The Reformed SSA Trader:

The Montreal-West Virginia-Frankfurt price stability paradox

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European covered bonds are a EUR3trn component of the global financial architecture that usually fly under the radar. These debt securities are issued by a bank or mortgage institution and collateralised against a pool of assets that, in case of the bank's failure, can be used to cover claims against it. Their use for liquidity management means they play a key role in ensuring the stability of the financial system.[1] **The assurance that a bank's 'covereds' can be used as collateral for borrowing cash from the European Central Bank is fundamental to their value and, with it, the market standing of the bank.**

The ECB has clearly stated its preferences towards climate alignment of its counterparties, investments, and policy operations, specifically mentioning the collateral programme as one area where they can incentivise climate action.[2] In this context, the recent decision of Bank of Montreal (ticker: BMO), with EUR8.9bn of collateral-eligible EUR covereds, seems perplexing. Following years of outsized, opportunistic issuance into EUR markets,[3] BMO recently removed restrictions on financing new coal facilities, in an action that seems to have been made to avoid being blacklisted by the US state of West Virginia.[4]

It is paradoxical that the ECB is providing a cost-of-capital subsidy for the capital structure of BMO, which may use this subsidy to fund coal projects which in turn contradict the ECB's climate objectives and are likely to threaten the ECB's primary mandate of price stability. The ECB has suggested that behaviour like BMO's will not be tolerated: when asked for her view if the fight against climate change could be sacrificed in order to deal with macro events such as the pandemic, the ECB president has commented: "I think those who would be tempted by that option would live to regret it." [5]

The recommendations/conclusions in this note are:

- **The ECB should remove BMO covered bonds from the lists of eligible collateral assets in the Eurosystem, to align with the ECB's primary mandate to safeguard price stability.**
- **Investors should be cognizant of exposure to BMO covereds as the spread effects that could result from the bonds being removed from the ECB collateral list could be significant.**

[1] Banks post covered bonds (their own as well as other banks') with the central bank to obtain cash for operations. Since the pandemic, roughly €500bn of covered bonds has been placed as collateral with the ECB, e.g. see "Global Covered Bond Insights Q3 2023", S&P Global, 29 Jun 2023.
[2] "The ECB's climate and nature plan 2024-2025", European Central Bank Economic Bulletin, Feb 2024; "ECB takes further steps to incorporate climate change into its monetary policy operations", ECB, 4 Jul 2022.
[3] See for example "Canadian Banks Hoard Cash With Record Ultra-Safe Bonds Abroad", Bloomberg, 22 Jul 2022; "BMO €2.75bn biggest euro since 2006 as fives blow out", The Covered Bond Report, 4 Mar 2024.
[4] "BMO Drops Anti-Coal Policy Amid Wall Street Rebuke of ESG", Bloomberg, 8 Apr 2024.
[5] "Interview with Financial Times", ECB web-page, accessed 30 May 2024.

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BMO change in coal policy

As reported, in late 2023 BMO removed its stated restrictions on financing new coal facilities, allowing it to support new greenfield coal-fired power plants or thermal coal mines – activities which it had previously ruled out.[6] As a result, it has avoided being blacklisted by the State of West Virginia and remains eligible for new West Virginia State financing mandates.[7]

According to its 2023 TCFD report, BMO group's loan exposures to carbon-related assets amounts to 20.4% of its total book (including 1.5 % of direct lending to non-renewable energy and power generation). It has now positioned itself to develop this business further.[8]

To outside observers, BMO's dropped policy may not be that surprising. AFII's monitoring of syndication fees derived from fossil activities identifies BMO as having a poor record: it is one of the lowest ranked institutions based on a net green/fossil funding league table kept by AFII,[9] see Table 1.

Table 1. Ranking of select banks based on net green/fossil funding fee intake, expressed as percentage of total fee intake. Source: AFII.

Rank	Bank	Net green/fossil	Rank	Bank	Net green/fossil
1	Swedbank	28.3%	24	ICBC	2.3%
2	Nordea	22.9%	25	HSBC	2.2%
3	Danske Bank	20.1%	26	Deutsche Bank	1.7%
4	SEB	19.7%	27	Standard Chartered Bank	1.0%
5	BNP Paribas	9.1%	28	Lloyds Bank	0.6%
6	BBVA	8.9%	29	Barclays	-0.3%
7	ABN Amro	8.0%	30	Morgan Stanley	-0.4%
8	Commerzbank	7.7%	31	Banco Santander	-0.5%
9	NatWest Markets	7.6%	32	SMBC	-0.7%
10	Commonwealth Bank	6.7%	33	Citi	-1.1%
11	Societe Generale	5.8%	34	JP Morgan	-2.4%
12	Credit Agricole	5.5%	35	Mizuho Financial	-2.7%
13	Nomura	5.5%	36	BofA Securities	-3.3%
14	Natixis	5.4%	37	MUFG	-4.0%
15	ING Groep	5.0%	38	Jefferies	-4.2%
16	UniCredit	4.4%	39	Goldman Sachs	-4.4%
17	UBS & Credit Suisse	4.3%	40	US Bancorp	-5.5%
18	Westpac Banking	3.9%	41	Scotiabank	-7.6%
19	Rabobank	3.6%	42	BMO Capital Markets	-7.7%
20	NAB	3.3%	43	TD Securities	-7.7%
21	ANZ Banking Group	3.3%	44	Wells Fargo	-7.8%
22	DNB ASA	3.1%	45	RBC	-7.8%
23	Intesa Sanpaolo	2.4%			

[6] See footnote 4 above, with further comments from the Treasury available in "W.Va. Treasurer announces four more banks on restricted list", The Parkersburg News and Sentinel, 10 Apr 2024.
[7] "Banks pulled in both directions by battle over fossil fuels", GlobalCapital, 12 Apr 2024.
[8] "2023 Climate Report", BMO Financial Group, accessed 31 May 2024.
[9] For full details please see "The Box: a tool for bank influence", AFII, 20 Dec 2023, with the latest data available in "The Box: green/fossil fee league tables Q1 24", AFII, 15 Mar 2024.

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Of course, BMO has its fair share of sustainability reports emphasising its environmental responsibility and partnerships with clients that are transitioning to a low-carbon environment.[10] Arguably, these environmental credentials are undermined by the bank's actions in relation to West Virginia. The state maintains a Restricted Financial Institution List of entities prohibited from tendering for public mandates.[11] The West Virginia State Treasurer is permitted to add financial institutions to this list which (in broad terms) refuse to deal with companies that directly or indirectly support the exploration, production, utilisation, transportation, sale, or manufacturing of fossil fuel-based energy.[12]

By dropping its own coal policy, BMO appears to have ensured it remains eligible for new West Virginia mandates. The financing opportunities afforded by the state, though, are limited. West Virginia's annual budget amounts to USD35.5bn.[13] The total AUM of the public pension system was USD20.2bn as of mid 2023,[14] which in comparison to most public pension funds in the EU is small. The state itself has very little debt, in the region of USD3bn,[15] although this reflects the small population of 1.775mn (2022). GDP per capita is almost exactly that of the European Union, at USD56.5k. These numbers suggest that the opportunity to capture fee business in the state may not be extraordinary compared to business opportunities in the European Union.

ECB greening collateral frameworks and BMO's coal policy

It is not farfetched to see the recent coal policy action taken by BMO as relevant to the ECB's primary mandate to maintain price stability: in the interview referenced above, the ECB president states "*climate change actually has an impact on price stability*". Assuming that expansion of thermal coal production and consumption has a negative climate change effect, logically, one must conclude that increasing coal financing will lead to negative effects on price stability.

Indeed, in recent years, the ECB has been vocal about its climate change mitigation intentions.[16] Importantly, the central bank has said in its 2024–2025 Climate and Nature Plan that it will continue to enhance the management of climate change risks on the Eurosystem.[17] This discussion has not happened in a vacuum, rather it is part of a debate among central banks globally. An overview is available in "Greening collateral frameworks",[18] where a particular distinction is made between 'risk' and 'footprint' approaches. The ECB's collateral programme and other liquidity measures have been instituted as supports for the transmission of monetary policy to achieve the ECB's primary objective,

[10] See "BMO reporting", BMO web page, accessed 4 Jun 2024.
[11] "Restricted Financial Institution List 2024", West Virginia State Treasurer, accessed 31 May 2024. Institutions put on the restricted list include "fossil fuel boycotters" such as BlackRock, Goldman Sachs, JPMorgan Chase, Morgan Stanley, HSBC, Citigroup and Northern Trust.
[12] "Chapter 12, West Virginia Code", accessed 31 May 2024.
[13] "Proposed Budget – Fiscal Year 2025", West Virginia, accessed 31 May 2024.
[14] "Annual Comprehensive Financial Report", West Virginia Consolidated Public Retirement Board, accessed 17 May 2024.
[15] "Debt Position Report as of December 31, 2022", West Virgina Treasury, accessed 17 May 2024.
[16] See"ECB takes further steps to incorporate climate change into its monetary policy operations", ECB press-release, 4 Jul 2022, or "ECB climate policy and EUR bond dynamics", AFII, 11 Jan 2023.
[17] "The ECB's climate and nature plan 2024-2025", ECB, Feb 2024.
[18] Dafermos, Gabor, Nikolaidi, van Lerven, Aug 2022. The INSPIRE Sustainable Central Banking Toolbox Policy Briefing Papers, Grantham Research Institute on Climate Change and the Environment.

suggesting that negative price stability effects (primary) from the collateral programme (secondary) should be seriously considered.[19]

Table 2. BMO's six series of ECB eligible covered bonds. Source: ECB and Bloomberg, accessed 31 May 2024.

ISIN code	Description	Maturity	Outstanding EUR amount
XS1299713047	BMO 1.597 09/28/35	28/09/2035	135,000,000
XS2607350985	BMO 3 3/8 07/04/26	04/07/2026	2,000,000,000
XS2351089508	BMO 0.05 06/08/29	08/06/2029	1,250,000,000
XS2544624112	BMO 2 3/4 10/13/26	13/10/2026	1,000,000,000
XS2430951744	BMO 0 1/8 01/26/27	26/01/2027	2,750,000,000
XS2465609191	BMO 1 04/05/26	05/04/2026	1,750,000,000
Total			**8,885,000,000**

The signalling effects of this trade-off between price stability or bank liquidity support are quite important as it will be magnified through other banks' policies. If the ECB enables BMO's path of action, other banks would reasonably assume that ongoing coal financing is not an issue for getting cheap access to ECB's collateral window. Therefore, it seems necessary for the ECB to at least provide guidance on what behaviour is sought.

A further quantitative point to consider is the crowding out/competition angle. Issuers that have credible transition plans may incur an opportunity cost if issuers with weak or non-existent transition plans continue to be eligible under the collateral framework. The more EUR investor capital that flows to non-aligned securities like the BMO covereds, the less there is to go into aligned issuers' covereds. This raises on a relative basis the cost-of-capital for aligned issuers.[20]

How could the ECB respond? It appears that the Governing Council has allowed itself a fair bit of discretion:

"***Looking ahead, the Governing Council is committed to regularly reviewing all the measures outlined above.*** *It will assess their effects and adapt them, if necessary: (1) to confirm that they continue to fulfil their monetary policy objectives;* ***(2) to ensure – within its mandate – that the relevant measures continue to support the decarbonisation path to reach the goals of the Paris Agreement and the EU climate neutrality objectives;*** *(3) to respond to future improvements in climate data and climate risk modelling or changes in regulation; and* ***(4) to address additional environmental challenges, within its price stability mandate.***"

"Further steps to incorporate climate change into ECB's monetary policy operations", Letter from ECB President to the Chair of the Committee on Economic and Monetary Affairs, 4 July 2022.

It should be noted that the ECB has put in a requirement for counterparties in the collateral programme to report under the Corporate Sustainability Reporting Directive (CSRD) by 2026.[21] However, this requirement does not apply to covered bonds and their issuers. Furthermore, CSRD does not instruct companies on climate policies. Therefore even if BMO complied with CSRD this would by itself do nothing to change its coal-financing approach.[22]

[19] Having said this, there has been limited impact in terms of trying to 'green' the collateral programme so far, see "ESG Strategist - Limited impact expected from the ECB greening its collateral framework", ABN Amro, 18 April 2024.
[20] See "European Banks in Deposits Tussle Rush to Sell Ultra-Safe Debt", Bloomberg, 15 Sep 2023.
[21] For a broader discussion on this and the general collateral framework, see "ESG Strategist - Limited impact expected from the ECB greening its collateral framework", ABN Amro, 18 Apr 2024.
[22] "Climate Risk: Regulatory Developments to Watch in 2024", BMO Capital Markets, 28 Feb 2024.

Impact of collateral eligibility

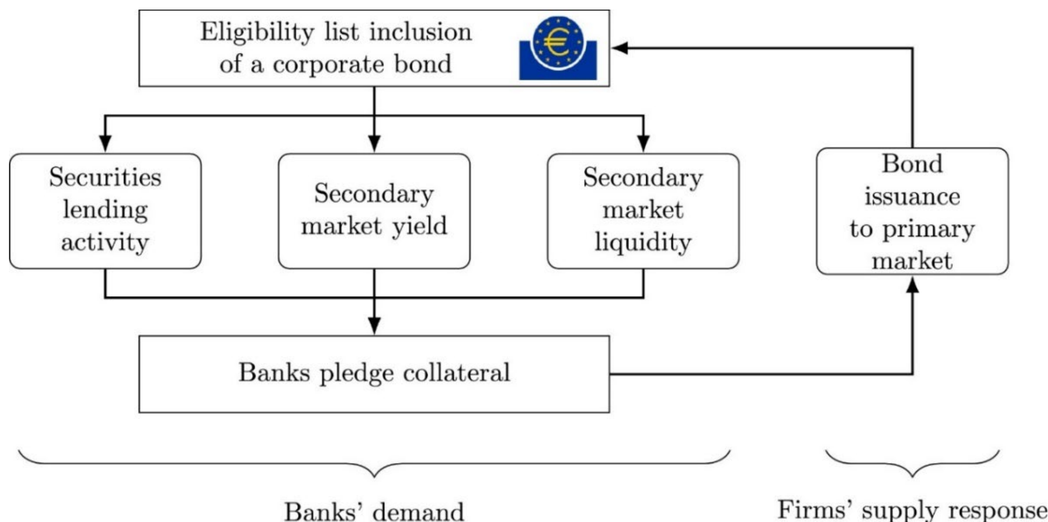
What then is the financial benefit to BMO from being able to access the ECB collateral framework? Research has shown that an issuer's bond spreads can be reduced significantly when its bonds are included in an ECB purchasing programme: the effect has been estimated to be 15 – 30bps for corporate bond purchase programmes, or 13bps or more for EU sovereigns at the time of the Eurozone crisis.[23] In a recent paper,[24] the authors offer the following explanation (see Figure 1):

"*Observing higher demand, long-term investors are more likely to bid on the primary market for bonds that are potential candidates for eligibility (i.e., newly issued bonds of issuers with outstanding EAs [Eligible Assets]), anticipating that these assets can later be repeatedly posted on the SL [Securities Lending] market in exchange for a fee.*"

A similar effect should be expected where a bank issuer's (covered) bonds are included as ECB eligible collateral. A slightly dated paper (2017) suggests the impact is around 10-11bps for covereds.[25] Even assuming a conservative 10bps reduction, where a bank issues EUR1bn in bonds, its annual interest savings would be EUR1mn. Perhaps more importantly though, access to the collateral framework enhances a bond's liquidity, something which is viewed favourably by investors.

The benefits do not stop there. Inclusion of an issuer's covered bonds in an ECB programme has also been shown to reduce the borrowing spreads on its money market borrowing and other sources of financing[26], thereby amplifying the cost reduction effect across the bank's capital structure. This effect is significant for BMO, which has USD100bn in outstanding bonds.[27]

Figure 1. Schematic of collateral eligibility, from Pelizzon et al. (2024).



[23] "Is collateral eligibility priced?", ECB, Feb 2017; ECB policies involving government bond purchases: Impact and channels", Krishnamurthy, Nagel & Vissing-Jorgensen, 2018.
[24] "Collateral eligibility of corporate debt in the Eurosystem", Pelizzon, Riedel, Simon and Subrahmanyam, Journal of Financial Economics, Vol 153, Mar 2024.
[25] "Determining the effectiveness of the Eurosystem's Covered Bond Purchase Programs on secondary markets", Holger Markmann and Joachim Zietz, Nov 2017.
[26] "The impact of the eurosystem's covered bond purchase Programme on the primary and secondary Markets", ECB Occasional Paper Series 122, Jan 2011.
[27] As per Bloomberg DDIS function, accessed 3 May 2024.

In summary, the quantitative evidence suggests that the ECB is providing cost-of-capital subsidies to entities that issue eligible collateral, as they benefit from lower funding costs than they would if their bonds were ineligible. Providing lower cost-of-capital to issuers that appear determined to contravene ECB climate policy, and by extension ECB monetary policy, arguably contradicts the bank's primary mandate.

The key takeaway from an investor perspective is to exercise caution around (covered) bonds from issuers such as BMO that may lose ECB collateral eligibility. Of course, ECB action is uncertain, especially in terms of timing, but we believe there is a non-zero probabililty that BMO covereds could be excluded. If this happens, we would expect BMO covered bonds to underperform the market.

Some BMO bondholders also run added risk, considering their own stakeholders' expectations that they will show environmental responsibility in their portfolio management. Backtracking on a commitment not to fund new coal projects speaks both to the environmental credentials and risk profile of BMO, whatever the other merits of its bonds.

Conclusion

BMO, an opportunistic EUR issuer of covered bonds, appears to have set climate policies in direct opposition to those of the ECB. If the ECB does not take action to exclude these bonds, then BMO will continue to benefit from the cost-of-captial enhancements that come with the ECB's collateral framework even though it is not aligned with the central bank's climate goals, and ultimately its primary price stability mandate.

Not only does BMO's enabling of coal finance work in opposite direction of Euro area price stability, it also – we argue – is unfair to banks that actually do align with the ECB's objectives. It is important that the ECB provides clear guidance on expectations of climate alignment among the users of its financing facilities and programmes.

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