ECB climate policy: Paradigm shift

Anthropocene Fixed Income Institute[(*)]

Today, Isabel Schnabel, a member of the Executive Board of the European Central Bank (ECB) gave a speech[1] with important implications for the European fixed income market. As context, the ECB owns around €345bn of corporate bonds and trillions of sovereigns and sub-nationals, as well as very large collateral exposures, and so is a key driver of fixed income flows and valuations in Euro-denominated markets.

From AFII's perspective, this represents a welcome paradigm shift in central bank climate policy and addresses concerns previously raised regarding the ECB's policies.[2]

In an almost unprecedented expression of central bank humility, the ECB declares:

"*Although our current actions in relation to climate change are ambitious, they are still falling short of the Paris objectives as they are not sufficient to ensure a decarbonisation trajectory that is consistent with carbon neutrality of our operations by 2050.*"

The speech goes on to define new modalities of its climate policy framework. The key takeaways are as follows:

- **The ECB will switch from a flow to a stock implementation approach to climate management of its portfolio(s).** The ECB will actively reshuffle risk from carbon intensive issuers to better climate aligned ones, rather than only doing so when undertaking reinvestment of matured bonds.

  "*For example, assuming full reinvestment, we would achieve only half of the total decarbonisation of our corporate bond holdings by 2030 if firms were to stop taking steps to decarbonise their activities […]. This effect depends to a significant extent on the actions of a few high-emitting companies [.].*"

  "*A flow-based tilting approach is thus insufficient to achieve our goal. […] We therefore need to move from a flow-based to a stock-based tilting approach for our corporate bond portfolio. This means that, absent any reinvestments, actively reshuffling the portfolio towards greener issuers would need to be considered.*"

  This is in line with the views of AFII as expressed in previous commentary.[3] Note that the stock approach will also be implemented in covered bond and asset-backed securities portfolios. The implications of this in terms of valuation of carbon intensive versus less carbon intensive bonds could be significant.

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[1] "Monetary policy tightening and the green transition", Speech by Isabel Schnabel, ECB, 10 Jan 2023.
[2] See, for example, "ECB Climate Plan Seen Hitting Debt Costs as Polluters Targeted", Bloomberg, 8 Aug 2022.
[3] See, for example, "Wind-down (of CSPP) is coming", 8 Jun 2022 ; "What if…the ECB had decarbonised its portfolio from the start?", AFII, 20 Sep 2022; "Tilt and Run: ECB climate policy update", AFII, 5 Jul 2022.

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- **The ECB will tilt public sector bond holdings toward green bonds, either by switching from government curves (where green bonds are relatively scarce) to SSAs, or from government grey bonds to government green bonds (where there is enough volume to do so).**

  This will drive a further push to green within the SSA space, and likely reduce exposure to non-Paris aligned SSA issuers; see "The Reformed SSA trader"[4] series of research pieces from AFII.

- **The ECB will adjust its collateral framework to implement climate measures in allowing access to it.**

  "*As a first step we will limit the share of assets issued by entities with a high carbon footprint that can be pledged as collateral by individual counterparties when they borrow from the Eurosystem. We will also consider climate-related risks when determining haircuts for corporate bonds.*"

  Collateral frameworks are important for letting non-domestic issuers get access to domestic markets. AFII has continuously questioned why the Province of Alberta[5] – an exclusion from the Swedish central bank due to its outsized carbon footprint[6] – has been allowed as collateral in the Eurosystem, which also has led the issuer to be able to issue a large chunk of cheap €-denominated debt.

- **The ECB confirms that addressing climate change is part of its mandate.**

  "Governments must remain in the lead in accelerating the green transition. By promoting green technologies and renewables energies they will enhance the productive capacity of the economy and thereby help restore price stability over the medium term."

  As inflation takes hold of economies globally, there has been a refocus by central banks towards the core mandate of price stability. Today the ECB has categorically confirmed that climate change has a direct impact on that mission, and therefore will be a clear focus.

- **The ECB promotes the idea of incentives for investees to reduce emissions.**

  "At the same time, we should not divest completely, at least not initially, from those companies whose actions are particularly important in managing the green transition, but rather foster incentives for them to reduce emissions further."

  The role of engagement for a fixed income portfolio manager has never been as clear as it is for an equity investor. We believe this statement provides support for the Sustainability-Linked Bond (SLB) product (the use of which continues to expand amongst European issuers[7]), where performance on sustainability KPIs can directly impact issuers' funding spreads.[8] Furthermore, this could also be interpreted as a willingness to actively engage with fossil intensive companies, where the ECB's exposure to Glencore may be an important bellwether.[9]

[4] See, for example, "The Reformed SSA Trader: Kreditanstalt Fossil Wiederaufbau", AFII, 1 Jul 2022.
[5] See, for example, "Technical note: An ECB Rapid Decarbonisation plan", AFII, 20 Oct 2020; "The ECB and Alberta's oil production tax holiday", AFII, 26 Oct 2020.
[6] "Sweden's central bank sells off bonds from Canadian provinces over climate concerns", Reuters, 13 Nov 2019.
[7] See, for example, "Air France-KLM: Come fly with SLBs", AFII, 9 Jan 2023.
[8] SLBs have previously been included in the ECB's operations: "ECB makes 'exceptional exception' for sustainability-linked bonds", IPE, 28 Sep 2020.
[9] Other capital providers are active in engaging with the issuer; see "Glencore shareholders demand more clarity on coal plans", Financial Times, 5 Jan 2023; "Notable fixed income fossils funding deals 2022", AFII, 22 Dec 2022.

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