Technical note: An ECB Rapid Decarbonization Plan

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Last week, the President of the ECB hinted that central banks should review their bond portfolio and other operations with regards to climate change:

> *"Ms Lagarde called on central bankers to 'ask themselves' if they were taking 'excessive risk' by trusting markets to correctly price environmental issues." ([FT], 14 Oct, 2020)*

We would agree on Ms Lagarde's hypothesis and suggest a reduction of such excessive risk taking.

In that vein, we propose a High-Level Excessive Emissions Grouping (HLE_2G) for the ECB's own operations, which – if implemented – could de-risk and decarbonize the ECB's portfolio and withdraw funding support for what to potentially more climate risk sensitive issuers. We base the HLE_2G on the ECB's own eligible asset list and the methodology described on the next page.[1]

We estimate a CO_2 footprint of around 3.5GT per annum from these issuers, roughly equivalent to 80% of the European Union's total annual CO_2 emissions.

Figure 1. High-Level Excessive Emissions Grouping, HLE_2G.

Issuer	Exclusion type	Ticker	Reference ISIN	CDS index
EnBW	Coal power	ENBW	XS0438844093	
ENEL	Coal power	ENELIM	XS0647298883	Main
Engie	Coal power	ENGIFP	FR0012990984	Main
ENI	Coal power	ENIIM	BE6305712331	Main
EP infrastructure/EPH	Coal power	ENAPHO	XS2034622048	
Fortum	Coal power	FUMVFH	XS1956037664	Main
Glencore	Coal operations	GLENLN	XS2228892860	Main
ArcelorM	Coal operations	MTNA	XS1936308391	Xover
CEZ AS	Coal power	CEZCP	XS2084418339	
Rio Tinto	Coal operations	RIOLN	XS0863076930	Australia
Vattenfall	Coal power	VATFAL	XS0417209052	
Anglo American	Coal operations	AALLN	XS0764637194	Main
EDP	Coal power	EDPPL	PTEDPNOM0015	Main
EDF	Coal power	EDF	XS0158194562	Main
Export Development Canada	Tar sands	EDC	XS1959338630	
Province of Alberta	Tar sands	ALTA	XS2149308970	
BP	Oil operations	BPLN	XS1040506112	Main
Equinor	Oil operations	EQNR	XS2178833427	Main
Lukoil	Oil operations	LUKOIL	XS0304274599	
OMV	Oil operations	OMVAV	XS2189614014	
Repsol	Oil operations	REPSM	XS2156583259	Main
Schlumberger	Oil operations	SLB	XS1898256257	
Shell	Oil operations	RDSALN	XS1476654584	Main
Total	Oil operations	TOTAL	XS1138641508	Main
BASF	Petrochemicals	BASGR	DE000A188WW1	Main
Arkema	Petrochemicals	AKEFP	FR0011651389	
Saint-Gobain	Cement	SGOFP	XS2150054372	Main
Heidelberg Cement	Cement	HEIGR	XS1387174375	Main
Holcim	Cement	LHNVX	XS1019821732	Main

The advantages of HLE_2G are its ease-of-implementation, parsimonious approach and its complementary characteristic to the green in the forthcoming EU Green Taxonomy. The majority of the highlighted issuers are traded in the main European credit indices, indicating relevance to the credit market.

Please be aware of the preliminary and draft nature, based on incomplete information, of the proposed list. Be aware that the eligible asset list is not the same as bond holdings under the CSPP.

[1] Available through List of eligible marketable assets, 15 Oct 2020.

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Construction of the list

The proposal has been generated through the ECB's own disclosure of credit risk holding as per the eligible marketable asset list, and our own overlay from public information sources. We make no assurances whatsoever with regards to the validity of those sources or the quality of our analysis: the list should only be viewed as an indication of what a Rapid Decarbonization list could look like. The High-Level specification is exactly that, we have focused on the key names from a credit perspective in the ECB list. If we were to operate a climate focused credit portfolio, we find the set of issuers reasonable to be underweight in from a legacy carbon exposure perspective.

We use a few simple rules:

- **Coal power generation** in excess of 1GW.
- **Coal operations,** such as mining or logistics, at a significant level.
- **Tar sands**, any operations and/or funding.
- **Oil majors** and active producers and developers.
- **Petrochemical** production at a significant level.
- **Cement** production at a significant level.

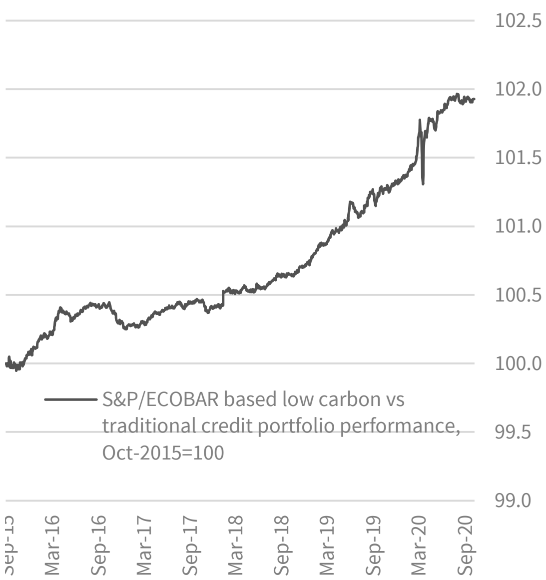
One might make an argument that some of the issuers are currently transitioning and thus should receive public support for such a process. However, we consider the issuers as historical beneficiaries of public support through carbon allowances/not accounting for their negative externalities, which are de facto now materializing as cost items for public coffers.

Performance considerations

In our earlier report *Low carbon credit performance, 2020Q3 update*, we review performance of a low-carbon tilted portfolio on an apple-for-apples comparison to a standard bond index. Over the past year, a lower carbon version of the index has outperformed the traditional version by 38 basis points per annum on average.

The results presented in Figure 2 are based on US investment grade bond data which makes it a good, if not perfect, indicator for European bond markets, and the relative performance of an ECB Rapid Decarbonisation program.

Figure 2. Low carbon vs traditional bond index relative return index.



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