The European Central Bank and the Future of Ethical Debt Market

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When assuming the position of President of the European Central Bank (ECB), Christine Lagarde decided to perform a strategic review of monetary policy as one of the first objectives of her term. The review aimed to take account on the ECB's agenda of the social and climate challenges faced by European society. According to Lagarde, the ECB should join forces with European institutions to counteract the threats of the 21st century, such as climate change and social inequality. This is because financial markets bear joint responsibility for building a sustainable development economy that reconciles economic interests with social responsibility.

Social responsibility is something relatively new when speaking of financial markets. Markets have always been a place for raising capital and maximising profits at some acceptable level of risk. The realisation that there is an ethical dimension to the activities of market actors, where acting for the higher and general good may conflict with financial self-interest, testifies to significant qualitative changes in the world of finance. These changes are all the more meaningful because ethical reflection on the activities of market actors is not only stimulated by mounting social pressure for qualitative changes, but also because the actors themselves are increasingly aware of the need to encourage financial institutions to engage in global efforts to promote sustainable development.

This increased awareness among investors, who are more and more interested in how the capital they lend will be used, indicates the emergence of an ethical debt market. Their involvement in the promotion of a sustainable economy puts an extra pressure on issuers to use the funds obtained in a socially responsible manner. Ethical debt instruments raised in this way oblige issuers to spend their loan facilities on objectives which are socially or environmentally positive for society. Thus, the benefits of such instruments are reaped not only by investors in the form of coupons, but also by the whole of society; for example, by enjoying cleaner air or better access to education.

The market for ethical debt securities has gained momentum in recent years. The green bonds market is by far the most popular, with a total value of issued bonds exceeding \$1 trillion in 2020. Among EU countries, Poland was the first to issue green bonds. Soon other countries followed, including France, Belgium, Lithuania, Ireland, the Netherlands, Hungary and Germany. Another ethical debt instrument is sustainable development bonds. Funds raised from these instruments are allocated in accordance with the United Nations Sustainable Development Goals (SDG) which aim to achieve "a better and more sustainable future for all". These goals include, for example, clean water, education, and climate action. Ethical debt instruments also include ESG bonds, where the issuer undertakes to spend the acquired capital to promote the environment, social responsibility and corporate governance; blue bonds, intended to finance projects aimed at saving aquatic life and water quality; vaccine bonds, supporting the distribution and promotion of vaccines to help prevent mortality in children up to five years of age. In addition, there are many other bonds devoted to financing "local" ethical goals: for example, Tobacco Control Social Impact Bonds, which support Zambian farmers in transition to alternative crops; Rhino Impact Bonds, which finance the protection of endangered species; and Youth Employment Bonds, which support employment programmes for young people unemployed for at least one year.

The ECB as a bond market actor

In recent years, central banks have become the key actors in the debt market, running bond purchase programmes all over the world. In Europe, the ECB has launched the Asset Purchase Programme (APP) to purchase debt securities on the secondary market. The securities purchased are issued both by state treasuries within the euro area under the Public Sector Purchase Programme (PSPP), and by the private sector under the Corporate Sector Purchase Programme (CSPP), the Asset-Backed Securities Purchase Programme (ABSPP), and the Covered Bond Purchase Programme (CBPP). The PSPP constitutes the largest part of the APP, representing more than 80 per cent of the total market. Originally intended to be only a temporary instrument for extraordinary interventions, the APP has become a permanent tool of the ECB's monetary policy, alongside such standard instruments as interest rates or open market operations (OMO).

Under Christine Lagarde, the ECB has declared its readiness to help combat climate change. The bank conducts economic analyses to assess the impact of climate change on the stability of market prices and the financial system, and monitors how the euro zone banking sector manages climate risks. These initiatives are supposed to accelerate the identification of threats that climate change may inflict on the financial system. On 25 January 2021 Lagarde announced the appointment of a special internal ECB task force to assist the advancement of the green agenda across the euro area. The ECB is also a member of the Network for Greening the Financial System (NGFS). Within the network, which includes other central banks and financial regulators from five continents, the ECB supports the transition towards a low-carbon economy.

These actions are important, increasing awareness among market participants and fostering the development of ethical financial instruments. Nonetheless, they limit the ECB's role to that of a "commentator" on the market situation which forecasts, analyses, evaluates and supervises, but does not actively create the market. Meanwhile, the unprecedented demand for bonds that the ECB generates through the APP determines price formation on the secondary market and gives the bank real power to shape the market.

This essay examines the power of the ECB to steer demand for bonds towards ethical debt instruments in order to make a real contribution to the development of an ethical debt market. First, the legal and economic context in which the ECB currently operates will be discussed, to establish the legal basis and the economic rationale for focusing its purchase programme on ethical bonds. Next, two scenarios will be considered for a targeted purchase of ECB's ethical bonds: under the current APP and under a separate, dedicated purchase programme. Finally, the current legal situation of the ethical bond market and the role of the EU in the ECB's ethical bond purchase action will be outlined.

Legal context of the ECB's purchase programmes

Primary law makes the European System of Central Banks (ESCB) responsible for conducting monetary policy. Article 127 of the Treaty on the Functioning of the European Union (TFEU) states "the primary objective of the European System of Central Banks ... shall be to maintain price stability". However, the article continues: "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 goals listed in Article 3 of the Treaty on European Union (TEU) include among others "balanced economic growth ..., [a] social market economy aiming at ... social progress and a high level of protection and improvement of the quality of the environment". It follows from the two treaties that while the main activities of the ECB are focused on maintaining price stability in the euro area, the bank also supports other Union policies, such as sustainable growth, social progress and improving the quality of the environment. Consequently, promoting the development of a market for ethical social and environmental bonds is not only a wise choice by the ECB but also its duty.

The powers granted to the ECB are considerable. Enjoying substantial autonomy, due to the relatively limited number of treaty provisions governing its operation, the ECB has been able to design a new, non-standard instrument to advance its monetary policy, the APP, which was not originally foreseen. The primary task of the ECB is to monitor price stability, as provided for by Article 127 TFEU. To meet this task, the ECB has various instruments, such as the system of minimum reserves or open market operations. Under open market operations, "the ECB ... may operate in the financial markets by buying and selling outright ..." At the same time, Article 123 (1) TFEU stipulates that "the purchase directly from [Member States] by the European Central Bank ... of debt instruments ... shall be prohibited". The combination of these provisions has allowed the ECB to create an instrument of "operations in the financial markets by buying" sovereign bonds "not directly from the Member States", i.e. on the secondary market, in order to achieve a better transmission of monetary policy, thus achieving price stability.

The framework of the programme is entirely determined by the ECB. The bank sets its volume through the rate of monthly purchases and the proportional distribution of purchases among countries, based on the so-called key for capital subscription. In addition, the ECB determines purchase limits in relation to the issuer and a specific security, and limitations on the execution of purchases. The ECB has resolved that, with regard to the PSPP, a certain minimum and unspecified period must elapse from the issuance of bonds until the possibility of their purchase by the ESCB, the so-called blackout period; this is to prevent the ECB from having any influence on price formation in the primary market. The ECB also only publishes data on total purchases at an aggregate level. This set of self-limiting measures by the bank is to guarantee the programme's compliance with Article 123 (1) TFEU.

Controversies around the ECB's purchase programmes

However, concerns about the lawfulness of the purchase programme, especially in its public part, have been regularly raised since its onset. The German Federal Constitutional Court requested the Court of Justice of the European Union (CJEU) to investigate a possible breach by the ECB of its mandate and of the prohibition on financing the EU member states. On 11 December 2018, the CJEU confirmed the monetary nature of the PSPP and thus its legal validity. In justifying its judgement, the CJEU found that because the injection of liquidity provided by the PSPP to the private sector facilitates credit provision to the euro area economy, supporting in this way aggregate consumption of firms and households, the higher expenditure thereby stimulates price growth and ultimately contributes to achieving the ECB's inflation target. It follows that the purpose of establishing the PSPP is price stability and therefore it falls under the ECB's mandate.

The opinion of the CJEU is extremely important for considering the role that the ECB could potentially play in advancing an ethical debt market. The CJEU's decision means that the basis for the validity of the purchase programme is its goal. The programme is legally valid because it seeks to improve the transmission of the ECB's monetary policy and, consequently, achieve price stability. It follows that the pursuit of any other goals, such as support granted to member states or, in the context of this discussion, facilitating the development of an ethical debt market, cannot invalidate the programme.

At the same time, the CJEU acknowledged the lawfulness of the programme only "as is,": specifically, in the form in which it was presented to the court, with all the underlying guarantees mentioned above. This point was stressed by the Advocate-General of the CJEU, Melchior Wathelet in his opinion on the judgement: "The validity of a programme such as the PSPP is therefore dependent on the guarantees surrounding it". A different programme structure, or any subsequent modifications to its form, such as linking purchases with the ethical nature of securities, could therefore potentially result in a negative assessment of its validity by the CJEU if the programme's ultimate goal was no longer monetary.

The above analysis demonstrates that the validity of the purchase programme rests on its monetary nature. However, beyond the programme's legal validity, a question also arises about the purpose of purchasing ethical debt instruments. Is the ECB able to have a real impact on the development of an ethical debt market through its ethical securities purchase programme?

The relevance of securities purchases to an ethical debt market

The ECB is already purchasing green bonds under both the public and the private components of the APP. The exact volume of purchases remains unknown, because the ECB does not disclose statistics on specific securities and only publishes aggregates for a given month, due to the as-yet modest size of the market. In the case of the public sector, green bonds still only account for around 1 per cent of the euro area's entire sovereign bond market. The ECB's green bond portfolio is consequently small, and analyses show that covering these bonds through the purchase programme has already contributed to falling yields, increasing the issuance of such bonds by the non-financial sector. For example, the trajectory of green corporate bond yields before and after the launch of the CSPP programme on 10 March 2016 shows a clear narrowing of the spreads between green bonds and reference bonds. The demand driven by the ECB has enabled issuers to finance their green spending at a lower cost, thus providing a stimulus for a more active engagement in environmental projects.

Despite the fact that the ECB already purchases green bonds under the APP, the framework of the programme does not provide for any declarative environmental or social objective. The purchase of green bonds by the ECB is therefore carried out as a "side effect", because these bonds made it to the basket of securities that were available for purchase. In fact, one of the distinguishing features of the APP is its multilateral neutrality. In the case of the PSPP, it is primarily expressed through proportional purchases made among EU countries, corresponding to their share in the ECB's capital – the "key for capital subscription" mentioned above. In the case of private sector instruments, purchases of green bonds are aligned with the availability of securities across different business domains and ratings. Other attributes of the APP that testify to its neutrality include purchases along the entire yield curve, adjusting the size of its programmes proportionally to demand and to regular inflation-adjusted revisions in line with the inflation target. The wide range of criteria is intended to allow for flexibility regarding the available instruments. Yet it also means that the APP does not discriminate, either positively or negatively, on the basis of the ethical or non-ethical nature of traded securities.

Against this background, the question arises whether the ECB could "stitch" ethical bonds into its purchase programmes in such a way as to contribute to supporting the development of an ethical debt market. In other words, does the ECB have the capacity to make ethical debt a point of interest for securities purchase programmes? There are two options for combining the ECB's purchase policy with ethical bonds: either under the existing APP or under a new programme devoted exclusively to ethical debt instruments.

Purchase of ethical bonds under the APP

In order for ethical bonds to make their way into the APP and have a specific purchase percentage allocated, it would in the first place have to be technically feasible. As mentioned earlier, the PSPP is the largest of the APP's schemes. Despite the positive trend of issuing ethical debt among European countries, the market for ethical sovereign bonds is still relatively small. One of the main assumptions of the APP (and one of the main reasons that the CJEU approved the programme) is to conduct purchases according to the capital key. Meanwhile, most euro area countries have not yet issued any ethical sovereign bonds. Due to both these factors, the even distribution of purchases of ethical debt instruments among EU member states is not possible.

Beyond these technical aspects, in order to link the APP with ethical debt the ECB would have to justify that their purchase specifically supported the programme's objective, compared to the purchase of "standard" bonds. This objective is "further enhancing the transmission of monetary policy, facilitating credit provision to the euro area economy, easing borrowing conditions of households and firms and contributing to returning inflation rates to levels closer to 2 per cent, consistent with the primary objective of the ECB to maintain price stability". The ECB thus justifies the implementation of the APP on the grounds that the purchase promises price stability through better monetary policy transmission. The question that then arises is whether the purchase of ethical bonds has a higher monetary policy transmission potential than the purchase of conventional securities and, therefore, deserves a special place in the APP.

Meanwhile, the ECB's rationale for implementing the APP is purely monetary. Referring to the PSPP, the ECB explains that "the sizable purchase volume ... will contribute to achieving the underlying monetary policy objective of inducing financial intermediaries to increase their provision of liquidity to the interbank market and credit to the euro area economy". The purchase of securities on the debt market is intended to increase liquidity in the financial sector, as this will further relax borrowing conditions for the real economy, meaning for businesses and households. This relaxation will in turn contribute to an increase in consumption and investment, and thus will translate into an increase in inflation. The direct objective of the APP is therefore to provide liquidity to banks which can then transmit it into the real economy through their lending activity, rather than funnel liquidity into any specific economic sector. Consequently, the ethical or unethical nature of bonds does not have a bearing on the operations of the APP.

Could the ECB overcome this problem by designing a separate debt purchase programme dedicated solely to ethical debt instruments?

Purchase of ethical bonds under a new programme

As noted, any ECB debt purchase programme must first and foremost serve monetary purposes, as confirmed by Article 127 TFEU. A new programme, under which the ECB would purchase only ethical bonds, would therefore have to demonstrate that the provision of liquidity to specific sectors of the economy, related to sustainable, green or socially responsible growth, can significantly contribute to restoring or maintaining price stability.

In this context, climate change and social inequalities are not impervious to the formation of market prices for goods and services. Droughts affect the supply of agricultural crops and drive prices up. Floods damage infrastructure and private property and increase insurance coverage costs in hazard areas. Global warming causes fluctuations in energy prices, which are a constituent of the Harmonised Indices of Consumer Prices (HICP) used by the ECB. Overregulation leads to higher operating costs for enterprises and, consequently, higher manufacturing costs. These short-term volatilities, if not properly addressed, could have long-term effects on inflation growth, as Lagarde has cautioned.

Given the above, the purchase of ethical debt instruments aimed at preventing such environmental or social effects and thereby counteracting inflationary pressure, has a monetary dimension and thus falls within the scope of Article 127 TFEU. Consequently, the ECB has legal grounds to purchase ethical bonds, alongside conventional bonds under the APP, not only “incidentally” but also to cover them intentionally through some of its purchase schemes.

The ECB itself contends that unfavourable social outcomes or climate change may directly affect inflation. From this perspective, Article 127 TFEU provides that the ECB has not only the option but an obligation to take preventive action. For example, at the end of 2018 the markets expected the APP to come to a close, and hence awaited a general reduction in demand for bonds. The bond yields, including those on green bonds, began to increase and the issuance of new bonds became less attractive to the issuers, as they were forced to pay higher interest on the new instruments. Anchoring interest rates on ethical bonds at a lower level (had the ECB continued to purchase them) would have encouraged issuers to channel their cheaply raised capital into ethical investment projects. The development of an ethical debt market would thus have received significant support by focusing the purchases on ethical bonds under a separate programme, independent of the current general market conditions, but determined by the relevance of ethical areas of the economy for price formation.

Precedence of the ECB's special purchase programmes

In fact, it would not be a novelty for the ECB to establish a special purchase scheme of this type, launched with the specific aim of intervening to counteract undesirable developments in price formation. In response to the COVID-19 epidemic, the ECB devised a temporary Pandemic Emergency Purchase Programme (PEPP) that structurally mirrored the APP. The goal of the PEPP was to counter serious threats to the monetary policy transmission mechanism caused by the epidemic. The ECB responded to a specific threat – the epidemic – which had implications for the transmission of monetary policy and, consequently, for price levels. Similarly, an ethical asset purchase scheme would seek to support specific, ethical changes in the economy, thereby improving the transmission of monetary policy and managing price formation.

Despite the special nature of the PEPP, its structure resembles that of the APP, with the validity of the public component confirmed by the CJEU judgement discussed above. In particular, the PEPP is managed by the capital key, meaning that it maintains the proportionality of purchases with respect to issuers, which is particularly relevant when purchasing sovereign bonds, given that the ECB is prohibited from directly financing EU member states under Article 123 (1) TFEU. If the ECB were to purchase ethical bonds (which still have relatively low liquidity, with some EU countries yet to issue them), it would not be able to do so while respecting the capital key. Therefore, it would be unclear whether a programme driven by the character of the bonds while remaining.selective as regards issuers could be consistent with the ECB's mandate, since it would fail to meet one of the basic criteria of the APP that secured the CJEU's approval for the PSPP.

In the past, however, the ECB has run purchase programmes that were not aligned with the capital key rule: for example, the Securities Markets Programme (SMP), launched in order to solve the problem of non-liquidity and dysfunction of the debt markets in Greece, Italy, Portugal, Ireland, and Spain; and Outright Monetary Transactions (OMT), where the ECB can purchase secondary market debt securities of countries where the transmission of monetary policy is disrupted. OMT remains one of the ECB's monetary instruments, although it has never been used to date. Both programmes envisaged an issuer-selective purchase of sovereign bonds determined by disturbances in the transmission of monetary policy and bond price instability in some European countries. The CJEU, which had the opportunity to address the OMT in its 2015 decision on Gauweiler and others versus the German Bundestag, stated that the specific assumptions of the programme made it monetary, and thus the programme could be carried out, even if it permitted the purchase of sovereign bonds from only some European countries.

The CJEU's approval of the ECB's existing practice as regards the OMT and the PSPP suggests what elbowroom the ECB would need to have in order to establish a new purchase scheme dedicated to ethical bonds. Apparently, as long as the programme goal is monetary, with the purchase aimed at maintaining price stability, the public part of the programme does not have to be aligned with the capital key. The monetary goal of purchasing ethical bonds would justify its implementation, despite the limited pool of issuers because of the currently small size of the ethical bond market. A programme designed in this way would not violate the principle of neutrality because, as in the case of the SMP and OMT, such purchases would not aim to support specific private issuers or member states financially but would be motivated by monetary considerations in purchasing ethical bonds, regardless of the issuer. As long as the purchase was made proportionally in relation to ethical issuers, the principle of neutrality would be respected.

Formal definition of the ethical debt

Although the ECB is already actively involved in combating climate change, its action still lacks an explicit social agenda. This absence deserves attention because of the impact of social inequalities on financial stability. As shown in the above analysis of the legal context of the ECB's operations, the bank has a legal basis for a new purchase programme that is separate from the APP. Such a programme would focus solely on ethical bonds in order to generate demand to support sustainable development investment and curtail the undesirable impact of climatic and social phenomena on price formation.

At the same time, under such a new scheme, the bonds subject to purchase would have to demonstrate unambiguous ethical attributes. Despite the growing popularity of ethical debt instruments in recent years, they have not yet been legally defined, either in domestic or supranational laws. The reasons for this lie in the fact that ethical securities do not formally represent a new legal concept of debt securities, whether in relation to issuer, security, or method of admission to trade. Instead, they fit into the legal definitions of the already existing debt instruments, as sovereign bonds, municipal bonds, corporate bonds, covered bonds, and so on.

To address this problem of legal definition, the International Capital Market Association (ICMA) has proposed the adoption of the following criteria to determine the social or green character of a bond: use of proceeds, meaning whether the acquired funds, in whole or in part, produce social or environmental benefits, such as promotion of universal access to food, drinking water or transport, development of green buildings, investment in renewable energy; project evaluation and selection process, i.e. whether the issuer clearly communicates project selection or rejection criteria to investors; whether the issuer clearly communicates project selection or rejection criteria to investors; management of proceeds, meaning whether the issuer properly supervises the use of funds obtained from ethical bonds for the declared purposes; and reporting, meaning whether the issuer provides investors with information on the use of funds in a transparent and regular manner.

At the EU level, when SURE (Support to Mitigate Unemployment Risks in an Emergency) was established following the COVID-19 outbreak, it was assumed that the social character of the bonds reflected the ICMA's guidelines. However, the ICMA does not have sole authority in this area. For example, when issuing a green bond in 2008, the World Bank asked the independent Norwegian think-tank Center for International Climate and Environmental Research (CICERO) to provide a second, independent opinion on whether the bond had an ethical nature. Meanwhile, different rating agencies are involved in the evaluation of ESG criteria, yet these ratings are inherently subjective and often misaligned with other ratings, due to different methodologies.

Issuers and investors must therefore cope with guidelines for ethical bonds which are not standardised and are often imprecise. Opinions vary over the correct threshold for determining whether a bond qualifies as "green". Does it require 100 per cent, 50 per cent or only 20 per cent of raised proceeds to be allocated to environmental initiatives? Similar differences exist over how to measure social benefits. The absence of legal provisions formally regulating the green or social nature of debt instruments means that the ethical label is not sufficiently defined and, thus, not credible, especially if the issuer is a less prominent entity than an EU member state or a supranational organisation. Insufficient clarity in this regard affects both investors' assessment of bond risk and potential yield and the investment decision itself. The sheer range of recommendations, guidelines and market practices is not conducive to market transparency.

The standardisation of the ethical bond market is thus a prerequisite for its further development and an obligation for the EU regulator. Article 3 TEU states that sustainable growth, full employment, social progress and improvement of the quality of the environment fall within the EU's remit. Through the promotion of social and environmental goals, the EU assumes an obligation to support the development of an ethical debt market.

Defining green securities

The EU is currently working on standardising the definition of green bonds. The aim of the regulation, which is scheduled for the end of 2022, will be twofold: to reduce market fragmentation, attributable to existing market and national practices; and to combat greenwashing, meaning products that do not meet basic environmental standards but merely "pretend" to be green. This coherent EU regulation for green bonds will increase market transparency and foster investors' trust, thus significantly contributing to the further development of the market.

There is also the question of how best to regulate the social bond market. So far, the EU has introduced an obligation of non-financial reporting by some large entities "in order to enhance the consistency and comparability of non-financial information ... relating to ... social and employee-related matters, respect for human rights, anti-corruption and bribery matters". However, there is no single definition of ESG which, as with the green bond market, would provide issuers and investors with a clearer picture of the criteria and thereby stimulate further market development. The EU should therefore start work on the legal framework of the social debt market, following the green bond classification model.

The introduction by the ECB of a new ethical bond purchase programme would have to be contingent upon the development of an EU-wide classification system for green and social bonds that would reassure investors (in this case the ECB) that the purchased instruments contributed to the promotion of ethical aspects of the economy. Once the EU has defined the legal framework of ethical debt instruments, the ECB will hold the full mandate to launch a new bond purchase scheme focused on ethical bonds. •

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