Central Banks

Climate Objectives in Central Banks' Funding Operations: how close to Green TLTROs?

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Executive Summary

Refinancing operations are a core monetary policy tool to provide liquidity for credit institutions. Whereas traditionally such operations have been short-term, since the Global Financial Crisis many central banks have been making increasing use of them and extending their maturity. Recently, some central banks in advanced economies, such as the Bank of Japan (BoJ), have started to align their objectives with the goal of a transition to a low-carbon economy, linking its monetary policy to climate change objectives. In fact, monetary policy is only one of the tasks affected by central banks' commitment against climate change; in addition to the contribution that the institution itself can make to financial stability and supervision and the drive for analysis and data availability. In this short-note we highlight the main characteristics of the BoJ funding support for the response to climate change. We then summarise the ECB's position on this issue, derived from its recent strategy review. **The BoJ has been the first to launch green liquidity operations, but in our view the definition of what is "green" seems quite loose and it remains to be seen the appetite of banks for such operations** (first auction in late December); although they have an incentive of twice as much as the amount outstanding of funds that counterparties receive (cost of 0%) to apply for this funding. Although it is understandable that central banks launch this type of operations to help in the transition to a greener economy and **the ECB has been very vocal in assuming a clear role in the fight to climate change**, **in its strategy review the ECB concludes that certain obstacles must be overcome in order to be able to launch these green TLTROs with minimum guarantees** (they see caveats in terms of definition and verification, and of the level playing field). Moreover, this should go hand in hand with the adaptation of the collateral framework. In addition, central banks should be careful not to put at risk their independence assuming goals that go beyond their mandate.

Pioneer, the Bank of Japan

The Bank of Japan at its June monetary policy meeting unveiled a plan to boost funding for fighting climate change (Funds-Supplying Operations to Support Financing for Climate Change Responses), joining a growing number of central banks that are stepping up efforts to address its economic and financial consequences. The BoJ decided to introduce a new fund-provisioning measure for financial institutions that increase loans and investment for activities aimed at combating climate change. The details of the measure were decided at its September Monetary Policy Meeting, and the fund-provisioning will likely be by year-end.

How is the program designed?

Purpose: To provide funds to financial institutions within the amount outstanding of their investment or loans that contribute to Japan's actions to address climate change, with a view to supporting private sector efforts on climate change.

Eligible counterparties, eligible investment/loans: Counterparties make investment/loans based on their own decisions. Discipline will be exercised through a certain level of disclosure.

- Financial institutions that disclose a certain level of information on their efforts to address climate change.
- Of the investment/loans made by counterparties as part of their efforts, those that contribute to Japan's actions to address climate change.

In this regard, **the BoJ does not seem to have an advanced taxonomy but rather is being quite lax as to what they seem to be able to accept**.

Terms and Conditions: Long-term support for financial institutions' efforts.

- Interest rate: 0% - The measure will fall under Category III (applied interest rate: 0%) in the Interest Scheme to Promote Lending.
- Twice as much as the amount outstanding of funds that counterparties receive will be added to the Macro Add-on Balances in their current accounts at the Bank (which is an incentive for banks).
- Duration of fund-provisioning: 1 year; rollovers can be made until the end of the implementation period. Effectively, this implies long-term financing from the Bank.
- Implementation period: in principle, until the end of fiscal 2030. The first loan disbursement is planned to take place in late December. Thereafter, loans will in principle be offered biannually.

And in Europe, will “green TLTROs” reach the ECB? Probably but not yet

In the recent review of its strategy, the ECB brought to the fore its firm commitment to climate change considerations in the conduct of its monetary policy. It acknowledged that physical and transition risks related to climate change have implications for both price and financial stability, and affect the value and the risk profile of the assets held on the Eurosystem’s balance sheet. The review outlined a comprehensive action plan, with an ambitious roadmap that covers key areas of ongoing and planned actions. The ECB acknowledged that an important part of the plan involves Eurosystem reliance on external developments, and thus incorporates inherent uncertainties. This includes the implementation of measures related to adoption of EU disclosures regulations. In summary, in this revision there is a lack of any specific move to green the ECB’s large refinancing operations (TLTROs), but it includes climate change considerations in monetary policy operations in the areas of disclosure, risk assessment, collateral framework and corporate sector asset purchases. It is worth noting that a general support to the central bank intervention is that the correction of the climate negative externality requires *"...replace the* ***market neutrality principle*** *by a* ***market efficiency principle****"*[1]. In this vein, with a broader consideration of

1 Isabel Schnabel, "From market neutrality to market efficiency", 14 June 2021. Welcome address by Isabel Schnabel, Member of the Executive Board of the ECB, at the ECB DG-Research Symposium “Climate change, financial markets and green growth”.

market efficiency principle, that in the reference is limited to the balance sheet operations of the ECB (non financial corporations and sovereign issuers), it might be feasible to bias TLTRO conditions to favour greener banking loans.

In this regard, on the TLTROs, **a recent ECB** paper[2] **which explores the possibility of Green TLTROs suggested that they could be structured to preserve the objective and modalities of standard TLTROs, while at the same time including incentives for banks to invest in green activities**. However, the central bank stressed that the **feasibility of such operations hinges on the availability of a proper definition of "green lending"**. While in principle the definition of green lending could rely on **the Commission's EU Taxonomy Regulation**, the monetary authority remarked that "the taxonomy **is not sufficiently prescriptive at present"** (only 2 of the 6 objectives of the green taxonomy have been defined, and discussions are underway on whether to introduce a social taxonomy and an intermediate taxonomy) **"**and banks do not collect the necessary information systematically". The central bank mentions **an important caveat,** which is **the absence of a consistent definition of environmental sustainability and of a reliable system of verification**, as it is unclear how to ensure that the fungible funds provided by banks are correctly and effectively used by individual borrowers to finance green projects. According to this, **substantial work would be needed** to improve data coverage and quality, including loan classification for debtors not subject to disclosure requirements (firms subject to Corporate Sustainability Reporting Directive will only disclose this information since 2024 and the rest do not have a clear deadline), and to set up the necessary verification processes and capacities.

The central bank concludes that these issues, "**given the essential role of TLTROs in supporting the economy and the need to ensure the most effective targeting, and in light of the need to overcome a number of hurdles, it seems premature to concretely envisage targeted green operations at the current juncture."** At the same time, progress on greening collateral framework and Green TLTROs ideally should work in tandem, as the collateral framework also has an important role in financial stability as it determines the conditions under which banks can access central bank credit.

In the meantime, the debate on Green TLTROs is there and could be intensified in the near future. As an example, there is a recent proposal for these kind of TLTROs, i.e. refinancing operations that provide banks with cheap funding if they lend in accordance with the EU's taxonomy of green activities; in particular, a pilot programme for energy efficient housing is suggested[3].

In summary, Green TLTROs seems to be in the roadmap of the ECB but not to be released in the short term. The ECB is aware that, when appropriate, it should be announced with a timely communication and a sufficiently long adaptation period which makes one think that they would never go as fast as the BoJ.

2 Climate change and monetary policy in the euro area.
3 See Targeting a sustainable recovery with Green TLTROs, Jens van 't Klooster and Rens van Tilburg September 2020 published by Positive Money Europe and the Sustainable Finance Lab.

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