June 15th 2021

Object: Response to your May 5th letter on the Bundesbank's position regarding climate integration in monetary and prudential policy

Dear President Weidmann,

We thank you for your response[1] to our letter and welcome your willingness to engage with activists and NGOs on this crucial matter.

As you rightly underline, greater efforts to protect the climate are urgently needed and 2021 will be a decisive year for climate action. These efforts require a resolute move from central banks to support climate targets defined by political powers and further the alignment of the financial sector with these goals.

The broken shield of central bank market neutrality

Much of your response is dedicated to playing down central banks' role in mitigating climate change. While the responsibility of political powers is clearly emphasized, central banks are painted as purely independent and technical organizations, severed from the political sphere, and therefore illegitimate to take on climate.

The limits and dangers of this line of reasoning are best found in the principle of "market neutrality[2]", that you define as the idea that central bank's operations should "interfere as little as possible with the functioning of markets and price formation". Contrary to what your unwavering defense of "market neutrality" could suggest, this principle is not a legal requirement for the ECB and its definition is loose and up for interpretation[3].

In fact, central banks' market neutrality does not exist. Any central bank intervention aims at producing some effects and requires choices, notably regarding the monetary tool used, that are non-neutral for markets[4].

By looking at ECB's asset purchases, several clear examples of such non-neutral monetary choices, grounded on political choices, can be uncovered:

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[1] Jens Weidmann (2021), "Greater efforts to protect the climate are urgently needed"
[2] Jens van 't Klooster & Clément Fontan (2019), "The Myth of Market Neutrality: A Comparative Study of the European Central Bank's and the Swiss National Bank's Corporate Security Purchases", *New Political Economy*
[3] Positive Money Europe (2021), *Why the ECB should go beyond market neutrality*
[4] Chiara Colesanti and Pierre Monin (2020), "Central Bank Market Neutrality is a Myth", *CEP*

- Prior to the Covid-19 pandemic, the ECB conducted its purchases of sovereign bonds in line with the shares each Eurozone member holds in the ECB capital. This approach was already different from an allocation based on their market capitalization, usually used by central banks as a benchmark for market neutrality. In response to Covid-19, the ECB deviated from this capital key to support increasing public spending.
- To limit credit risk, central banks usually limit their bond purchases to those rated as investment grade. In response to the pandemic, the ECB notably declared that it is not required to sell a bond when it falls below investment grade.

In your response, you also implicitly recognize the non-neutrality of asset purchases by saying that asset purchases have an impact on the yield of non-eligible assets, including those that could "foster the green transformation"[5].

Addressing the carbon bias, instead of eluding it

When focusing on climate change, the defense of central bank independence and market neutrality doctrine have two major negative consequences:

1. It leads the ECB to ignore the climate objectives set by the EU and Member states, despite its mandatory[6] secondary objective to support the general economic policies in the Union.
2. It drives the ECB to reproduce or amplify market failures, therefore contributing to climate change.

The ECB notably amplifies market failures through its asset purchases, when buying large amounts of bonds from high carbon companies. To reject the ECB's carbon bias, you argue that, as minimum credit quality requirements must be met to protect the ECB's balance sheet, any potential bias should be measured against the universe of eligible assets.

We believe this argument is misleading. Commenting on an ECB working paper by Papoutsi and al[7], Isabel Schnabel recognized the ECB's "emission bias". The current credit quality requirements used by the ECB do not account for environmental and climate impact or risk and the study by Yannis Dafermos and al[8] reveals that the selection process of the poll of eligible assets - based on these criteria - is the main cause of the ECB's carbon bias. Therefore, your argument for rejecting the ECB's carbon bias comes down to avoiding considering its causes.

The ECB's carbon bias and disregard for EU climate objectives do not follow from the ECB's price stability mandate. They are the result of a series of choices taken by the ECB. As it has done before - including during the Covid-19 crisis - the ECB can review its doctrine to ensure that it achieves its mandate in a sustainable manner.

In fact, doing so is necessary for the ECB to keep on achieving its mandate. As the German Constitutional Court recalled, the ECB is supposed to balance the effects of monetary policy with other policy areas of the EU[9]. This "necessity requirement" has clearly been disregarded when the ECB failed to even evaluate the impact of its asset purchases[10]. Furthermore, it happens that climate inaction would severely threaten price stability.

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[5] It is also worth mentioning that the effect on yield referenced in President J.Weidmann's response is not specific to "green" or "low carbon" bonds. It affects all classes of non-eligible bonds, including those emitted by carbon intensive companies. As carbon intensive companies make for a higher share of the bond market than low carbon ones, it is likely that this benefits more carbon intensive companies.

[6] Frank Elderson (2021), « Greening monetary policy », *ECB*

[7] Isabel Schnabel (2021), « From green neglect to green dominance? », *ECB*

[8] Yannis Dafermos and al (2020), *Decarbonising is easy, beyond market neutrality in the ECB's corporate QE*

[9] Javier Solana (2020), « A reminder from the courts for the European Central Bank to take climate change seriously », *LSE*

[10] Client Earth (2021), "ClientEarth sues over climate impact of ECB policy"

Mandatory reporting is not a risk management option

The fact that climate change represents a threat to price stability is now well-established[11]. In your response and on several occasions before, you underlined that central banks should do more to address climate-related risks in their own balance sheet. However, your suggestion to condition eligibility to the climate risk disclosure by counterparties falls short of the bar you just set:

1. Disclosure is by no means the equivalent of risk management. Knowing risks is no guarantee to reduce them. For that to happen, action must be taken on disclosed information.
2. The overlying assumption behind your propositions is that financial markets will efficiently integrate the new information and reduce their exposure accordingly. This disregards the fact that financial markets are currently already failing to adequately reflect climate risk, even based on the information currently available, and will always remain difficult to precisely evaluate because they are characterized by radical uncertainty[12].

For firefighters facing a forest fire, knowing where and how the fire is spreading will not do any good if they don't act on it or if they wait until the fire spins out of control to do so. Similarly, for the ECB to focus on non-financial reporting and wait for hypothetical financial metrics to act simply means letting climate related financial risks accumulate and giving up on its price stability objective.

Mandatory reporting would not allow for the integration of climate risks in asset purchases, and therefore not fulfill ECB's legal obligation to protect the balance sheet. On the contrary it would establish a "two tracks" system, where "classic" financial risks are considered through credit quality requirements while climate-related financial risks are somewhat recognized but not accounted for. In light of the German Constitutional Court's PSPP ruling you repeatedly mentioned, such a disregard for climate risks could be sanctioned.

The Network For Greening the Financial System (NGFS) itself emphasizes that acting now, on the basis of non-financial metrics, could be less costly for central banks than waiting for precise financial information[13]. At the same time, the De Nederlandsche Bank (DNB) stressed it would champion a "precautionary approach" to climate risks at the ECB, that entails mitigating climate change to mitigate the related risks[14].

Is the Bundesbank getting on the right track?

Dear President Weidmann, we do not ask the ECB and the Bundesbank to substitute European States in taking climate action, but merely to fully account for the historical market failure that climate change is and to satisfy their secondary mandate by contributing to EU climate objectives. To fulfill their primary mandate, we ask them to use the full extent of their powers to help mitigate a climate crisis that will severely destabilize the financial model they pledged to protect and the functioning of monetary policy itself.

Since your response on May 5th, you have reviewed your position. We warmly welcome the fact that you open the door to the decarbonization of its asset purchases and underline that relying solely on disclosure and ratings would be insufficient to address climate-related risks in the ECB's monetary operations[15].

[11] Isabel Schnabel (2021), « From green neglect to green dominance? », *ECB*
[12] Hugues Chenet and al (2021), "Finance, climate-change and radical uncertainty: Towards a precautionary approach to financial policy", *Ecological Economics*
[13] NGFS (2021), *Adapting central bank operations to a hotter world: Reviewing some options*
[14] DNB (2021), *Annex 1 Climate related financial disclosure*
[15] Jens Weidmann (2021), "Climate risks, financial markets and central banks' risk management", *BIS*

However, we stress the Bundesbank should further acknowledge the need for a precautionary approach to climate risks[16]. Waiting for a hypothetical ideal climate risk metric is not an option and the Bundesbank should advocate for the immediate decarbonization of ECB operations based on the information already available. As they concentrate climate related risks[17], fossil fuel assets and companies should be the first to be targeted, especially when they develop new projects. Furthermore, the Bundesbank should be open towards reviewing the monetary policy of the Eurosystem based on its compatibility with the Paris Agreement.

If "central banks do not have a magic wand[18]" to save the planet, they do have a duty to stop contributing to its destruction. The ECB and the Bundesbank must start gearing their powers to not jeopardize the future of the citizens they serve by further destabilizing the climate and at the very least work to help the EU achieve its climate goals instead of undermining them. Like the EU and all Member states, the ECB and the Bundesbank must strive to become Paris-aligned.

Already more than 32 000 people[19] call on you to get on this path by supporting ambitious climate measures at the ECB, including measures to end all support to highly polluting activities through asset purchases and the list of collateral, starting with fossil fuels.

Yours sincerely,

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16 Reclaim Finance and al (2021), *The Green Swan Toolkit: Four priorities to ensure financial stability in the age of climate change*

17 Joseph Stiglitz (2021), Speech at the Green Swan Conference / Reclaim Finance and al (2021), *Fossil fuel: the new subprimes? How funding the climate crisis can lead to a financial crisis*

18 Jens Weidmann (2020), "Central banks cannot solve climate change on their own", *Bundesbank*

19 Petition by SumOfUs, 350.org, Reclaim Finance, Urgewald, the Koala Kollektiv and Positive Money Europe