Veblen Institute for Economic Reforms

When Central Banks outline their Options for Climate Action

Analysis of the latest NGFS report on the "greening" of monetary authority actions

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As the European Central Bank (ECB) prepares to define its strategy on environmental sustainability, the global network of central banks NGFS explores the "greening" of monetary policy in its new report. But, as in previous reports, calls for action are tempered by analysis of the many risks that might be associated with central bank climate "activism". The NGFS seems less concerned about the risks of insufficient action than about the risks of resolute "greening". The underlying assumption is that there is a trade-off between central bank climate action and the effectiveness of its monetary policy.

The report warns of many contradictions between the new and old objectives of monetary policy, but does not suggest any way of defining priorities. In the end, it seems to be paving the way for "little touches of green" rather than "broad strokes". Contrary to the NGFS' assumptions, the greening of monetary policy could be seen as a means of reconnecting bank activity to useful financing, i.e. as a source of greater efficiency for monetary policy and central bank action.

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Introduction

In a recent technical report, "Adapting central bank operations to a hotter world. Reviewing some options" (March 2021), the Network for Greening the Financial System (NGFS, the global network of central banks and financial supervisors established in 2017) reviews nine options available to central banks for adapting monetary policy to the demands of climate action within their current mandate.

Compared to previous NGFS publications[1], the report shows a positive development in several respects. The question of central banks' "climate mandate" is no longer under debate and the urgency of action is explicitly recognised, at least in the area of climate change mitigation. The adaptation of the monetary policy operational frameworks[2] seems both legitimate and necessary. However, the way in which the nine options presented in the report are assessed suggests that only some of them will be adopted, and that their implementation will be slow. Admittedly, we are already accustomed to the NGFS' very (too?) nuanced style where calls for action are immediately attenuated by the listing of numerous reasons appearing to argue in the opposite direction. The new report is no exception and emphasises, for example:

- The need to balance conflicting objectives: climate risk mitigation on the one hand and monetary policy efficiency on the other;
- Unintended consequences on financial stability;
- The risk of legal challenges from investors or securities issuers who feel aggrieved by measures such as exclusion from the collateral framework or the application of disadvantageous haircuts.

By constantly qualifying the climate problem and pitting it against other issues, without deciding on or proposing any prioritisation of objectives, the NGFS seems to pave the way for "little touches of green" rather than "broad strokes". In what follows, we identify the main points of agreement and disagreement with the NGFS analysis.

The options presented by the NGFS

The report identifies nine options, broken down into three types of monetary operations (see Table 1 in the Appendix for a more detailed description) practised by central banks:

- Refinancing terms offered to banks:

    1) Adjust refinancing criteria to the profile of the bank's loan portfolio
    2) Vary the cost of refinancing according to the collateral pledged by the bank

[1] We reviewed previous NGFS reports in: The Case for a "*Whatever it takes*" Climate Strategy; Wojtek Kalinowski & Hugues Chenet, Note by the Veblen Institute, December 2020, pp. 14-19.

[2] The Veblen Institute devoted its dossier entitled "The ECB at a time for decisions" to this subject. See in particular: "The Role of Monetary Policy in the Ecological Transition: An Overview of Various Greening Options".

3) Make access to refinancing conditional on the disclosure of extra-financial information, and adjust terms based on the commercial bank's carbon footprint.

- Collateral accepted in refinancing operations:

4) Vary haircuts according to the type of asset posted
5) Exclude certain types of assets from eligible collateral
6) Introduce other types of assets
7) Define criteria for the eligible collateral pool as a whole.

- Asset purchase programme:

8) Target purchases instead of reflecting market conditions
9) Exclude certain types of assets from purchase transactions.

A welcome call for action in spite of radical uncertainty

Following Mark Carney's lead[3], central banks and the NGFS itself are approaching the climate change issue from the perspective of the financial risks that climate change poses to the banking and financial sector. This "risk-based approach" had the merit of making climate change an area of concern for central banks, but at the same time it seemed to slow down their responses to the problem: by reiterating the observation of the "data gap" and the weakness of the methodologies for measuring these risks accurately, it ultimately suggested postponing action pending reliable quantification of the risks at stake. [4]

It is on this front that a change of approach seems, at last, to be taking place, with the report explicitly incorporating the "dual-materiality" principle[5] and admitting that weaknesses should not prevent central banks from acting. The NGFS mentions two possible methods for driving change, without deciding between the two: a "learning by doing" approach, somewhat in the spirit of the qualitative and adaptive approach that we recommended in the Veblen note "The Case for a "*Whatever It Takes*" Climate Strategy", versus designing "a comprehensive climate-adjusted framework", which is closer to the risk-based approach with its search for perfect metrics, unattainable due to the radical uncertainty involved.

[3] Following the "tragedy of the horizon" speech given in September 2015 by Mark Carney, then governor of the Bank of England, central banks gradually put climate change on their agenda (they are just beginning to broaden their outlook to include biodiversity issues).

[4] For a detailed discussion see The Case for a "*Whatever It Takes*" Climate Strategy, op. cit.

[5] In the technical jargon now enshrined in European legislation, this term indicates that the focus is not only on the economic or financial consequences of climate change (as in "climate-related financial risks") but also on reverse causality, i.e. the impacts of economic and financial choices on the environment and the climate.

A questionable assumption of inherently contradictory objectives

Each of the nine options discussed is evaluated by the NGFS using four criteria:

- Implications for the effectiveness of monetary policy
- Contribution to climate risk mitigation
- Effectiveness as a measure to protect the central bank's balance sheet from risk
- Operational feasibility.

By combining these four criteria, the NGFS produces the following table:

Table 2. **Simplified comparative assessment of the selected generic options under review**

The assessment is based on qualitative expert judgement, and more formal quantitative analysis may be needed. It aims to guide the reader through the report and should not be interpreted as recommending any measure. Colour-coding is used to avoid any "netting" across criteria. The table uses a limited number of colours for reasons of simplicity. More nuanced analyses of options are provided in Annex 1.

Source: NGFS (2021)

This qualitative approach is clearly preferable to mathematical models such as the "climate risk" model. Note, however, the contrast in the colours of the first and second rows of the table above, i.e. the difference in assessment of the effects of the various options on the effectiveness of monetary policies and on climate action. In terms of climate change mitigation, all options are presented as having positive or very positive effects.

This assessment is necessarily very subjective as we are moving into uncharted territory; perhaps none of the nine measures will be truly effective, and others may have to be sought to generate a real impact[6]. But above all, look at the difference compared with the analysis of the effects on monetary policy effectiveness: these effects are deemed to be highly variable and, on the whole, rather negative. Only one option stands out as positive, namely

[6] Among other things, this assessment does not take sufficient account of the responses of banks and financial actors to some of the measures discussed by the NGFS, nor of the need to support these measures with others to avoid unintended effects. For example, will securities excluded from refinancing migrate to shadow banking to create liquidity via repo finance and securities lending?

the inclusion of new types of assets in the collateral framework used for refinancing operations.

We are left with the impression that these are conflicting objectives. The NGFS points out that certain options could reduce the room for manoeuvre of monetary policy and affect its transmission. If, for example, the exclusion of carbon-intensive collateral was introduced, would the pool of eligible collateral not become too small, making it impossible to conduct monetary policy? If the carbon footprint of certain banks made them ineligible for refinancing, what would happen to their continued operation and what would be the impact on their customers? And so on.

This line of reasoning seems to argue for narrow, targeted measures, finely calibrated so as not to affect the effectiveness of monetary policy. While priorities seem clear in the introduction to the report, the picture becomes blurred as difficulties emerge and contradictions appear. It is certainly vital to examine the impact of potential measures on the effectiveness of monetary policy, but it appears problematic to do so without ever questioning the current effectiveness of monetary policy, the difficulties of its transmission to the real economy, and its impact, particularly that of asset purchases, on medium-term financial stability. Contrary to the NGFS' assumptions, the greening of monetary policy could be seen as a means of reconnecting bank activity to useful financing, i.e. as a source of greater efficiency for monetary policy and central bank action.[7]

In any case, supposedly less climate-efficient measures should not be used to justify monetary policy transmission problems already in existence and not previously recognised or identified by the central bank.

The diversity of central banking practices is not adequately reflected in the analysis

The NGFS network is global, but the discussion contained in this new report mainly reflects the "Western" model of central banking as it has emerged in recent decades, based on the principle of monetary policy "neutrality" and a strict separation between the actions of governments and those of the central banks. Some examples offered do not do justice to the diversity of green central banking practices employed in many emerging economies and developing countries (India, Bangladesh, South Korea, Brazil, China, etc.). In fact, central banks often already play an active role in these countries, with a broader range of measures being applied than those discussed by the NGFS—whether aimed at financing the ecological transition, coordinating monetary policy and public spending or imposing restrictive rules (prudential or credit allocation) on the banking and financial system[8].

On the other hand, this new report does reflect the European context accurately, and comes at a time when the European Central Bank (ECB) is about to define its strategy on "environmental sustainability" (one of the six topics included in its strategic review launched in January 2020 and supposed to be completed by mid-year); one can assume that the NGFS'

[7] "Brown assets might be the next subprime", Eric Jondeau, Benoit Mojon, Cyril Monnet, VOX EU, 16 April 2021.

[8] For an overview of this diversity of practices, see Simon Dikau and Josh Ryan-Collins, Green Central Banking in Emerging Market and Developing Country Economies, New Economics Foundation, October 2017.

definition of "what is possible" is broadly the same as that of the ECB as it considers future action in this area.

The options presented are out of synch with monetary policy developments

The diversity of operational frameworks across jurisdictions means that there is no consensus on how to adjust the operational framework to climate risk. However, the NGFS report seems to pay more attention to measures relating to refinancing operations and collateral, seven of the nine options discussed, than to asset purchases. This approach focuses on conventional operations; the relevance and effectiveness of the measures will likely depend in part on their duration and on the time horizon of the proposed refinancing.

But the crucial point lies elsewhere: the unconventional measures taken since the global financial crisis of 2007/08 and reinforced in response to the COVID-19 pandemic have already transformed the size and composition of central bank balance sheets considerably, and altered even more profoundly the actual method of central money creation: **central banks are now creating more central money by purchasing securities than by refinancing commercial banks** (53% of the ECB's total assets are securities held for monetary policy purposes).

If this trend were to continue, surely the greening of monetary policy would primarily be achieved through the recalibration of asset purchases, especially of public assets? This would require **upstream coordination between public issuers and the central bank** to ensure their eligibility for central bank purchase programmes. In this case, the securities issued would have to be used to finance investment plans or projects with a proven contribution to the ecological transition. The size of the ecological component of the public investment plans giving rise to the issue of public securities would then become a determining parameter.

The report makes little mention of the **"balance sheet policy"** through which the greening of monetary policy could be achieved, and does not address the diversity of green central banking practices employed internationally. Instead, it suggests that CBs could adopt a portfolio management approach. But a central bank is not an investor like any other, and the SRI (socially responsible investing) rationale is not, in our view, the best justification for its climate or environmental action. A central bank is not a bank, nor an investment fund, nor a fortiori a company, but an institution serving the common good. Its responsibility is not so much to protect itself from risk as to protect society, including through the provision of active support to banks and finance rather than the mere sorting of assets purchased. The SRI concept applied by private finance has proven completely incapable of truly transforming financial flows; in any case, it applies to private securities, whereas the bulk of asset purchases made by central banks involve public debt[9]; for the latter, the greening relates to the orientation of the public spending financed in this way.

[9] For example, the ECB's corporate sector purchase programme (CSPP) represents only 7-8% of QE.

What are the options for greening public sector purchase programmes?

It is regrettable that government securities are, from the outset, excluded from the discussion even though they constitute the bulk of the purchase programmes currently being conducted by the ECB and other central banks, programmes which in turn account for the bulk of current money creation[10]. The issue of how to deal with public debt in the context of the greening of the financial system is certainly a particularly complex one, involving the coordination of monetary policy with fiscal policies, the "green budget", the earmarking of public spending for climate objectives, etc. In the European context, this applies in particular to the greening of the European Semester[11] and of recovery plans.[12] **This European coordination, which remains largely to be introduced, far exceeds the prerogatives of the central banks alone.** However, the latter have the legitimacy to lead the discussion and propose specific methods of achieving this coordination, as the community of European experts is already doing[13]. As such, this is a missed opportunity, especially since, by the NGFS' own admission, its reports are only intended to fuel the debate among central banks and regulators.

It is understandable that the NGFS restricts the notion of responsible investment by the central bank to its portfolio of private securities and does not risk addressing the issue in relation to its portfolio of sovereign securities[14]. If sovereign government securities deemed insufficiently committed to the ecological transition were to be disqualified in some way by the central bank, the risk would be that the States most in need of financing for their ecological transition would probably find themselves downgraded by the rating agencies, vulnerable to "punishment" by the markets, and consequently facing the greatest difficulty in undertaking their transition.[15] This is a thorny issue which, in the case of the euro area, may accentuate the tensions and differences of opinion between core and peripheral

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[10] The ECB offers a telling example: assets held for monetary policy purposes represented 0% of the Eurosystem's balance sheet in December 2000, and 52.82% in December 2020. This significant fact prompts a broader discussion on the transformation of money creation itself, which is increasingly detached from the classic bank credit mechanism. See, on this subject, Jézabel Couppey-Soubeyran and Pierre Delandre, "La transition monétaire: pour une monnaie au service du bien commun" [Monetary transition: the case for money serving the common good], note by the Veblen Institute, May 2021.

[11] The European Semester is the main tool for coordinating fiscal policies in the EU. Its evaluation criteria should be thoroughly reviewed to make it a genuine tool for the EU's ecological transition. See "The European Semester and why it matters for the EU Green Deal". A policy brief by Climate & Company, May 2021.

[12] In order to access the funding provided for in the "European Recovery and Resilience Plan", each Member State must submit an action plan to the European Commission, which has to evaluate it. As with the European Semester, the Commission's evaluation criteria should be thoroughly reviewed and significantly greened in order to turn the process into an effective tool for the ecological transition of public spending in Europe.

[13] See for example, Marta Domínguez-Jiménez and Alexander Lehmann, "Accounting for climate policies in Europe's sovereign debt market", Bruegel Policy Contribution Issue no. 10/21 | April 2021.

[14] For example, at the end of 2020, 94% of the purchases made under the PEPP programme involved public debt securities. See https://www.ecb.europa.eu/pub/annual/html/ar2020~4960fb81ae.en.html

[15] This argument is developed in U. Volz, J. Beirne, N. Ambrosio Preudhomme, A. Fenton, E. Mazzacurati, N. Renzhi and J. Stampe. 2020. *Climate Change and Sovereign Risk*. London, Tokyo, Singapore, and Berkeley, CA: SOAS University of London, Asian Development Bank Institute, World Wide Fund for Nature Singapore, and Four Twenty Seven.

countries. It also raises the question of the pressure that the central bank can exert on States, the legitimacy of which is debatable.

What supervisory model should be in place to support banks?

These greening measures will expose banks to varying degrees of transition risk depending on the speed and extent of the decarbonisation of their balance sheets. This will require support from the central bank, just as commercial banks will need to support their clients by encouraging the decarbonisation of their activities and facilitating the decarbonisation of their own balance sheets. The problem is the same at central bank level. It will have to support the banks in their transition efforts. For example, when publishing the first results of the climate stress tests, the ECB mentioned the possibility of raising the capital requirements for the most exposed banks[16]. This would fall within the scope of its supervisory role, but is something that the report fails to mention.

The risk of legal challenges: is this a genuine concern?

The **legal risk** that could arise from the greening of the monetary policy operational framework is mentioned several times in the NGFS report. Could banks or companies initiate legal action on the grounds of discrimination if their access to central bank money or market financing is made more difficult by the application of carbon conditions? In our view, the central bank should be more concerned about the risk that its action will be deemed insufficient or even an obstacle to the ecological transition. The **liability risk** that Mark Carney referred to in his "tragedy of the horizon" speech as being a consequence of climate risk for the players in the banking and financial sector also applies to the central bank. In April 2021, the National Bank of Belgium was sued by the NGO ClientEarth for climate damage in connection with its contribution to the ECB's asset purchase programme that benefits polluting companies.

One thing is certain: in order to gain the citizens' trust regarding its commitment to the ecological transition, the central bank will have to be very transparent about the content of its balance sheet and its climate action plan. Whatever it requires from banks in order to green their access to central liquidity, it will also have to produce itself, by communicating its climate risk exposures and mitigation strategy to the market. The disclosure aspect is emphasised in the report, which highlights the approach taken by the Bank of England, which in 2021 became the first central bank to disclose its exposures.

Is the issue of mandate truly resolved?

The question of whether or not climate risk is part of the central bank's mandate is no longer an issue for the NGFS. Central bank action is justified by the "climate risk", which no longer affects solely the balance sheets of banks and other financial intermediaries (level of prudential regulations and climate stress tests); the impact of climate risk on monetary policy and the central bank's own balance sheet is now being put forward as justification for taking the climate issue into account and adjusting monetary policy.

[16] "ECB stress test reveals economic impact of climate change", *Financial Times*, 18 March 2021.

This shift is clearly perceptible in the European context where, according to both legal analyses[17] and the speeches being given by leaders such as Christine Lagarde and François Villeroy de Galhau, **the ECB would be forced to act in the name of its primary objective, namely price stability**. If it becomes widely accepted that central bank climate action is justified by its "core" mandate rather than by secondary objectives, this would supersede the calls often made by civil society representatives to clarify these secondary objectives[18]. Even the "hawks" most attached to the narrow mandate of price stability would then be forced to acknowledge the need for the central bank to act against climate risk.

This is, in our view, a significant reinterpretation of the legal framework, despite the fact that the ECB's mandate has not changed; the "primary" and "secondary" objectives are still expressed in the same way. It suggests that the systemic impact of climate risk on the real economy, on financial risks, on market prices and, therefore, ultimately, on the conduct of monetary policy should be genuinely taken into account. Climate risk is likely to affect all the central bank's objectives (economic, monetary and financial stability) and therefore its credibility. This provides a strong argument for adjusting the monetary policy operational framework to accommodate climate risk and help mitigate it. Nevertheless, if the ECB is committed to the greening of its monetary policy, it would benefit from clarifying the justification used (in terms of monetary, macroeconomic or financial stability) following its strategic review.

Finally, because the NGFS is required to conduct its discussions and work within the context of the central banks' mandate, it does not venture to consider the need for changes to the mandate, let alone analyse it. The NGFS report seems to make the assumption that central banks will actually succeed in greening their actions within their current mandate. We hope so too, but this is at most a working hypothesis. However, insofar as the interpretation of the mandate leads to greening being a required outcome, it seems premature, to say the least, to exclude unconventional options from the debate. These might include, for example, the monetisation of some of the financing of the ecological transition, since this is prohibited by Article 123 of the TFEU and is not feasible without substantially amending the Treaty.

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[17] See Yolaine Ficher, "Global Warming: Does the ECB mandate legally authorise a 'green monetary policy?'", in Frits-Joost Beekhoven van den Boezem, Corjo Jansen, Ben Schuijling, *Sustainability and Financial Markets*, Wolters Kluwer, 2019, pp. 176-181.

[18] See for example the collective opinion piece "La BCE devrait avoir un mandat politique clair qui expliciterait quels objectifs secondaires sont les plus pertinents pour l'UE" [The ECB should have a clear political mandate spelling out which secondary objectives are most relevant for the EU], *Le Monde*, 9 April 2021.

Appendix

Options discussed in the NGFS report

Table 1. **Selected stylised options for adjusting operational frameworks to climate-related risks**

	Credit operations[a]	
(1)	Adjust pricing to reflect counterparties' climate-related lending	Make the interest rate for central bank lending facilities conditional on the extent to which a counterparty's lending (relative to a relevant benchmark) is contributing to climate change mitigation and/or the extent to which they are decarbonising their business model.
(2)	Adjust pricing to reflect the composition of pledged collateral	Charge a lower (or higher) interest rate to counterparties that pledge a higher proportion of low-carbon (or carbon-intensive) assets as collateral or set up a credit facility (potentially at concessional rates) accessible only against low-carbon assets.
(3)	Adjust counterparties' eligibility	Make access to (some) lending facilities conditional on a counterparty's disclosure of climate-related information or on its carbon-intensive/low-carbon/green investments.
	Collateral[b]	
(4)	Adjust haircuts[c]	Adjust haircuts to better account for climate-related risks. Haircuts could also be calibrated such that they go beyond what might be required from a purely risk mitigation perspective in order to incentivise the market for sustainable assets.
(5)	Negative screening	Exclude otherwise eligible collateral assets, based on their issuer-level climate-related risk profile for debt securities or on the analysis of the carbon performance of underlying assets for pledged pools of loans or securitised products. This could be done in different ways, including adjusting eligibility requirements, tightening risk tolerance, introducing tighter or specific mobilisation rules, etc.
(6)	Positive screening	Accept sustainable collateral so as to incentivise banks to lend or capital markets to fund projects and assets that support environmentally-friendly activities (e.g. green bonds or sustainability linked assets). This could be done in different ways, including adjusting eligibility requirements, increasing risk tolerance on a limited scale, relaxing some mobilisation rules, etc.
(7)	Align collateral pools with a climate-related objective	Require counterparties to pledge collateral such that it complies with a climate-related metric at an aggregate pool level.
	Asset purchases[d]	
(8)	Tilt purchases	Skew asset purchases according to climate-related risks and/or criteria applied at the issuer or asset level.
(9)	Negative screening	Exclude some assets or issuers from purchases if they fail to meet climate-related criteria.

Source: NGFS (2021)

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