Is QE creating a bubble for carbon-intensive assets?

Fears grow that BoE bond buying could undermine recommendations in financial stability report

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In July, Bank of England governor Mark Carney will present a report to the G20 outlining climate risks to financial stability, but London School of Economic researchers argue the central bank's own corporate bond buying programme could undermine the report's recommendations.

Launched in September 2016, the BofE's £10bn programme has 49.2 per cent allocated to utilities and manufacturing, which are responsible for 52 per cent of UK emissions while accounting for 11.8 per cent of gross value added.

This could disproportionately increase bond prices and encourage additional debt issuance in high-carbon sectors relative to low-carbon alternatives, argues the LSE report.

The concerns are true also of the ECB's programme, which has accumulated €75bn of corporate bonds. Shell and Volkswagen have both been beneficiaries of bond buying, with corporate debt issuance for the former falling into negative territory following the announcement of the programme. Volkswagen car loans were abandoned from the ECB's asset-backed security purchases following the 2015 emissions scandal. There is evidence that the ECB's programme has impacted spreads in the utilities, energy and auto sectors, says Newton Investment Management credit analyst Scott Freedman. "Ethical bond investors may choose to avoid fossil-fuel emitters, among other principles, and therefore may not have benefited to the same extent from spread tightening."

However this could benefit ESG investors as the programme unwinds. "The sectors that did not benefit much, such as ex-carbon intensive industries and green bonds, should outperform," says Freedman. "However, we are mindful that credit markets are expensive, in our view, and those sectors will therefore not be immune to repricing on technical or fundamental grounds."

For active managers, the BofE programme provided an opportunity to sell bonds that "ticked the boxes" and reinvest into issuers unlikely to make the list "where spreads weren't compressed for artificial reasons", says Royal London Asset Management head of credit research Martin Foden. Between the announcement of the programme, a response to the UK's exit from the European Union, and the release of its first list of purchases a month later, spreads on the Bank of America Merrill Lynch sterling-denominated investment-grade bond index fell 14 basis points.

> *The idea that this programme has impacted funding costs feels over-engineered*

"But what has subsequently happened is a compression between the issuers that are on the list and those that aren't. It's not material, but it's generally lowered funding costs for the whole market," Foden says, adding primary issuance is also up across sectors. "The idea that this programme in isolation has materially impacted the funding costs of more carbon-intensive companies rather than less carbon-intensive companies feels slightly over-engineered."

Both central banks have no exposure to renewable energy issuers, the LSE report says. None are eligible within the BofE programme, while Innogy is the only euro-domiciled issuer eligible under collateral criteria. Three others – Vela Energy, WindMW and Breeze Finance – would otherwise be eligible under maturity and credit criteria.

However, it is possible for carbon-intensive companies to issue so-called green bonds, where proceeds are earmarked for specific green projects, Freedman says. The ECB holds 18 green bonds out of a total 935 individual issues representing 1.9 per cent.

French utility company EDF, for example, issues green bonds, and therefore may be investable for ethical investors, even though these ethical investors may avoid their non-green bonds. "Green bond pricing will have benefited indirectly from the tightening in EDF's other bond spreads," Freedman says.

This isn't enough for all responsible investors though. Jupiter Global Ecology Diversified fund manager Rhys Petheram says they have previously avoided green bond issues from Repsol and Abu Dhabi Bank over concerns about the issuer. "For those kind of companies we have a bigger hurdle, so we want to see the green projects that they're doing being best of class. We also ▷

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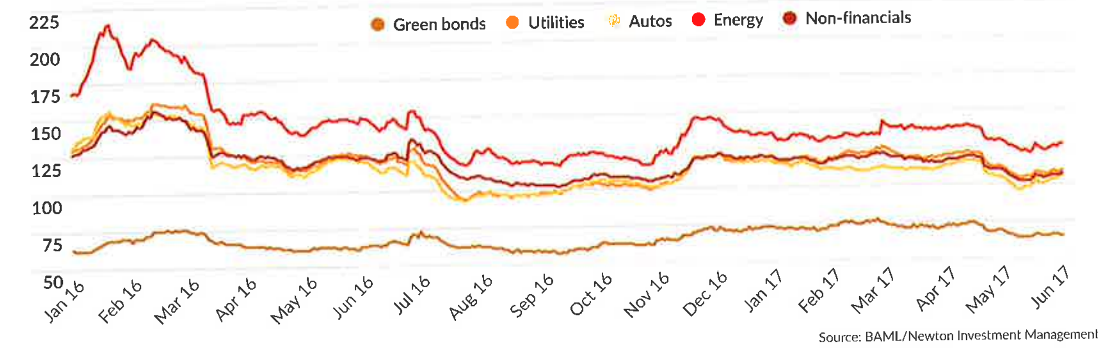
European investment grade index spreads by sector



Source: BAML/Newton Investment Management

like to see it being part of a general transition story." Funds raised aren't always ringfenced, he adds.

Selection criteria

A number of investors are sympathetic to the constraints the BofE and ECB face when it comes to corporate bond buying. Because central banks are mindful of preserving secondary market liquidity an index-weighted approach to purchases makes sense, says Newton's Freedman.

"The Bank of England basically has a mandate to make sure inflation stays at 2 per cent over a two-year horizon and to make sure financial markets are stable," says policy adviser at independent climate change think tank E3G Sam Maule. "To the extent the Bank of England has got involved in the transition to the low carbon economy so far has just been to flag that climate change could pose really substantial risks to the stability of the financial system." E3G has recently submitted recommendations for Esma to address climate and sustainability risks to financial markets, as part of the review of European Supervisory Authorities.

While the sectors represented in both banks' bond buying programmes don't reflect the make up of the wider respective economies, they do not diverge far from the CSPP or CBPP-eligible universes, which exclude financials. Energy represents 9.5 per cent of estimated ECB purchases while making up 8.6 per cent of the eligible universe, while utilities account for an estimated 24.7 per cent of purchases, compared to 24.5 per cent in the eligible universe. The BofE has 3 per cent allocated to energy compared to 3.8 per cent in the eligible universe and 39.4 per cent allocated to utilities compared to 33 per cent in the eligible universe.

But the LSE report highlights that eligibility criteria favours the status quo by "supporting industry incumbents and reinforcing existing market distortions" and therefore is not truly neutral. The Green Party for the European Union has previously proposed "green QE" that would support assets driving the transition to a low-carbon economy, although LSE notes that currently the size of the potential market might be too small for the ECB or BofE to wade into.

> *The ratings agencies have made little effort to get to grips with the climate issue*

High carbon industries are capital intensive and highly geared making them more likely to issue bonds, argues Asset Owners Disclosure project chief executive Julian Poulter. "It is like when investors allocate more capital to index funds – it actually bolsters the high carbon economy because it gives more capital to the majority assets." Incidentally, the Bank of Japan's purchase of ETFs through its quantitative easing programme is considered less carbon intensive by the LSE researchers as the Nikkei skews towards the technology and consumer goods sectors.

"The issue here is the ratings agencies who, apart from S&P, have made little effort to get to grips with the climate issue," says Poulter. Last year, six credit agencies, supported by a group of investors managing $16trn in assets, committed to including ESG considerations in their ratings. Fitch was not involved, but S&P and Moody's were both included.

RLAM corporate governance manager Ashley Hamilton Claxton explains that they do bespoke research and analyse a lot of unrated bonds. "We looked at all the sectors that are typical within fixed income and looked at the ones that pose the highest risk in our perspective to our portfolios and then we applied our ESG analysis to those sectors." Water utilities, energy and oil and gas have been the focus so far.

It's time for the Bank of England and ECB to follow suit, argues Poulter. "Central banks must now join a range of leading companies and investors in having their own base case, which is far more balanced towards a low-carbon future than the short-term market one which inevitably favours high-carbon incumbents." The LSE report also recommends this as an option for central banks to change their purchasing strategy, though notes it would be time and resource intensive.

Setting the tone

The purchase of carbon-intensive assets contradicts and may undermine signals financial regulators are making about climate risks, the LSE researchers argue. Mark Carney, joined by businessman Michael Bloomberg, will present the G20 with the final report from the Task Force on Climate-related Financial Disclosures (TCFD) when the forum meets in Hamburg in July.

All companies would be encouraged to outline impacts from a 2-degrees Celsius rise in temperatures on their business models and incorporate climate risk into their financial reporting, if the recommendations from the draft report are adopted.

Central banks would set a good example for the private sector by mirroring the recommendations of the report, the LSE researchers say. Author Sini Matikainen, a policy analyst at LSE's Grantham Research Institute, praises Carney's leadership already on the issue, including a number of speeches on the risks of climate change to financial stability. The Bank has also published papers on climate risk issues, such as its impact on monetary and financial stability and on the insurance sector.

Given the TCFD recommendations are voluntary, the Bank of England stepping up and implementing them first would send the right message to financial institutions, says E3G's Maule, who previously worked at the Bank as a financial market analyst. "Because one day Mark Carney's giving a speech about the importance of companies and financial institutions disclosing their exposure to climate risks and the next the Bank's purchasing debt of fossil fuel companies so you could see how that could be confusing too in sending mixed signals."