Interview with Börsen-Zeitung

INTERVIEW

Interview with Yves Mersch, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, conducted by Kai Johannsen and published on 21 November 2020

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Mr Mersch, is it part of the European Central Bank's mandate to engage with the capital market segment of green and sustainable finance?

The EU Treaties require the ECB to give primacy to the objective of price stability. If ECB's engagement with the green and sustainable financial sector were necessary for maintaining price stability in the euro area, it would fall within the remit of our primary objective. I don't think that applies at present.

In addition, the ECB has what are known as secondary objectives. Without prejudice to our primary objective of price stability, we support the general economic policies in the EU "with a view to contributing to the achievement of the objectives of the Union". One of these objectives is to work towards "a high level of protection and improvement of the quality of the environment". This justifies why the ECB is also looking into sustainability.

However, contrary to what some may argue, that does not mean that the ECB is free to take the initiative and decide itself how "a high level of protection and improvement of the quality of the environment" is to be achieved. For good reason, that remains the privilege of elected politicians.

What are the risks facing green and sustainable finance over the coming years?

I would see it as a risk if green finance degenerated into a pure marketing tool. If investors want to make the world a greener place, they need to know how their investments contribute to more sustainability. To put it in technical terms, I see the risk of informational market failures if information on the sustainability of businesses and financial products is inconsistent, largely not comparable and at times unreliable or even completely unavailable. Definitions of what constitutes a sustainable investment are often subjective and inconsistent. The EU taxonomy is a promising initiative, albeit incomplete. Its practical usability remains a challenge. Plans are also under way for widely applicable industry standards.

What else is needed?

Better and more standardised non-financial reporting will also be crucial. This is essential for correctly pricing the risks. Sound reporting is the cornerstone of appropriate risk management.

Finally, financial institutions, including banks, need to ensure they can identify at an early stage, and deal with, the risks emerging from the effects of climate change and a rapid transition to a carbon-neutral economy.

Only once these prerequisites are met can sustainable finance prosper and have a tangible impact on the real economy. Otherwise there remains a risk of “greenwashing” and of an unsustainable “green bubble” detached from fundamental data.

The EU taxonomy for green and sustainable finance is a complex system of classification intended to give investors and providers of financial products certainty as to what can be classified as green and sustainable. Is this a masterstroke by the EU that will advance this market segment and possibly also serve as an example for other countries and regions?

The EU Taxonomy Regulation is important. A sound classification system provides investors with valuable information for their investment decisions. The taxonomy was designed with green bonds in mind. Its application to other financial products may not be as straightforward and the overall design might need to be adjusted.

Moreover, the system is indeed very complex.

What does that mean for risk assessment in practice?

I see a certain gap between its envisaged objective and its practical usability.

However useful the taxonomy may be for green investment decisions, it will not help in the risk assessment of economic activities exposed to climate risk. Finally and more fundamentally, the taxonomy is only one piece of the puzzle: granular data at the corporate level are required in order for it to be usable.

If we address these shortcomings, the EU can set an example for the parallel processes now under way in other countries. We have one of the most advanced frameworks for sustainable finance. The EU taxonomy can be an important element in promoting the EU regulatory approach abroad, and in strengthening the EU's role as a global hub for sustainable finance.

When do you expect financial markets and market participants to be fully green and sustainable?

I don't think that the entire financial sector will one day be green. There are many industries that are neither clean nor dirty and they also raise funding on the market. Moreover, I don't think we can stop climate change by choking off entire sectors of the economy. We should rather create the right incentives through, say, fiscal policy measures, including carbon pricing and other regulatory tools.

Finally, the financial sector can indeed help, but it can't save the planet on its own.

We are now transitioning towards green and sustainable capital markets: what specific transition risks do you see in this phase?

The transition towards a greener and more sustainable capital market may lead to a repricing of assets. If this adjustment happens abruptly, i.e. if the redirection of capital proceeds in an unexpected or disorderly way, we talk about transition risks.

However, compared with the potential economic losses arising from climate risks, the transitory losses that may occur are paltry. But individual banks could certainly be hit hard: the bulk of exposures to the most energy-intensive borrowers are held by just a few banks. In other words, a few banks have very high exposures.

Are the banks already providing sufficient disclosure on specific risks that are neither green nor sustainable, i.e. largely brown assets, and do you already incorporate these in the ECB's banking supervision? How far do the banks go in their disclosure and do they go far enough for the ECB?

I see a need for further action in that regard. It's true that the disclosure of climate-related risks has improved, but mostly the information is just not detailed enough, and only seldom supported by quantitative data.

We will soon be publishing a "Guide on climate-related and environmental risks". The Guide sets out how, in our view, institutions should take climate and environmental risks into consideration in their business strategies, governance and risk management frameworks and how these are to be disclosed. We looked at the disclosure for last year from a sample of the institutions that we supervise – more than half of them did not even meet the minimum requirements set out in the Guide. In relation to this we will soon be publishing a report on the disclosure of environmental risks of the banks under our supervision.

Does that provide any first lessons for the ECB?

Yes. That is why we will devote our 2022 stress test to the topic of climate change. This stress test should not only be analytical and top-down, but, in the hope of a better data situation, a better taxonomy and better standards, also enable a meaningful bottom-up approach.

Are you concerned that a major case of greenwashing could arise, which could trigger a chain reaction and result in a sharp downturn in the financial markets? Are the markets sufficiently forearmed against this, or in other words, are they stable enough?

There is no doubt that greenwashing is an issue, even if an improvement is in sight. The European Commission will soon present a legislative proposal for an EU green bond standard. However, a green bond does not necessarily tell us how green a company is as a whole. The classification relates instead to individual assets that these bonds are intended to finance. These assets are only part of the company’s balance sheet, which could indeed also include conventional assets with a bigger carbon footprint. Thus, on their own, green bonds are not sufficient for a greener real economy.

What would in your view be helpful?

A welcome Commission initiative concerns the introduction of an EU ecolabel for financial products and in particular for investment funds. This should allow retail investors who are concerned about the environmental impact of their investments to rely on a trustworthy and verified label and hence make informed investment decisions. At the same time incentives could be created for financial markets to develop more products with a reduced or positive environmental impact.

It remains a problem that markets may not yet be able to correctly assess the fundamentals of green financial products. This is for instance the case with green bonds, where there are large differences in the extent to which the bond proceeds are truly invested in green and sustainable projects.

How important are sustainability ratings? Do you already deploy these ratings in your supervision? Are the ratings robust enough for an appropriate estimation of risks and opportunities?

The current environmental, social and governance (ESG) ratings of banks do not reflect their lending to companies with high carbon emissions. Similarly, they are also not an appropriate measure of credit risk. These ratings are more concerned with social responsibility.

Carbon emission figures could provide a better proxy for the physical and transition risks to which companies are exposed.

An issue that comes up repeatedly is that each agency uses different metrics for their sustainability ratings: the same data are assessed or weighed in different ways. Should providers therefore report several sustainability ratings or just one?

The fact that ratings vary so much across providers is largely due to three factors: first, the underlying raw data and calculation methodologies;

second, the methodologies used to compute the ratings; and, third, the qualitative elements underlying each assessment. Therefore, providers should present metrics and ratings in a transparent way so that investors can understand them.

What is even more important is that data gaps in the underlying data are closed. This brings us back to disclosure, for which the taxonomy framework and reliable labels for sustainable financial products – including an EU standard for green bonds – are crucial.

Does the ECB deploy green and sustainable investments in its fund management – of pension funds, say? If so, what are the investment criteria, what kinds of investment are excluded?

The pension funds are managed autonomously. The management has undertaken to adhere to the United Nations Principles for Responsible Investment and thus to include sustainability standards.

In addition, we have increased the share of green bonds in our own funds portfolio and will continue to do so in future. We follow the Sustainable and Responsible Investment Guide for Central Banks’ Portfolio Management from the Network for Greening the Financial System, of which we are a member.