

## A Green ECB Collateral Policy

### A proposal for a minimum green share collateral policy

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In the course of the public debate on sustainable finance and the EU's ambitions to reach the CO<sub>2</sub> reduction targets of the Paris Agreement, the role of central banks has been repeatedly evoked. Also, sustainability is expected to be an element of the European Central Bank's strategic review. This cepInput focusses on sustainability in the ECB's collateral policy.

- ▶ When lending central bank money to private credit institutions, the ECB demands these to offer assets as collateral. This collateral protects the ECB in case of a counterparty default. Any preferential treatment of green assets by the ECB in its collateral policy would channel funds into sustainable economic activities and lower the capital costs of these activities.
- ▶ Such preferential treatment is unlikely to be motivated by the ECB's primary objective to maintain price stability but may serve to support the general economic policies in the Union. At the same time, it must be compatible with the principle of market neutrality.
- ▶ We propose a green ECB collateral policy that demands all ECB counterparties to hold a minimum share of green assets in their collateral pools. This would be consistent both with the ECB mandate and the principle of market neutrality.

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## 1 Introduction

The overarching aim of the EU's sustainable finance agenda is to enable the EU to reach the Paris Agreement targets on the reduction of carbon dioxide and other greenhouse gases as defined in the United Nations' 2030 Agenda for sustainable development. More concretely, the EU Commission intends to do so by making sustainable investments more attractive to private capital.

In this perspective, the EU has agreed upon an EU-Taxonomy for sustainable investments.<sup>1</sup> Policy discussions are ongoing on sustainable financial advice<sup>2</sup>, on the role of sustainability in prudential rules for banks and insurances<sup>3</sup>, on a EU Green Bond Standard<sup>4</sup> and on extending non-financial reporting.<sup>5</sup>

In the course of the public debate on sustainable finance, the role of central banks has been repeatedly evoked as central banks, as lenders of last resort, have considerable means at their disposal to influence the attractiveness of investments in sustainable activities. Also, Christine Lagarde in her capacity as President of the European Central Bank (ECB) has announced that the ECB will assess, as part of the strategic ECB-review, the impact of sustainability risks on the ECB collateral framework, thus pointing to the interrelations between sustainability and monetary policy.<sup>6</sup>

This **cepInput** explores this topic. Accordingly, it first sets out in section 2 the function of collateral in the European Monetary Union (EMU) legal framework. In section 3, it illustrates how central bank collateral relates to sustainability. Section 4 addresses the limits for the ECB in pursuing a green collateral policy. In section 5 we offer a proposal for a green ECB collateral policy.

## 2 Collateral in the EMU: Function and legal framework

One of the most important activities of the European System of Central Banks (ESCB) in pursuing its monetary policy objective is the conduct of open market and credit operations with credit institutions.<sup>7</sup>

At regular intervals, the ECB lends central bank money to private credit institutions ("counterparties") to influence capital market interest rates and hence inflation. Primary EU law obliges the ECB to base all such credit operations with credit institutions and other market participants, on "adequate collateral".<sup>8</sup>

This collateral should protect the ECB against the credit risk ("default risk") of these counterparties not being able to pay back the borrowed money to the ECB. In case the private bank cannot repay the

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<sup>1</sup> Van Roosebeke, B. (2020), EU Taxonomy for Sustainability – Summary and Assessment, [cepAdhoc](#) from 14 January 2020.

<sup>2</sup> Draft Commission Regulation amending delegated Regulation (EU) 2017/2359 with regard to environmental, social and governance preferences in the distribution of insurance-based investment products [ARES(2018) 2681527] and draft Commission Regulation amending Regulation (EU) 2017/565 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive [Ares(2018)2681500].

<sup>3</sup> Amongst others, see European Banking Authority, [Consultation Paper, Draft Guidelines on loan origination and monitoring](#), EBA/CP/2019/04, 19 June 2019.

<sup>4</sup> EU Technical Expert Group (2019), [Report on EU Green Bond Standard](#).

<sup>5</sup> On 18 February 2020, the EU-Commission initiated a [public consultation](#) on the revision on the non-financial reporting directive.

<sup>6</sup> Lagarde C., Climate change and the financial sector, speech delivered at the launch of the COP 26 Private Finance Agenda - London, 27 February 2020.

<sup>7</sup> This activity involves the ECB and the national central banks of the Eurozone. Simplifying, in the following we will refer to the ECB.

<sup>8</sup> Article 18.1 ESCB-Statute.

borrowed funds to the ECB, the ECB will take recourse to the collateral. This collateral can be bonds or equity. Demanding collateral protects the ECB from incurring losses, which may undermine its reputation. Also, excessive central bank losses may negatively affect European taxpayers, as they may make it necessary to recapitalise the ECB.

The ESCB Statute empowers the ECB to establish general principles for open market and credit operations and allows the ECB to decide what “adequate collateral” means.<sup>9</sup> Accordingly, in its General Documentation Guideline the ECB has established a single framework for eligible assets common to all Eurosystem credit operations.<sup>10</sup> The stated objective thereof is to protect the Eurosystem from the abovementioned counterparty risk.<sup>11</sup>

Besides setting out a number of eligibility criteria<sup>12</sup>, the Guideline sets credit quality requirements that assets must comply with to be eligible as collateral. Notably, all eligible assets must meet credit quality step 3 on the Eurosystem’s harmonised rating scale.<sup>13</sup> For assets rated by credit rating agencies, this means those must have a rating of at least BBB-.<sup>14</sup>

Finally, all eligible assets are subject to risk control mechanisms.<sup>15</sup> For instance, if the value of collateral dwindles below a certain threshold, new collateral has to be called in.<sup>16</sup> Additionally, the value of collateral assets is reduced by applying “haircuts” to anticipate losses that would materialise in case of the liquidation of assets by the ECB.<sup>17</sup>

### 3 Collateral and sustainability

Central banks’ collateral policy has a direct effect on the cost of capital that security issuers – e.g. non-financial enterprises that issue bonds or equity – incur. All else equal, demand for securities that are central bank eligible will be higher than for securities that are not, as they offer additional use as collateral to investors which are central bank counterparties. Thus, these positive liquidity effects lead to lower capital costs for the issuers of eligible securities than for issuers of comparable securities with a comparable risk-return profile that are not eligible.<sup>18</sup>

This is also true in the case of preferential treatment of green assets by the central bank in its collateral policy. Such treatment will lead to a relative increase of recapitalisation costs for non-green economic activities as compared to green activities. Thus, collateral policy may serve as an instrument to conduct a green central bank policy which aims at channelling funds into sustainable economic activities.

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<sup>9</sup> Article 18.2 ESCB Statute.

<sup>10</sup> Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (General Documentation Guideline); therein: Considerandum No 20 and Article 58 (1).

<sup>11</sup> Considerandum No 18 General Documentation Guideline.

<sup>12</sup> Amongst other, these relate to the principal amount, coupon structure, denomination (only Euro is accepted) as well as type and place of establishment of the issuer of the asset.

<sup>13</sup> Article 82 General Documentation Guideline (for marketable assets) and Article 108 General Documentation Guideline (for non-marketable assets).

<sup>14</sup> As creditworthiness for eligible assets is assessed along the Eurosystem credit assessment framework (ECAF), credit quality can be based a.o. on external credit assessment Institutions (ECAIs), national central banks’ in-house credit assessment systems (ICASs) or counterparties’ internal rating-based (IRB) systems (Article 119 General Documentation Guideline).

<sup>15</sup> Article 127 General Documentation Guideline.

<sup>16</sup> Article 128 (2) (b) General Documentation Guideline.

<sup>17</sup> Article 128 (2) (a) General Documentation Guideline.

<sup>18</sup> Schoenmaker (2019), Greening Monetary Policy, Bruegel Working Paper Issue 2, pp. 7 with further references.

## 4 The limits to a green collateral policy by the ECB

In the following, we assume that any green collateral policy by the ECB implicates a change of the General Documentation Guideline. While the ECB is entitled to change the General Documentation Guideline, this prerogative is not unlimited but bound to its capacity of monetary policy authority under the Treaties. For this reason, in section 4.1, we assess the legal limits set by the ECB's mandate to such amendments.<sup>19</sup> In section 4.2, we investigate whether a green ECB collateral policy complies with the self-imposed principle of acting in a market neutral way.

### 4.1 Compatibility of green collateral policy with the ECB's mandate

The monetary mandate of the ECB is set out in Article 127 (1) TFEU: "The primary objective of the European System of Central Banks (hereinafter referred to as 'the ESCB') shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119."

We first investigate in section 4.1.1 whether a green ECB collateral policy is necessary for maintaining price stability. In that case, there can be no doubt that the policy is covered by the ECB's monetary mandate. In section 4.1.2 we investigate whether a green ECB collateral policy can be covered by the ECB's secondary objective of supporting economic policies. In section 4.1.3 we investigate whether the fact that ECB action must comply with the principle of an open market economy with free competition sets any limits to green ECB collateral action.

#### 4.1.1 The ECB's primary objective: Maintaining price stability

The link between central bank collateral policy and monetary policy is only indirect. The main aim of collateral policy is to avoid central bank losses which can occur as a consequence of defaults of counterparties in monetary operations. If massive, such losses could impair the credibility of the central bank and thus its ability to maintain price stability. Hence, central bank collateral policy can – in general – be seen as a relevant measure enabling the ECB to fulfil its primary objective of maintaining price stability.

Whether this also goes for an ECB policy decision to "green" its collateral policy by a change of the General Documentation Guideline will depend on the exact design of the ECB's action. However, even though the effects of a preferential treatment of any kind of green assets on money supply and hence on inflation rates depends on many variables, the following speaks against a green collateral policy being covered by the ECB's primary objective:

- The share of green assets as percentage of total eligible assets is growing, but still rather small. The proportion of green bonds relative to total bond issuance denominated in euro rose to almost 9% by the end of 2019.<sup>20</sup> Thus, the effect of a preferential treatment of any kind of

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<sup>19</sup> Under Article 282(4) TFEU, the ECB is to adopt such measures as are necessary to carry out its tasks in accordance with Articles 127 TFEU to 133 TFEU, with Article 138 TFEU and with the conditions laid down in the Statute of the ESCB and of the ECB.

<sup>20</sup> ECB (2020), [The international role of the Euro](#), June 2020

green assets would be limited to a small share of the capital market. This is unlikely to have material effects on capital market interest rates and hence economic development and inflation.<sup>21</sup>

- A green collateral policy is unlikely to boost banks' lending capacity at the ECB and hence influence the monetary transmission channel. There is little evidence that collateral constitutes a bottleneck for commercial banks in accessing central bank money.<sup>22</sup>
- It cannot be excluded that a green collateral policy will lead to a mere substitution of non-green assets by green assets in banks' collateral pools.<sup>23</sup> This would have no effect on the amount of central bank money fed into the economy.

Concluding, a green change to the ECB's collateral policy is unlikely to be motivated by the ECB's primary objective to maintain price stability. The ECB's secondary objective will hence be of greater relevance for a green ECB collateral policy.

#### 4.1.2 The ECB's secondary objective: Supporting economic policies in the EU

Without prejudice to price stability, the ECB shall, as a secondary objective, also support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.<sup>24</sup> These include, inter alia, "full employment" and a "balanced economic growth", but also, particularly relevant in the present context, "a high level of protection and improvement of the quality of the environment".<sup>25</sup>

The Treaty provisions above suggest that ECB action in support of the European sustainable finance agenda would be within the remit of the central bank's mandate, as it would be ultimately devoted to the protection of the environment. However, such action would be subject to two fundamental conditions.

##### 4.1.2.1 Condition 1: only contribution to the success of economic policies

Article 127 TFEU confines the ECB's role to that of mere supporter: The ECB may not take the lead, i.e. select autonomously an economic policy objective and pursue it alone. Accordingly, the ECB's action is legitimate only if (1) efforts in other areas of policy making exist and can be documented<sup>26</sup> and (2) the ECB's intervention contributes to the success of such efforts without taking the lead.

Whether or not a green change to the ECB's collateral policy meets this requirement will obviously depend on the exact nature of the ECB's action. As to the first requirement, the EU is truly committed

<sup>21</sup> Obviously, this effect might well be endogenous. Minimum shares of lower haircuts on green assets might offer incentives for commercial banks to purchase green bonds. In the medium term, this may also increase supply of such bonds. See: Nyborg (2017), [Collateral frameworks: The open secret of central banks](#).

<sup>22</sup> In recent years, the ECB has loosened its collateral standards, which has led to a surplus availability of eligible collateral. According to Nyborg, K. (2016), Central bank collateral policy and financial fragility, in 2013, banks only used 5% of eligible assets as collateral.

<sup>23</sup> Counterparties maintain a pool account at the ECB where they deposit eligible collateral. (Article 2 (73) General Documentation Guideline).

<sup>24</sup> Article 127 (1) TFEU, Article 2 ESCB Statute.

<sup>25</sup> Article 3 (3) Treaty on the European Union (TEU).

<sup>26</sup> The initiatives must not necessarily be at the EU level, because Article 127 TFEU talks about general economic policies "in" and not "of" the Union.

to reaching the "2030 targets" agreed in Paris. The Taxonomy<sup>27</sup> and Disclosure<sup>28</sup> Regulation on sustainable investment agreed upon by the European legislator and a number of sustainable finance initiatives launched by the Commission are a clear proof thereof. However, as to the second requirement, the question may arise whether the ECB's green collateral action goes further than the economic policies on sustainable finance do, thus putting the ECB in the lead, creating a conflict with Article 127 TFEU. This may be the case if the objective of the ECB's action is to *directly* lower capital costs of green investments.<sup>29</sup> The EU's economic policies in the field of sustainable finance aim at such effect only indirectly. The Taxonomy and Disclosure Regulation mainly creates transparency as to the sustainability of investments and leave it up to the investors to allocate their money and hence influence capital costs. Indeed, regulatory measures aiming at directly influencing capital costs, e.g. a green supporting factor in banking regulation, are politically highly controversial and have been rejected for the time being.

#### 4.1.2.2 Condition 2: no prejudice to price stability

Green eligibility criteria for collateral are in line with the ECB's mandate only if they are "without prejudice to the objective of price stability".<sup>30</sup> Accordingly, any ECB initiative in support of the general economic policies in the Union should be reviewed through a two-step approach. First, it must be evaluated whether the initiative has an impact on the ability of the ECB to reach price stability as quantified by the Governing Council of the ECB. Then, if such impact were found to exist, it should be assessed if it qualifies as a "prejudice" to reaching price stability for the purpose of Article 127 TFEU.

Following the Weiss judgement those steps seem to overlap. Indeed, since the Treaties do not quantify the objective of price stability, the ECB found itself in need to specify it as a precondition for its own activity. This is what the ECB did in 2003 by defining the objective of maintaining price stability as the maintenance of inflation rates at levels below, but close to, 2% over the medium term. In Weiss, the CJEU validated the legitimacy of this decision, stating that is not vitiated by a manifest error of assessment and does not go beyond the framework established by the TFEU.<sup>31</sup> This means that, as of today, the inflation rate target of 2% over the medium term defines price stability under Article 127 TFEU. Accordingly, any monetary policy choice that prevents the ECB from reaching such target amounts to an infringement of Article 127 TFEU.

In the view of the above, the ECB will act in full compliance with Article 127 para. 1 TFEU only if its green collateral policy does not endanger the return of inflation rates to levels below, but close to, 2% over the medium term.

#### 4.1.3 The principle of an open market economy with free competition

ECB action needs to be in compliance with "the principle of an open market economy with free competition, favouring an efficient allocation of resources".<sup>32</sup> As this principle applies to all economic

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<sup>27</sup> Regulation (EU) 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, ELI: <https://eur-lex.europa.eu/eli/reg/2020/852/oj>.

<sup>28</sup> Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, ELI: <http://data.europa.eu/eli/reg/2019/2088/oj>.

<sup>29</sup> According to the CJEU, the key element for the purpose of ascertaining whether a measure belongs to the area of monetary policy is its objective. The instruments which the measure employs in order to attain those objectives are also relevant. [EuGH, Rs. C-493/17 (Weiss), Judgement of 11 December 2018, para. 53, [ECLI:EU:C:2018:1000](https://eur-lex.europa.eu/eli/jud/2018/1000) and case-law thereby cited].

<sup>30</sup> Article 127 (1) TFEU.

<sup>31</sup> Weiss, para. 56, 57.

<sup>32</sup> Article 127 (1) TFEU.

policies in the EU<sup>33</sup>, it is not easy to grasp whether it imposes a real boundary on the exercise of monetary policy.

The case law of the CJEU provides very limited indications in this regard. In *Échirolles* and in reference to economic – not: monetary – policy making, the Court concluded that that principle could not be interpreted as imposing clear and unconditional obligations which may be relied upon by individuals before the courts.<sup>34</sup> According to the judges, “what is involved is a general principle affecting any economic policy, whose application calls for complex economic assessments which are a matter for the legislature or the national administration”.<sup>35</sup>

All in all, the judgement in *Échirolles* does not allow for any conclusion as to the legal value of the principle of an open market economy in monetary policy making. As the ruling was delivered in the area of economic policy, which, unlike monetary policy, is a competence that remains primarily with the Member States<sup>36</sup>, it offers an answer to the question of what effects such principle is susceptible to produce in the legal order of the Member States, but it does not clarify whether it can affect the legitimacy of the activity of the ECB.

Indeed, the principle of an open market economy can hardly be an insurmountable condition of compliance with EU law for the activity of the ECB. This is mainly due to the uncertain boundaries of the concept of an open market economy, which is not defined by primary law.<sup>37,38</sup> In this sense, the obligatory content of Article 127 (1) TFEU is determined by the conditions of the market in a given moment in time and evolves when those change. Thus, it is very hard for a Court to review compliance with it.<sup>39</sup>

In conclusion, the principle of an open market economy with free competition does not seem to be credibly invocable to challenge the legitimacy of ECB’s collateral policy in Court.

## 4.2 Market Neutrality

As lenders of last resort, central banks have unlimited resources and their action can, e.g. through asset purchases or collateral policy decisions, distort prices. Whereas all central banks’ activities naturally have an impact on prices, the central bank has a self-interest in not distorting market prices. Without a properly functioning price building mechanism on capital markets, the transmission mechanism cannot function adequately; and hence, the central bank cannot effectively observe nor steer inflation. For this reason, central banks generally strive at acting in a market neutral manner.<sup>40</sup> The ECB has repeatedly expressed its desire to act in a market neutral way. This holds true especially for its

<sup>33</sup> Article 119 (1) TFEU.

<sup>34</sup> Judgment of 3 October 2000, *Échirolles Distribution*, C-9/99, EU:C:2000:532, para. 25.

<sup>35</sup> Judgment of 3 October 2000, *Échirolles Distribution*, C-9/99, EU:C:2000:532, para. 25.

<sup>36</sup> The EU merely has coordinating competences in this field (Article 121 TFEU).

<sup>37</sup> Kaiser K., *The objective of price stability and the principle of an open market economy: what trumps?*, ESCB Legal Conference, 2018, p. 30.

<sup>38</sup> „It has been suggested that [the principle of an open market economy] was included in Article 127 (1) with two considerations in mind. First, in order to prevent the imposition of quantitative limitations on the provision of credit by financial institutions, which has traditionally been a favourite instrument of French monetary policy and, secondly, to protect the ESCB from undertaking rescue operations as a lender of last resort” (Tridimas T., *Community Agencies, Competition Law, and ECSB Initiatives on Securities Clearing and Settlement*, Year-book of European Law, Volume 28, Issue 1, 2009, p. 272 – 273).

<sup>39</sup> Tridimas T., *Community Agencies, Competition Law and ECSB Initiatives on Securities Clearing and Settlement*, Year-book of European Law, Volume 28, Issue 1, 2009, p. 273.

<sup>40</sup> BIS (2015), *Central bank operating frameworks and collateral markets*, CGFS Papers No 53, referring to market neutral behaviour concerning collateral policy.

asset purchase programmes<sup>41</sup>, but also for questions regarding the digitalisation of finance<sup>42</sup> and sustainable finance<sup>43</sup>.

Especially regarding collateral policy, ECB authors stress the importance of market neutrality: “A collateral framework and its criteria and/or requirements should 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).”<sup>44</sup>

## 5 Proposal: A Minimum green share collateral policy

Any change by the ECB of its General Documentation Guideline to introduce a green collateral policy must meet the above-mentioned limits, i.e. remain within the ECB’s mandate, comply with the open market principle and be market neutral. As illustrated above, such green collateral policy can be covered by the ECB’s mandate as part of its secondary objective.

As for the open market principle and the market neutrality, a commonly discussed ECB action in favour of a green collateral policy is very critical. It is regularly proposed that the ECB should apply lower haircuts for green assets, making them more interesting to ECB counterparties for use as collateral.

This proposal is not convincing. Such a decision would result in a departure of the risk-oriented approach of collateral policy. The very starting point of that approach is the fact that collateral is supposed to avert risks from the central bank. Deviating from that approach for green assets not only questions the justification for collateral policy. It is also manifestly not market neutral as only green issuers or sectors will benefit from favourable eligibility requirements and hence from capital costs which are lower than without such treatment.

For similar reasons, we also oppose the ECB interfering directly in the assessment of the credit quality of collateral by attaching a higher weight to sustainability issues. Not only would this stand in stark contrast to the comprehensive importance of credit quality assessments by external credit rating agencies to the collateral framework. Even though the reliance on rating agencies is regularly criticised<sup>45</sup>, a

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<sup>41</sup> Wuermeling (2018), Prospects for monetary policy implementation Speech at the 2018 Banking Evening at the Deutsche Bundesbank’s Regional Office in Baden-Württemberg, 06.02.2018, saying: “Purchases should remain market-neutral wherever possible. The Eurosystem is at pains not to impair the functioning of the markets and price formation.” Cœuré (2018), Embarking on public sector asset purchases, Speech at the Second International Conference on Sovereign Bond Markets, Frankfurt, 10 March 2015, saying: The concept of market neutrality means that, while we do want to affect prices, we do not want to suppress the price discovery mechanism. We will operationalise this principle by ensuring a high degree of transparency around our interventions and by closely monitoring their impact on liquidity and collateral availability.”

<sup>42</sup> Wuermeling (2020), Post Corona – EU regulation and banking supervision after the shock, Speech at a video conference held by the EU Public Affairs Committee of the Association of German Banks (BdB), distinguishing between “technology neutrality” and “market neutrality”.

<sup>43</sup> Weidmann (2019), Climate change and central banks Welcome address at the Deutsche Bundesbank’s second Financial Markets Conference, 29.10.2019, Frankfurt am Main, saying: “Our mandate is to preserve price stability, and policy implementation needs to be in line with principle of market neutrality. Skewing asset purchases to green bonds, say, would run counter to this principle, which is anchored in Article 127 of the EU Treaty.” Lautenschläger (2019), A call for Europa, Heinrich Heine Universität Düsseldorf, 30.10.2019, saying: “(...) we have to make sure that we are not creating market distortions, of course – we have to remain market-neutral. This means that the ECB can only buy a limited amount of the green bonds available on the market.” Mauderer (2019), Structural changes in financial markets and implications for monetary policy implementation Speech at the DZ Bank International Capital Markets Conference, 29.08.2019.

<sup>44</sup> Bindseil et al. (2017), The Eurosystem collateral framework explained, ECB Occasional Paper Series No. 189, European Central Bank.

<sup>45</sup> Cf. the G20’s June 2012 Los Cabos declaration calling for reducing the reliance on credit rating agencies’ ratings and subsequent reports by the FSB (e.g. Peer Review Report of May 2014).

turn-away by the ECB from using these ratings seems rather hypothetical as there are no convincing arguments why the ECB would be better able to assess sustainability risks as the specialised credit rating agencies can. Also, sustainability-oriented credit quality assessment of collateral by the ECB would sit oddly with the EU prudential framework and with the several initiatives recently launched to embed environmental, social and governance (ESG) factors in this framework.<sup>46</sup>

In our opinion, a more appropriate option for the ECB to incorporate sustainability concerns into its collateral policy would be a “minimum green share collateral policy”: For each counterparty, the ECB may set an identical minimum share of collateral assets by that counterparty that must be green. This may increase the attractiveness of sustainable assets, increase demand and lower capital costs of sustainable investment and endangers neither the ECB’s market-neutrality nor the risk-oriented approach of collateral policy.

In order to act in a market neutral way, the minimum share of green assets must reflect the share of green assets in the overall market for eligible assets. Currently, this share is well below 5%, but rising. According to the ECB, 9% all euro nominated bonds issued in 2019 were green, social or sustainability bonds.<sup>47</sup>

We do not expect the ECB to decide upon whether or not a security relates to a sustainable activity. Such decisions may be very contested and of a political nature. Rather, the ECB might refer to the green taxonomy regulation as adopted by the European Parliament and the Council. All securities relating to activities that have been found to be green (or sustainable) according to the taxonomy could then qualify for the minimum green share of collateral. In doing so, the ECB would maintain its independence and stay out of political controversy.

Two caveats however apply. First, the taxonomy has been adopted, but is not yet operational. The development of the green bond standard, based upon the taxonomy, is still pending. It may take years for economic activities to qualify as sustainable and hence for issuers to demonstrate taxonomy-green securities that may qualify for the ECB minimum share treatment. Secondly, although the taxonomy sets the EU-standard for environmental, social and governance investments, it will deal with environmental investments first. And when doing so, it will prioritise a subset of environmental investments lie climate over others, e.g. biodiversity. This means that at least during a transitional phase, only some security issuers can qualify as green, whereas others have to wait for the precise taxonomy criteria. This time-lag questions the market neutrality of the minimum green share approach. If the ECB were to take that seriously, it would have to wait for the full application of the environmental part of the taxonomy, before it puts the minimum green share collateral policy into practice.

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<sup>46</sup> See ESMA's Strategy on sustainable finance, 6.02.2020, accessible at <https://www.esma.europa.eu/press-news/esma-news/esma-sets-out-its-strategy-sustainable-finance>; EBA's Action Plan on sustainable finance, 6.12.2019, accessible at <https://eba.europa.eu/financial-innovation-and-fintech/sustainable-finance#collapseOne>; an overview of EIOPA's ongoing initiatives in the area of sustainable finance as listed at [https://www.eiopa.europa.eu/browse/sustainable-finance\\_en](https://www.eiopa.europa.eu/browse/sustainable-finance_en).

<sup>47</sup> ECB (2020), [The international role of the Euro](#), June 2020

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