending a signal to also support the EU in its goal of becoming climate neutral by 2050.

Even if combating the consequences of climate change is primarily the task of national governments, the Eurozone's central bankers do not want to be idle observers. Nor should they be. The issue is too urgent. The more that governments and other institutions pull together and build up some traction, the sooner results can be expected.

The ECB emphasizes that it is acting within its mandate. In its opinion the consequences of climate change and the EU's transition to climate neutrality will affect growth and inflation not only in the short term, but also the long term and thus will also have a long-term impact on the equilibrium interest rate. The central bank writes, "Climate change and the transition towards a more sustainable economy affect the outlook for price stability through their impact on macroeconomic indicators such as inflation, output, employment, interest rates, investment and productivity; financial stability; and the transmission of monetary policy."[1] And climate change and the transition to a low carbon economy may also affect the value and risk profile of the ECB's balance sheet, leading to a potentially undesirable accumulation of climate-related financial risks. Against this background, the ECB sees the inclusion of climate change impacts as being justified by its mandate, as formulated in the EU Treaties: To provide price stability under Article 127.1 in the Treaty on the Functioning of the European Union (TFEU), to support economic development in the monetary union downstream under Article 127.3, and to ensure sustainable economic development under Article 3.

[1] https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210708_1~f104919225.en.html

Critics will object that this interpretation of the ECB's responsibility for price stability leaves plenty of room for the ECB to address other social and economic policy issues in the future, which may also have an impact on "inflation, output, employment, interest rates, investment and productivity." In other words, the ECB could easily make its mandate too wide and lose its focus.

But in our opinion this argument does not apply to the issue of climate protection. Not including climate risks as a factor in monetary policymaking is not a solution. If risks to financial market stability emerge due to the environment, natural disasters or global warming, they must be addressed. This is in the interest of investors, financial institutions and financial supervision, which is one of the ECB's responsibilities. Therefore, the ECB's desire to involve the climate in its calculations looks reasonable and logical.[2]

1.2. No unlimited scope for ECB action

However, there will be limits. A sole focus on climate protection cannot happen and is unlikely to. The ECB's primary mandate remains price stability. Conflicts between objectives could arise, for example, if a politically desirable increase in CO2 prices led to a permanent rise in the inflation rate, even above the target level of two percent, via second-round effects such as wage increases. The ECB would then – even with its new, symmetrical[3], inflation target of two percent – be required to react with a more restrictive monetary policy. This might also imply downsizing the number of bonds in the ECB's portfolio, including actively selling them. The portfolio currently includes government, corporate, and green bonds. For green bonds the issuer seeks to use the funds obtained to finance environmental and climate protection measures. Green as well as government and corporate bonds are likely to be equally affected by any reduction. Giving climate protection greater importance in monetary policy should not, in our opinion, develop into green dominance at any price.

Another question is the issuance of green long-term targeted tenders (TLTROs). Long-term tenders provide banks with liquidity for three to four years in order to stimulate lending to companies and private households. A one-sided preference for banks that have a stronger focus on loans for sustainable or green projects would violate the principle of equal treatment. In addition, these long-term tenders, which are special repurchase agreements, often have to be issued in economically difficult times (i.e., recessions) in order to ensure there is sufficient liquidity for the banking sector and to prevent a credit crunch. In the research paper published by the ECB in connection with the strategy review, the authors do not directly rule out these green long-term tenders.[4] However, the authors explicitly point out that such operations must be tied to proper definitions of the green criteria. This is currently still "pie in the sky" as constant definitions of those criteria are not available, yet. It is conceivable that in the longer term green long-term tenders could be offered as an additional source of liquidity supply, but without impairing the basic supply of the entire banking system and thus financial stability.

2 / How does the ECB intend to implement this "greener" monetary policy?

2.1 What is known so far from the road map

In order to put its decision into action the ECB has presented a comprehensive road map that should set the stage for changes in the monetary policy framework by 2024. This will affect the ECB in its role as a banking supervisor and as a central bank. As this road map deals with the consequences of climate change, the "E" for Environment is likely to be the focus. The "S" for Social and "G" for Governance, or corporate management, are likely to receive less attention. The ECB's road map comprises the following areas:

Economic models and risk analysis:

- Further development of macroeconomic models with a view to assessing the implications of climate change for monetary policy transmission
- Improving statistical data for climate change risk analyses, and the impacts on green financial instruments.

[2] https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210708_1~f104919225.en.html
[3] Whereas in the past the ECB wanted to approach the 2.0% threshold asymmetrically from below, in the summer it allowed itself the option of allowing inflation to remain above this mark for a longer period of time as well
[4] https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op271~36775d43c8.en.pdf?c29941b5e2dbeb3168b6e48f362a2b87

Implications of climate change for financial stability:
- The ECB will start conducting climate stress tests for financial institutions in 2022 to assess the risk exposure of the financial system in the euro area to climate change.

Collateral framework and asset purchases:
- In order to be accepted as collateral for lending operations with the ECB (open market operations), and to qualify for the asset purchase program, companies will be required to disclose their climate risks in the future. This could be done in light of the EU's Sustainability Reporting Directive, which is likely to be adopted in 2022.
- Purchases of corporate sector securities.
  - Climate criteria will be added to rules for purchases of securities. Improved due diligence on this basis.
  - Issuers must, at a minimum, accept the Paris Climate Agreement or commit to the targets contained therein.

Based on the road map, the individual measures will be put into place by 2024. Initially, these are only announcements in most areas, which will then be elaborated more fully by working groups. We therefore expect to see more detailed announcements in the coming years. The first two sets of issues in the action plan concern the original tasks of the ECB. Economic analysis is the ”bread and butter” of a central bank. We believe its stronger involvement in the environmental area could contribute to a significant improvement in its related data and has the potential to significantly improve the models used to estimate the consequences of climate change. In addition, there are tasks related to financial stability, which include the climate stress tests announced for 2022 to better assess how climate change and the gradual decarbonization of the economy will affect the risk position of the financial system in the euro zone. This is certainly useful and should help to make it possible to assess the current situation more profoundly.

A more far-reaching issue is the further disclosure of climate risks faced by companies, which is likely to involve financial institutions as well as corporates. First, financial institutions can only participate in open market operations with the central bank if they offer collateral accepted by the Euro system. This can be government or corporate bonds, but also non-marketable assets or cash. The largest part of the eligible collateral universe is government bonds. Corporate bonds account for around 11%, with significant volatility over time, depending in part on the state of the economy. Financial institutions are therefore likely to put pressure on companies to disclose their climate risks, as their bonds otherwise cannot be used as collateral with the ECB. In addition, however, there is also growing direct pressure on companies. If they issue bonds, it would certainly be an advantage that the bond can potentially be purchased by the ECB. When markets are weak, this could provide provide a measure of protection against a significant widening in yield spreads compared to government bonds.

The ECB announcements should therefore force companies to consistently disclose their climate risks, if they have not already done so. The EU's sustainability reporting directive, the Proposal for a Corporate Sustainability Reporting Directive (CSRD), could serve as a guide for companies on how to do so. The ECB intends to publish details on the requirements in 2022.

2.2 The ECB's portfolio to become greener...

Taking climate change into account might have consequences for the ECB's asset purchase program. Currently, the portfolio includes not only government bonds, but also corporate bonds, ABS and covered bonds. Will the ECB in the future reward issuers who actively combat the consequences of climate change? If it does, it will not apply to the Public Sector Purchase Programme (PSPP). It is true that the ECB buys green government bonds from euro area states. But an active preference for individual states on the basis of greener policies is not envisaged. The ECB would fear resistance from countries that have not yet progressed far towards a lower-carbon economy. In addition, a change of this kind would imply a shift away from the capital key that determines the allocation of government bond purchases within the euro area. The Governing Council would be certain to vote against that. Therefore, it is only the Corporate Sector Purchase Program (CSPP) that might potentially be affected. The program, launched by the ECB in June 2016, now holds bonds worth around EUR 300 billion. According to figures from the ECB and Bloomberg Finance L.P., this represents around 12% of all outstanding euro corporate bonds and a full 27% of the bond universe available to the ECB for the CSPP.

Since it is likely to take until (at least) 2024 in some cases before the road map is implemented, it might be questioned whether it might be relevant for the CSPP at all. But even in its new monetary policy strategy, asset purchases remain key for the ECB and its monetary policy. The ECB's projections currently assume a medium-term miss of the inflation target, with inflation still too low, and the ECB believes that purchases of corporate bonds have contributed to the broad improvement in financing conditions. In addition, reinvestments are likely to continue even after a possible first hike in key interest rates. Thus, we expect the ECB to remain an important influence on corporate bond prices, especially as it can purchase up to 70% of a corporate bond issue.

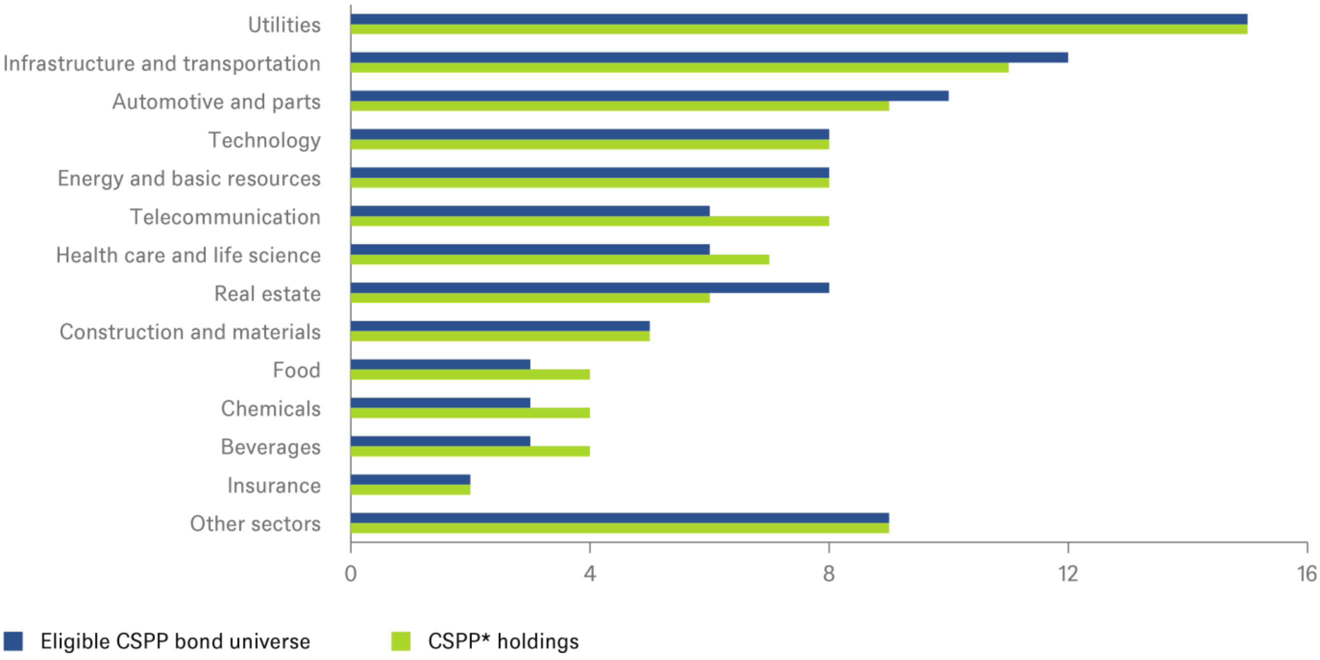
2.3 …but the basis for this still needs to be created

The first step for climate change and the ECB's corporate bond portfolio is likely to result in enhanced due diligence. Issuers must at least accept the Paris climate protection agreement or commit to the targets contained therein. No precise date has yet been set for this. Our analyses show that around 40% of the corporate bonds held by the ECB in its portfolio already meet this criterion. That share will increase further in the coming years due to the increasing disclosure requirement which ultimately represents a somewhat non-binding commitment to climate targets and should not be a major hurdle for companies.

An ECB decision to actively green its own portfolio in 2022 would have a much larger impact on companies and capital market investors. So far, the ECB has been buying in a market-neutral manner within the CSPP, in proportion to the market volume. It has no preferences for specific sectors or issuers. The chart shows that it is largely successful in this. In line with this principle, it also holds green bonds; their share in the ECB portfolio is assumed to be around 20%.[5] But the market-neutral key also poses a problem, as certain sectors are currently present on the bond market at a rate significantly disproportionate to their weight in the economy.

These sectors, in turn, are predominantly carbon-intensive, such as utilities, automakers, transportation and logistics (see chart). They account for around 35% of total purchases and are thus overrepresented compared to their share of the economy. They issue large amounts of bonds, of which many are purchased by the ECB in accordance with its market neutrality principle. However, this means the ECB's portfolio is highly carbon intensive.

ECB BUYS PROPORTIONAL TO THE MARKET: THIS MAY CHANGE IN THE FUTURE



Source: ECB Corporate Sector Purchase Programme as of 3//2021
Note: Internal classification of economic sector. *Note for all tables: nominal CSPP holdings as at end of Q1 2021. CSPP bond holdings with a remaining maturity below 6 months are excluded. The numbers may not sum to 100% due to rounding.

The high carbon-intensity of the portfolio was criticized by various members of the Executive Board in the run-up to the "Strategic Review."[6] In our view, two approaches, already mentioned by various ECB representatives, might prove useful in reducing the carbon intensity of the ECB's corporate bond portfolio:

_ "Negative screening," in which certain companies are explicitly excluded. This would certainly be the most effective way to reduce the carbon intensity of the portfolio. However, it might also expose the ECB to criticism that it has an industrial policy. Moreover, there is the question of whether the negative list would actually hinder the transformation towards a greener

[5] https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op271~36775d43c8.en.pdf?f26c937c8b72f2d321adc33893e17197
[6] https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp210303_1~f3df48854e.en.html

policy. Companies could be penalized for being too ”dirty” in the past, but not necessarily being so in the future. The Swedish Riksbank, for example, has adopted this approach for its portfolio of corporate bonds as well as criteria from the UN Global Compact[7]. In addition, the bank carries out its own assessment of sustainability based on external data and its own research.
_ The ”tilting approach” offers an alternative. The Bank of England recently made proposals for its corporate bond portfolio to steer asset bond purchases away from the principle of market neutrality toward companies that are committed to the goal of climate neutrality.[8] This proposal is preferred by some members of the ECB, most notably by Executive Board member Isabel Schnabel[9]; it sends signals without excluding companies a priori.

Regardless of which approach the ECB takes, we expect it to be much more active in moving its portfolio toward decarbonization in the medium term. As a result, there are likely to be winners and losers; companies could find the ECB's decision directly affects their refinancing costs. The extent to which there is potential for a legal challenge is uncertain. Asset purchases remain controversial in some euro area countries, and this will also be the case if the ECB adopts a more active role in climate protection. According to a survey by the Center for Financial Studies, 64% of experts and executives reject the idea of the ECB pursuing a ”green” component in its monetary policy – e.g., by purchasing green bonds – while only 32% would welcome it.[10] Against this backdrop, determining the criteria by which the ECB invests and establishing transparency in its investment decisions will be crucial in coming years.

3 / The market is already reacting

”In the ECB's asset purchase program, it is evident that a very high proportion of ”green” new issues were purchased under the CSPP. In recent months, there has been a sharp increase in green-labeled issues in the euro-denominated corporate bond market. Green new issues have become particularly popular in the utilities sector," says Markus Wiedemann, Co-Head of Credit EMEA at DWS. All in all, we expect the green bond market to continue to grow in coming years. It is becoming increasingly important for investors as ESG criteria increasingly determine investment decisions. And we expect the ECB to remain active in the market, though its purchases are restricted to investment-grade bonds.

"As a result of the supply expansion, the premiums (so-called greeniums) for ”green” bonds have fallen compared to ”normal” bonds, so green bonds are no longer trading at as high a yield discount as they were at the beginning of the year. This effect could also be partly explained by the overall increase in valuation levels,” Wiedemann adds.

”Greeniums” are also a factor in government bonds. Taking the German government bond as an example, the difference in yield between the commercial bond and its greener twin is currently around 4.5 basis points,” explains Oliver Eichmann, Head of Rates EMEA at DWS. ”But the greenium of Bunds is more pronounced than for other government bonds in the euro area.” In addition, slight differences in premiums in Italy and France can be seen. The strong relative performance of green Bunds appears to be rooted in their comparatively low supply (versus French government bonds, OATs, for example) and the special structure (”swap option”). Thus, holders of the ”green” Bund are allowed to exchange their security for the traditional bond at any time. This should address concerns that new ”green” bonds would be less liquid and therefore potentially more difficult to trade.”

4 / Right direction, but implementation is key

In deciding to incorporate climate change considerations into its monetary policy the ECB has made a landmark decision that is likely to have consequences in both the short and long term. The governing council seems to be venturing further into political territory and they will have to reckon with opposition from those who are already critical of the ECB's widening scope for action and also from those who could be negatively affected by the measures, such as issuers of bonds that the ECB does not classify as acceptably green. Nevertheless, the change the ECB is making seems almost inevitable. The immense challenges posed by climate change demand a contribution from all parts of society and from all major institutions. In addition,

[7] https://www.unglobalcompact.org/what-is-gc/mission/principles
[8] https://www.bankofengland.co.uk/paper/2021/options-for-greening-the-bank-of-englands-corporate-bond-purchase-scheme. Source: Bank of England
[9] Isabel Schnabel 14.06.2021: From market neutrality to market efficiency. Source: ECB
[10] https://www.ifk-cfs.de/de/media-lounge/news-newsletter/artikel/article/cfs-survey-on-the-new-strategy-of-the-ecb.html. Source: Center for Financial Studies, 21.07.2021

climate change may have an impact on the value of bonds and therefore on the stability of individual financial institutions and the value of the ECB's bond portfolio.

The comprehensive road map that the ECB plans to implement in the coming years appears likely to be just the beginning. Improving macroeconomic analysis and assessing the implications of climate change for financial stability remain important and welcome steps. Crucial to implementation will be the databases and assessment criteria on which the ECB builds its decisions. The push by a major institution like the ECB should serve as a catalyst, increasing the quantity and quality of relevant data and CO_2 transparency within the industry. It could also further encourage standardization of ESG methodology. In our opinion the ECB's close interaction with the EU, which ultimately sets the guidelines, has the potential to further increase the impact of these future ECB standards. All in all, we feel that the ECB is responding appropriately to the challenges of climate change. It is not giving way to overall green dominance of policymaking but rather taking targeted measures to address the consequences of climate change for monetary policy.

In our view, this will likely have the following consequences for the market:

_ Simply by announcing that it will include climate protection in its monetary policy the ECB is signaling an important change. Climate protection becomes a relevant issue for many in the European financial sector. In view of the ECB's substantial market power, market participants are likely to consider positioning themselves accordingly.
_ The ECB's actions are likely to contribute to a sustained high volume of green bond issuance. The ECB is likely to remain active in the market. The minimum rating for bond purchases is likely to remain investment grade.
_ In 2022 the ECB will have to decide how to proceed with its own corporate bond portfolio. The carbon intensity of its portfolio is rather high and we expect it to actively reduce it in the future.

GLOSSARY

The asset purchase programme (APP) refers to purchases of marketable debt instruments by the ECB.

Asset-backed securities (ABS) are securities whose income payments, and thus value, is derived from and collateralized (or "backed") by a specified pool of underlying assets.

One basis point equals 1/100 of a percentage point.

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

A corporate bond is a bond issued by a corporation in order finance their business.

Covered bonds are securities similar to asset-backed securities (ABS) which are covered with public-sector or mortgages loans and remain on the issuer's balance sheet.

Investors increasingly take environmental, social and governance (ESG) criteria into account when analyzing companies in order to identify non-financial risks and opportunities.

The equilibrium real interest rate is the real rate of return required to keep the economy's output equal to potential output, which, in turn, is the level of output consistent with flexible prices and wages as well as constant markups in goods and labor markets.

The euro (EUR) is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

The European Central Bank (ECB) is the central bank for the Eurozone.

The European Union (EU) is a political and economic union of 27 member states located primarily in Europe.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Financial stability is a state in which the financial system - i.e. financial intermediaries, financial markets and market infrastructures - is resilient to shocks as well as unexpected developments in financial imbalances.

Green bonds are fixed-income instruments designed specifically to support specific climate-related or environmental projects.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

OATs are bonds which are issued by the French Government

The Paris Agreement was reached after the 2016 United Nations Climate Change Conference in Paris. It sets goals on greenhouse-gas emissions mitigation, adaption and finance.

The public sector purchase programme is a programme by the ECB, which consists of the purchase of bonds issued by euro-area governments, agencies and European institutions.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

A repurchase agreement is a contract under which the owner sells a fixed-income security to another party (usually a central bank or other financial institution) within a limited period of time while agreeing to repurchase the security.

The Riksbank is the central bank of Sweden and located in Stockholm.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Targeted longer-term refinancing operations (TLTROs) refer to the ECB's providing of financing to Eurozone banks.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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IMPORTANT INFORMATION – NORTH AMERICA

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