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POLICY BRIEFING

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WHY AND HOW THE ECB SHOULD GO BEYOND 'MARKET NEUTRALITY'

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KEY POINTS

- The **debate on the role of the ECB for climate change** is rightly focusing on whether the central bank should follow a strict "market neutral" approach when conducting asset purchases.

- **Following a strict market neutrality rule means the ECB is automatically aggravating climate change.** Research evidence suggests the asset purchase programme and liquidity operations fuel financial instability and expose the ECB to potential financial losses.

- **Market neutrality is not a legal requirement** and its definition is loose and up for interpretation. Hence, there is no barrier to revisiting the ECB's approach and including climate criteria in monetary policy.

- Renouncing market neutrality does not necessarily mean politicizing the EC's policies by giving total power to the ECB in adopting green criteria arbitrarily via a sectoral approach, as often feared.

- Instead, **the ECB should adopt the EU's green taxonomy as a new benchmark** when defining eligibility to its collateral and asset purchase eligibility framework. This framework has been purposefully designed to ensure a level playing field between companies and asset issuers.

- **Clear guidance on this point by the European Parliament** will support a successful conclusion of the ECB's strategy review due to be concluded by September 2021.

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INTRODUCTION

Under the leadership of ECB President Christine Lagarde, a debate has finally started on whether and how the European Central Bank should play a role in supporting the EU's climate and environmental objectives. As this debate evolves, a key aspect is now centering on whether the central bank should follow a strict "market neutral" approach when "conducting asset purchases and liquidity operations".

As pointed out in the ECB's documentation[1], the underlying motivation of the market neutrality framework is to ensure that its operations do "*not lead to the preferential treatment of distinct asset classes, issuers or sectors and should avoid market distortion (implying that e.g. individual issuers or sectors benefit unduly from eligibility requirements)*".

The necessity to move beyond a strict application of market neutrality is increasingly understood within the ECB, as manifested by recent declarations by President Lagarde, Executive Board members Isabel Schnabel and Frank Elderson, including at the 25 January 2021 ECON Committee meeting with Frank Elderson[2]. The ECB has formally recognised the problem by including this aspect in its 2021 research agenda.[3]

1. WHY SHOULD THE ECB GO BEYOND MARKET NEUTRALITY?

1.1 Market neutrality is a contradictory tool

By nature, any central bank intervention is at odds with the notion of market neutrality, because central banks constantly intervene to influence market outcomes[4]. When central banks adjust their balance sheets they always make choices - e.g. between the private and public sector, between safe and risky assets.

The concept of market neutrality would lead to the logical conclusion that, for instance, central banks would buy assets across the entire economy, but this is not the case. In fact, for instance, the ECB decides to buy only non-financial bonds, choosing assets-backed securities from the real estate market or auto-loan backed securities.

What's more, central banks such as the ECB always make a choice when they assess credit risk, when it comes to the collateral they accept. As such, the ECB can decide to change their criteria according to the different circumstances, such as a global pandemic that threatens the global economy. In this context, central banks have complete discretion whether to extend or restrict the eligibility of the assets they wish to purchase.

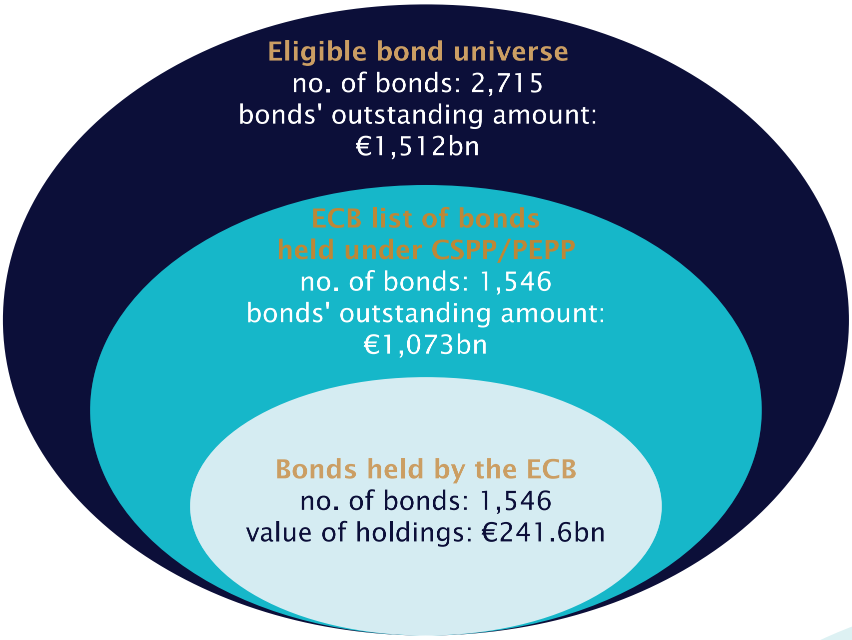
> **By nature, any central bank intervention is at odds with the notion of market neutrality, because central banks constantly intervene to influence market outcomes**

1. Bindseil U. et al (2017), *The Eurosystem collateral framework explained. https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op189.en.pdf.*
2. Positive Money Europe *https://youtu.be/JSmblIonreg*
3. *https://www.ecb.europa.eu/pub/conferences/html/20210106_Legal_research_programme_2021.en.html*
4. *https://www.cepweb.org/central-bank-market-neutrality-is-a-myth/*

1.2 Market neutrality clashes with climate

In practice, the market neutrality principle is implemented by buying bonds in proportion of their market share.[5] For example, the composition of the Corporate Sector Purchase Programme (CSPP) portfolio reflects proportionally the market capitalization of the European corporate bond market. As carbon intensive corporates represent a large part of the European corporate bond market, ECB's CSPP portfolio is also very carbon intensive. Research shows more than half of the €241.6 billion in corporate bonds held by the ECB at the end of July 2020 have been issued by companies in carbon-intensive sectors.[6] The analysis also indicates that 62.7% of the bonds held by the ECB come from carbon-intensive sectors that contribute only 17.8% to employment and 29.1% to gross value added in the euro area. Researchers point out that this is due to application of the market neutrality principle in the ECB asset purchase programmes.

Figure 2: Eligible bond universe, ECB list and bonds held by the ECB, as of July 2020



Moreover, when it comes to liquidity operations, the collateral framework of the ECB does not distinguish between climate-aligned and climate non-aligned assets. Recent research published by the Banque de France finds that collateral pledged is indeed not aligned with the targets of the EU.[7] Without any climate criteria, the "business-as-usual" approach behind the market neutrality principle is exacerbating the climate crisis.

1.3 Market neutrality entails a financial risk for the ECB's balance sheet

Indeed, as climate-related shocks can have a devastating impact on the value of certain asset classes, such as those related to utilities and fossil fuel industries (ie. "stranded assets''). By following a market neutrality approach, the ECB is exposing itself to similar risks, by taking onto its balance sheet that the ECB is (or will soon be) discouraging private investors to buy. Revisiting the principle of market neutrality would help better address these risks, protecting the ECB's balance sheets from financial instability.

5. Hercelin, N. (2019) Why the ECB should go beyond "market neutrality", *https://www.positivemoney.eu/2019/09/ecb-market-neutrality-doctrine/*
6. Greenpeace (2020) ECB's purchasing policies skewed towards carbon intensive industries, *https://www.greenpeace.org/eu-unit/issues/climate-energy/45166/ecb-purchasing-policies-skewed-towards-carbon-intensive-industries/*
7. Oustry, A. et al (2020) Climate-related risks and central bank's collateral policy: a methodological experiment, *https://publications.banque-france.fr/en/climate-related-risks-and-central-banks-collateral-policy-methodological-experiment*

2. HOW THE ECB CAN GO BEYOND MARKET NEUTRALITY?

Abandoning market neutrality as a core operating principle of asset purchase programme doesn't mean getting rid of a robust risk assessment framework and neither to move to a sectoral policy, as it is often feared by critics.[8]

2.1 Market neutrality is not a legal requirement.

Market neutrality has often been presented as an unavoidable legal requirement of the ECB.[9] However, when asked to confirm the legal grounds for market neutrality in a letter addressed to an MEP, President Lagarde provides no legal justification for its implementation, mentioning that the ECB's operational framework is solely based on the "principle of an open market economy with free competition".[10]

As pointed out by ECB Executive Board member Frank Elderson: "it would be an important step to acknowledge that acting in accordance with the principle of an open market economy, does not necessarily imply that the ECB should under all circumstances strictly adhere to market neutrality".[11]

As the ECB itself confirmed recently, market neutrality "is not mentioned in primary EU law and the meaning given to such a notion in the doctrine is extremely heterogeneous".[12] As such, it is a principle that can be reviewed over time.

> **"the principle of market neutrality is not part of the Treaty (...) and there will be an opportunity to revisit the way we interprete it in our mandate.**
>
> **Frank Elderson, ECB board member**

2.1 If not market neutrality, which benchmark to use?

Some central banks, such as Swiss National Bank[13] have also announced an exclusion criteria for coal related assets. While those would be very useful measures in the short term, they represent only a narrow segment of the market.

Some academics have suggested the inclusion of a carbon emission criteria.[14] However, the ECB has expressed the concern that a pure carbon-intensity analysis is backward-looking and could be misleading insofar as it does not represent whether a company is making any efforts to transition itself to a low-carbon trajectory.[15]

The EU Taxonomy on sustainable investments, which will be implemented in 2022, is precisely contributing to addressing this problem. It is described by the European Commission[16] as "a tool to help investors, companies, issuers and project promoters navigate the transition to a low-carbon, resilient and resource-efficient economy". The EU Taxonomy could be incorporated into the ECB policies, helping it to identify financial activities that contribute to the EU's environmental objectives.

8. Gros, D. (2020) The Dangerous Allure of Green Central Banking, Project Syndicate
9. See speech by Bundesbank President Jens Weidmann, *https://publications.banque-france.fr/en/climate-related-risks-and-central-banks-collateral-policy-methodological-experiment*
10. *https://www.ecb.europa.eu/pub/pdf/other/ecb.mepletter191122_Urtasun~2dc928d018.en.pdf*
11. *https://www.europarl.europa.eu/doceo/document/A-9-2020-0218_EN.html*
12. *https://www.ecb.europa.eu/pub/conferences/html/20210106_Legal_research_programme_2021.en.html*
13. *https://www.climate-alliance.ch/blog/swiss-national-bank-drops-coal*
14. Schoenmaker, D. (2019), 'Greening Monetary Policy', Working Paper Issue 02, Bruegel.
    Lengwiler, Y. and Orphanides, A., Options for the ECB's Monetary Policy Strategy Review, Study for the ECON Committee, European Parliament, 2020.
15. Letter from Christine Lagarde to MEPs *https://www.ecb.europa.eu/pub/pdf/other/ecb.mepletter200928_MEPmembers~329298ba99.en.pdf*
16. European Commission (2020). "Financing a sustainable European economy" *https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf*

A key feature of the EU sustainable finance framework (the EU Taxonomy and the Sustainable Finance Disclosure Regulation) is that compliance by companies will be based on two dimensions: the alignment of the company's current activities (turnover), but also the alignment of its capital expenditure (CapEx), which represents any future capital investments.

The revision of the Non-Financial Reporting Directive starting in 2021 will further ensure that companies will be reporting the sustainability impact data that allow asset managers and the ECB to align their investments to the Taxonomy's objective.

With such a reporting framework soon in place, the ECB can develop a fair approach where a company that is currently highly engaged in climate-harming activities can still be eligible to access the ECB's operations if, at the same time, it is investing sufficiently to align its activities with the EU's climate objectives.

3. WHAT CAN THE EUROPEAN PARLIAMENT DO?

As Christine Lagarde said in an online speech on October 14th: "In the face of what I call the market failures" we have to ask "whether market neutrality should be the actual principle that drives our monetary-policy portfolio management". To further encourage this paradigmatic evolution inside the ECB, the European Parliament should:

- Call explicitly on the ECB to use the EU Taxonomy as an alternative benchmark to market neutrality in its annual resolution on the ECB (rapporteur Sven Simon);
- Tasks the ECON Committee to contribute to the *ECB's legal research agenda* by commissioning research and monetary dialogue briefings on this aspect;
- Notify formally the ECB that environmental protection is currently the most relevant and urgent general objective of the EU (as per Article 3 TEU) which the ECB can and should support without prejudice to price stability as part of its secondary mandate (Art 127 TFEU);
- Accelerate legislative efforts in order to ensure smooth and speedy implementation of mandatory sustainability impact disclosure regimes for companies.
- Call for an acceleration of legislative proposals to complete the EU Taxonomy Regulation with social and good governance objectives, so that the EU taxonomy becomes a fully operational framework as soon as possible.

ABOUT POSITIVE MONEY EUROPE

Positive Money Europe is a not-for-profit research and campaigning organisation whose mission is to build a diverse and powerful movement pushing for a progressive reform agenda of the European Central Bank and Eurozone institutions so they support a fair, democratic and sustainable economy.

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