The greening of monetary policy

Central banks around the globe are currently investigating how to join the fight against climate change. Here's what they're already doing and what they still could and perhaps should do

ECB President, Christine Lagarde

While most central banks are still fighting the economic impact of the pandemic, another more structural topic is in view: climate change. The discussion on how central banks could and should join the broader fight against climate change already started before the pandemic and has recently gained momentum.

? Why should central banks care about climate change at all?

Climate change affects the entire globe, countries and societies. Automatically, central banks have to care about it significantly. More specifically, climate change affects central banks and monetary policy in two ways: through the impact of growth and inflation and through financial stability.

As for the economic impact, climate change and climate policies will also have an impact on inflation and financial markets. It starts with more volatile and severe weather conditions and their effect on agriculture products. It continues with potential natural disasters and their impact on the economy and inflation; it ends with the need for investment and the structural change of the entire economy in the transformation towards carbon neutrality.

As far as financial stability is concerned, climate risks are those which can impact or disrupt business activities and the institutions financing them. For financial institutions, these mainly relate to credit risk (collateral depreciation, defaults by businesses or households), market risk (repricing of commodity prices or equity prices following climate-related events), underwriting risk (insurance losses) and liquidity risk.

? What could be meant by greener monetary policy?

On the financial stability side of monetary policy, multiple initiatives have seen the light.

The best example of a joint initiative is the recent Task Force on Climate-related Financial Disclosures (TCFD) of the Financial Stability Board (Bank of International Settlements). By giving guidelines to companies around the world on how to disclose climate-related financial risks and opportunities, it allows financial markets to price them correctly. It helps companies that face a rocky transition to a low-carbon economy, with sudden value shifts or cost surges, should they rapidly have to adjust to the new landscape. Funded in 2018 and currently chaired by a European Central Bank Board member, the Central Banks and Supervisors Network for Greening the Financial System (NGFS) will continue to "*define and promote best practices to be implemented within and outside*" its members, it is currently the largest group tackling the issue.

> *Banks will have to disclose to what extent their activities are environmentally sustainable*

An influential example could be green differentiated bank capital or reserve requirements: in the eurozone, our last study shows that starting next year, banks will have to disclose to what extent their activities are environmentally sustainable according to the definitions set out in the EU taxonomy regulation. Once it has enhanced the transparency and comparability of Environmental, Social and Governance (ESG) performance metrics of credit institutions, climate risk-weighting methods could be applied to banks' balance sheets to adjust their capital needs. In the eurozone, the ECB is preparing a climate stress test. There's more detail on that here.

As for monetary policy instruments, the scope of central bank action is probably limited to asset purchases, requirements for collateral but also green targeted longer-term refinancing operations options. This would have signalling effects but also discriminatory effects through interest rates. However, for corporate bond purchases, this would mean that central banks would have to leave the principle of market neutrality.

? What are central banks actually doing?

While the discussion on how to integrate the fight against climate change into central banks' monetary policy strategies is still ongoing, central banks around the world already started to implement green strategies into their own investment portfolios. Central banks manage several of those: their policy portfolio, their own portfolio, and then the funds they manage for their employees (typically their own pension funds) or for third parties. In theory, Socially Responsible Investing (SRI) strategies could be applied to any of them, but currently, the focus is on central banks' own investment portfolio or pension funds, not (yet) the policy portfolio.

Taking climate change into account in central banks' investment strategies can potentially follow several principles. It starts with the exclusion and disinvestment of sectors posing significant ESG risks. Exclusion strategies are not new, they date back to slavery and gaming boycotts by Quaker investors in the early 19th century. They reappeared in the 1970s with weapons (in the context of the Vietnam war), tobacco and South African businesses (in the context of the fight against apartheid), only to reach fossil fuel businesses later in the century. A next step would be to follow ESG integration strategies before going to more marginal practices like "best-in-class" strategies or impact investing. Currently, most central banks apply negative screening and ESG integration.

The trend towards greener monetary policy is there, but still has a long way to go

For example, The Banca d'Italia has included ESG criteria in two equity portfolios of its own funds (140 securities with a total market value of around EUR 8 billion, which represents 6% of its financial investments in euros). The Banque de France published its first Responsible Investment Report in 2019, showing that assets worth EUR19bn in its own portfolio and pension fund were managed with ESG integration, with some funds even directed towards impact investing. In February, the ECB announced a common stance for climate change-related sustainable investments in the non-monetary policy portfolio.

In December 2020, the NGFS conducted a survey among its principal members, which are mainly central banks, to gauge who was doing what. The results show that the trend towards greener monetary policy is there, but still has a long way to go: if one excludes green bond inclusions (which is used by less than half of surveyed institutions), less than 25% of central banks are applying negative screening in their policy portfolio.

Number of central banks applying SRI strategies to at least one type of assets in the following portfolios

SSA, corporate or covered bonds and equities Source: NGFS survey (Dec 2020)

SRI intensity

	Policy Portofolio	Pension Portofolio	Own Portofolio	Third Party Portofolio
Negative Screening	9	4	7	3
Green Bonds	16	2	13	3
ESG integration	4	4	6	1
Best in Class	2	4	4	0
Engagement	1	3	6	1
Impact Inv.	1	0	1	0

More than 20%

No. of CB (/40) applying the strategy to at least on type of assets (SSA, corp or covered bonds and equities)

From this, we can see that few central banks use SRI strategies even in their smallest portfolios (pension funds) but that their own portfolios are more likely to be managed by SRI strategies. In terms of policy portfolios, the potentially more impactful portfolios by size, it seems that green bonds are the main tool considered, together with negative screening. However, let's remember that until governments start to issue green bonds on a larger scale these principles can only apply to the small share of the policy portfolio that is not allocated to sovereign bonds.

? What's the state of the debate in Frankfurt?

In the eurozone, the discussion has changed from whether to what the ECB should do to support the EU's fight against climate change. The ECB's secondary mandate allows the ECB to support the EU's economic policies, as long as the goal of reaching and maintaining price stability is fulfilled. These economic policies of the Union actually explicitly include "*a high level of protection and improvement of the quality of the environment*". This offers sufficient legal room for the ECB to actively engage in the fight against climate change.

> *Using the ECB's own investment portfolio to support the transformation towards a carbon-neutral economy is a no-brainer*

The current debate at the ECB seems to focus on those principles we mention above. Using the ECB's own investment portfolio to support the transformation towards a carbon-neutral economy is a no-brainer. However, there are two other possible ways forward that are more controversial.

One way forward could be 'green QE'. The ECB's current holdings under its corporate sector purchase programme (CSPP) show a clear underrepresentation of the services sector compared with manufacturing, utility, automobile and transportations sectors. The latter tend to be those with particularly high emission shares. Hence, ECB purchases taking the emission of a company into account could make sense; not necessarily at sector level but differentiating between companies.

> *Such a strategy could conflict with the ECB's principle of market neutrality*

Even given the very different sizes of the market volumes, such a strategy could conflict with the ECB's principle of market neutrality. Also, penalising 'carbon-intensive' sectors could undermine these sectors' transformation towards carbon-neutrality as it increases costs of potentially required investments. Another disadvantage of 'green QE' is that QE is clearly intended to bring inflation back to target. It is supposed to be definite.

In our view, the ECB's inflation target will be reached earlier than the EU's climate targets. So how to conduct 'green QE' if there is no need for QE anymore? Maybe green asset purchases related to liquidity provisions?

Another way forward could be through the ECB's role as bank supervisor and its collateral framework. A climate-aligned framework would operate through similar channels as 'green QE', mainly via penalising non-green bond holdings and consequently the interest rate channel for corporate financing. However, contrary to 'green QE', a 'green collateral framework' would be permanent. Depending on a climate rating, climate footprint or ESG scores, different haircuts could be applied to corporate bonds used as collateral.

In any case, the ECB will in our view try to align its next steps with the EU taxonomy regulation and disclosure requirements for companies and banks.

Obstacles to central banks' activism

In practice, one risk of greening monetary policy is an overburdening of central banks. The main part in the fight against climate change has to be taken by governments. Monetary policy should not be in the driver's seat but play a supporting role. Also, the question is how effective steering the fight against climate change through (discriminatory) interest rates can be, particularly when rates are low. For central bank purists, another risk is that they could become too politicised. The discussion on what central banks can do will continue. In our view, the most likely outcome will be a combination of green QE and changes to the collateral requirements.

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