20 January 2020
Sustainable bonds

# ECB

## Eat your greens

**Sustainable bonds could soon become a hot topic for the European Central Bank and its Corporate Sector Purchasing Programme, CSPP. Sustainability is not explicitly mentioned in the ECB's mandate, but you just have to look at Christine Lagarde's nomination speech, which strongly underlined climate change issues, the EU Commission's work on green bond taxonomy, and EU President Ursula von der Leyen's Green Deal for Europe to realise its increasing importance. In this report, we outline four possible scenarios that could be adopted should the ECB assume a more sustainable policy and analyse their implications and limits.**

## Sustainability: Our four scenarios for the ECB

### 1 The ECB decides to buy only green bonds

The European Central Bank could decide to purchase sustainable/green bonds only. This would reduce the ECB's eligible bonds to 134 bonds or 70% of c.€68bn as of today (the ECB cannot buy more than 70% of a bond issue). The organisation could base its purchasing on the Green Bond Standards as set out by the European Union. Not all self-labelled green bonds may qualify and this may result in an even smaller investable universe.

**72%** of corporate green bonds have been issued by utility companies

Under this scenario, another limitation would appear. Sector diversification would be very restricted. As of end 2019, 72% of all corporate green bonds have been issued by the utilities sector. As a result, this scenario appears to us to be unlikely. However, if this option were to be put into place, we would expect green bond spreads to outperform plain vanilla.

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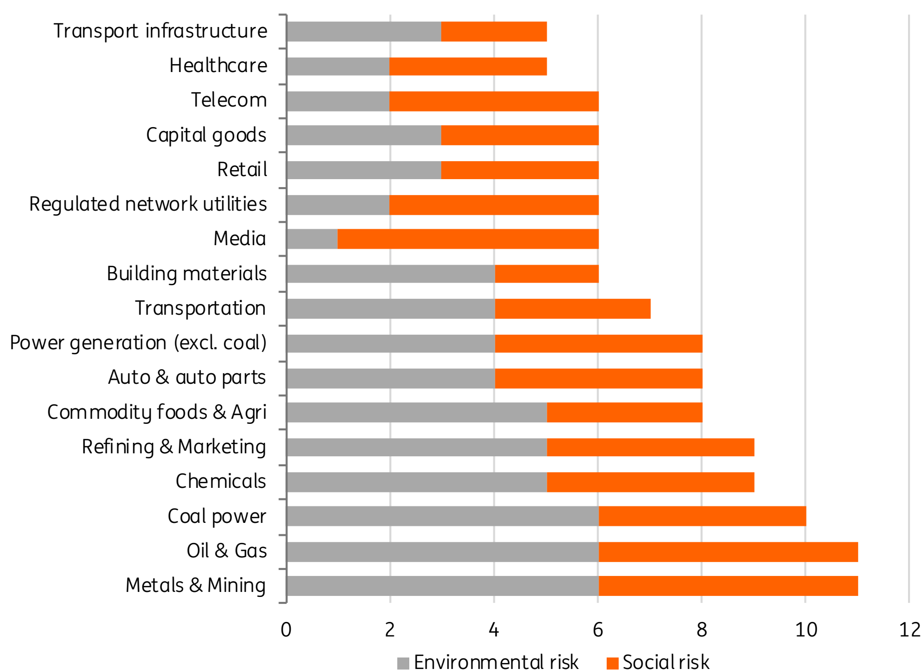
## 2 Invest on the basis of ESG/Risk scores

A viable option for the ECB to increase its sustainability, is to invest based on assigned ESG (Environmental, Social and Governance) scores or Risk scores per company/ISIN. Utilising the scoring system may allow the ECB to concentrate on purchasing bonds from issuers that are more 'green', and actively avoid 'dirtier' companies. For instance, using Figure 1 as a proxy, the ECB could underweight sectors that have higher ESG risk scores, such as metals & mining, oil & gas, power generation based on coal and chemicals.

If this were to be the case, greener companies with higher ESG scores would benefit from performing spreads, whereas low ESG score companies, for instance the oil & gas sector, would underperform. If the ECB does begin buying more sustainable bonds, we are likely to see the green and ESG curves outperform their grey alternatives. This would create a small funding advantage for green bonds, which will increase the incentive to issue green instruments, particularly due to the considerable amount of new and recent issues that are being bought up in the CSPP.

**Fig 1 S&P: Environmental and social risk scores per sector (June 2019)**



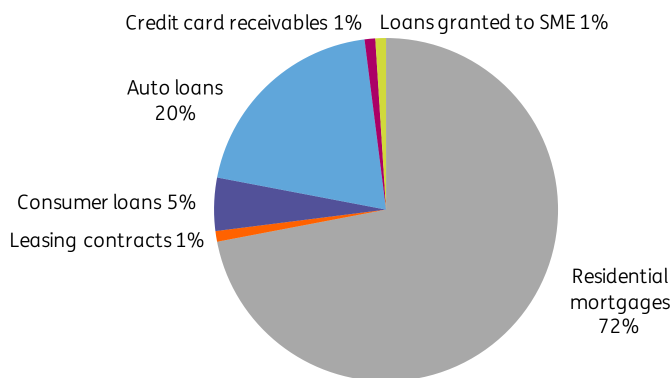

Source: Standard & Poor's, ING

## 3 Decide to sell non-green/low ESG score names or sectors

With a number of asset managers and pension funds introducing ESG strategies into their investments, the ECB could decide to follow the trend. On a more drastic note, the ECB could even decide to actively sell bonds. Currently, the green bond market is too small, therefore the selling of non-green bonds is unlikely. But if the ECB began to sell bonds with low ESG scores, we would see a nuclear reaction with the creation of a large differential between green companies and 'dirty' companies. The severity of this option would lead to a significant market distortion, not to mention the prospect of real green/ sustainable investors being crowded out.

According to S&P's environmental and social risk scores as an example, the ECB could actively sell energy and industrial names with high risk scores. Interestingly, we believe the autos sector would not be at the top end of higher risk sectors but, with an overall 8 score, the sector is above the average (score 6). Turning to the ECB's ABSPP, as illustrated in Figure 2, we can see it is overweight auto loans. This is another area in which selling may be an option that would encourage more sustainability within the ABSPP portfolio.

**Fig 2 Weighting of collateral type held in ABSPP**




Source: ECB, ING

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## The ECB no longer invests in carbon intensive corporates

Our fourth scenario takes into consideration the possibility that the ECB no longer supports corporates that are considered highly carbon intensive. This step would trail after a growing number of investors who limit their energy sector exposure according to their own ESG criteria and/or ESG scores provided by external providers. We believe that the oil & gas sector, as happened for the tobacco industry, could experience an investor exodus. Other sectors could be impacted, notably metals & mining and chemicals.

### Oil & gas issuers: higher spreads but overall small impact on cost of debt

During its first purchasing programme, the ECB invested in 45 bonds issued by European oil & gas companies (ENI, OMV, Repsol, TOTAL). All eligible corporates benefited from the ECB's CSPP but Southern European corporates even more so as it kept the cost of debt for these corporates at decent levels when spreads escalated on economical and/or political issues.

*"10bp to 30bp wider"*

In a scenario in which the ECB shuns the oil & gas sector, we estimate spreads would go up by 10bp for the highly rated oil & gas companies and by up to 30bp for the lower rated based on current spreads on non-eligible bonds.

Despite this potential negative effect, the impact would be marginal for these companies. Looking at the European oil & gas names cited above, their cost of debt only represents between 0.5% and 1.5% of their total costs. On top of this, the most international oil & gas players issue bonds in other currencies and could still easily access capital markets less attentive to climate change issues.

## The green bond market set another record in 2019

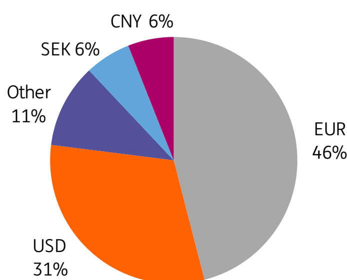
**€78bn**

2019 was another record year for green bonds. An equivalent of c.€170bn of self-labelled green bonds was issued. With a 46% share, or €78bn, the euro remained the most used currency to issue a green bond

Looking at the entire market (all currencies), Governments/Sovereigns, Supranationals and Agencies (SSAs) took the lead with 43% of the total €170bn in green bonds issued. Corporate non-financials accounted for 31% of this total (utilities 16%, industrials 14%, other corporates 1%). Financial institutions also recorded their best year with an equivalent of €43bn of green bonds issued, or 25% of the total.

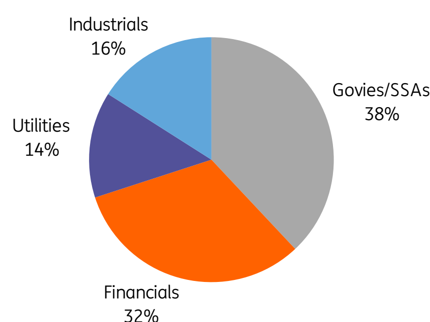
As far as bonds issued in euro is concerned, Governments and SSAs led the issuance in 2019, followed by financial institutions. Utilities and industrials accounted for 30% of all euro green bonds. This 30%, or c.€23.5bn, was the investible primary green bond universe for the European Central Bank's CSPP programme.

**Fig 3 Total green bond issuance in 2019 per currency**




Source: Bloomberg, Green Bond Radar, ING

**Fig 4 Euro currency green bonds per sector in 2019**



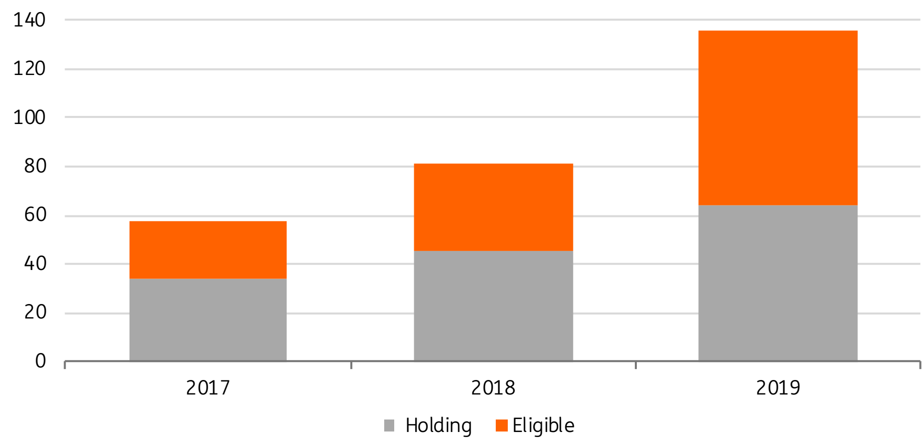

Source: Bloomberg, Green Bond Radar, ING

### The ECB has room for more green bonds

Before Christine Lagarde's nomination, Mario Draghi's first CSPP, initiated in June 2016, was not totally shy of including green bonds in the holding. Altogether, the CSPP1 acquired 52 green bonds, based on the holdings as at the end of August 2019. This number was almost in line with the green bond universe at that time.

We have seen Lagarde be very open about a push for a greener portfolio. Thus far, the ECB has purchased a few green bonds since the recommencement of the CSPP, but not to an overly significant extent, which suggests there may be more to come. The number of green bonds being held by the ECB in the programme has risen to 68, equating to 5% of the holdings. However, we calculate the eligible green bond universe to be 134 bonds, worth approximatively €68bn. This means that the ECB still has plenty of green bonds it can pick up, despite the overall green bond market being still very limited. Of the 105 new CSPP bond purchases since November 2019, 12 were green, equating to 11% of the purchases, which we believe could signify more green purchasing to come.

**Fig 5 Number of green bonds under CSPP holding vs total eligible green bonds**




Source: ING, ECB, Bloomberg

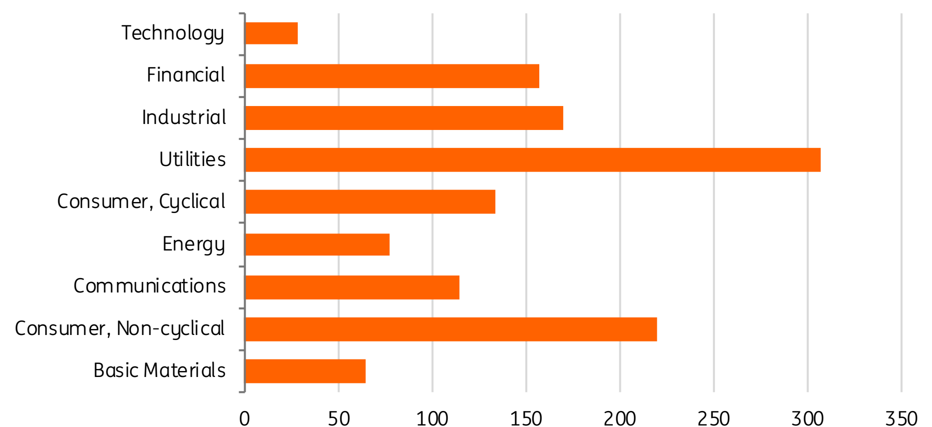
> *"68 of 134 eligible green bonds have been picked up"*

On a global basis, the ECB is relatively underweight in green bonds, as it has failed to keep up with the green issuance pace. This is illustrated in Figure 5, where we can see that at the end of 2017 the ECB held 61% of eligible green bonds, dropping slightly to 57% in 2018, with the level now standing at 51%.

**51%** of eligible green bonds have been purchased by the ECB

As shown in Figure 6, the ECB's sector of choice within the CSPP is the utilities sector; this has not deviated since the programme recommenced. However, the utilities sector does issue proportionately the greatest number of green bonds. There are two ways of looking at this, either the ECB is buying green bonds because it favours utilities, or the ECB is buying utilities because it is looking to invest in green bonds.

**Fig 6 Amount of bonds held in CSPP by sector**




Source: ING, ECB, Bloomberg

# Green bonds: not the only weapon in the armoury

## Carbon pricing: getting to the root of the problem

The aim of the Paris Agreement is to limit global warming to at least 2˚C, preferably 1.5˚C. This requires an unprecedented reduction in global greenhouse gas emissions of around 50% by 2030 and 95% by 2050 compared to 1990 emission levels. The first best solution according to the agreement is to price $CO_2$ emissions, as $CO_2$ is the most critical of the greenhouse gases. In contrast to influencing the *financial conditions* of green companies, pricing *carbon* gets to the root of the problem of climate change and differentiates between green and non-green companies through the amount of carbon they emit.

## Oil and gas majors hardly impacted by current carbon prices

The seven European oil & gas majors were responsible for 275 megatons $CO_2$ emissions in 2018, which is about 1% of global energy related $CO_2$ emissions. Of this 1%, 92% comes from controlled sources such as refining sites (direct emissions) and the remaining 8% from energy use (emissions generated in the energy sector). Taxing total emissions against the current EU ETS (Emissions Trading System) price of €24/tonne $CO_2$ would increase operating costs by 0.7% on average (ranging from 0.5 to 3.5%). Such a marginal cost increase is unlikely to have a substantial environmental impact. In practice, the cost increase is even smaller as:

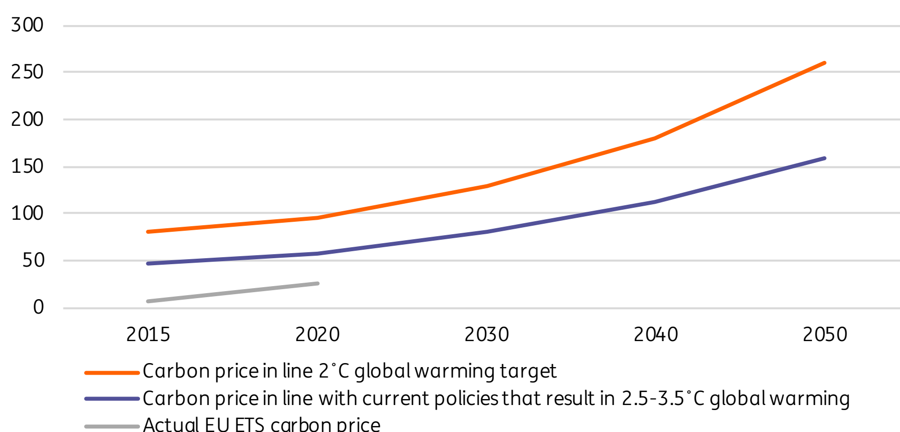
1) Oil & gas majors are multinationals with sizable activities outside the EU ETS system. For example, only one-third of the main Dutch oil & gas major's activities are in the EU for instance. In many regions carbon is not taxed or is less strictly regulated.

2) Even within the EU ETS, only a fraction of actual emissions is taxed due to the free allowance of emission rights.

*"A carbon price of €100/t$CO_2$ is needed"*

Current climate policies by governments across the globe are expected to result in 2.5˚C to 3.5˚C global warming by the end of the century. Figure 7 shows the cost-effective carbon price up to 2050. It implies a global carbon price of around €60 per ton $CO_2$ is currently in place. However, a carbon price of approximately €100 is needed today to limit global warming to 2˚C in a cost effective way. These prices would increase the combined operating cost base of European oil & gas majors by 1.8% and 3.0%, respectively. That is a substantial but not unsurmountable increase to keep global warming within the necessary planetary boundaries. Note that the cost increase ranges from 1.9% to 14.5% in the 2˚C pathway, so carbon pricing will be felt unevenly.

**Fig 7 Carbon prices (2015 constant prices)**




Source: CeDelft, UN, Bloomberg, ING

## Our conclusion

Sustainability is not explicitly mentioned in the ECB's mandate. Its main goal and mandate is to maintain price stability in the euro system. It is, however, not the ECB's sole aim. There are secondary goals to "support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union". According to the European Union, one of the objectives is to provide "sustainable development based on balanced economic growth and price stability, a highly competitive market economy with full employment and social progress, and environmental protection".

The Governing Council of the ECB is to meet on Thursday 23 January for a strategic review. Although our ING German chief economist expects it to be an uneventful meeting, the organisation may give some hints on the direction its CSPP could take in regards to sustainability. We may review our four scenarios if a direction is revealed.

From our perspective, we believe that an 'all green bond' CSPP is extremely difficult given the limited green bond universe. A purchasing programme based on excluding low ESG score corporates or certain sectors in the future are the scenarios we see as the most actionable. We are also aware that the ECB has mandated working groups to study a move towards a green policy. However, any implementation would require a voting process and specific frameworks to be put in place. All in all, a potential move towards sustainability will take time.

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