



Economic Comment-
tary

Sustainability con- siderations when purchasing corpo- rate bonds

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Table of contents

	Summary	3
1	Central banks and sustainability	5
2	Law and risk management	6
3	The Riksbank applies norm-based negative screening	8
3.1	International standards and norms	8
3.2	Sustainability considerations in practice	9
4	Concluding comments	10
	References	11

Economic Commentaries

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Summary

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Over the past year, the Riksbank has implemented several measures to alleviate the effects of the pandemic on the Swedish economy. For instance, the Riksbank has, for monetary policy purposes, purchased bonds issued by Swedish non-financial corporations.²

One question that has been discussed in recent years is whether central banks should give consideration to sustainability when they purchase corporate bonds for monetary policy purposes.³ This question is relatively new and many central banks are now trying to investigate to what extent they can include sustainability in their work, given the legal prerequisites and economic aspects. For instance, these questions are included in the European Central Bank's current review of its monetary policy strategy, which is expected to be finalised later this year.⁴

How far central banks can go in their consideration of sustainability depends on, among other things, the links between climate risks and monetary policy and financial stability, and on what scope there are within the respective central bank's area of responsibility to contribute to a transition to a less fossil-based economy.

Something that has become increasingly relevant more recently are the physical risks and transition risks linked to sustainability and climate change. These are considered sources of financial risk for those who own securities issued by companies exposed to sustainability risks.⁵

Just like other central banks, the Riksbank has an obligation to manage financial risks due to measures taken for monetary policy purposes. The Riksbank has therefore decided, with effect from January 2021, to apply so-called norm-based negative screening when purchasing corporate bonds, which means that the Riksbank only purchases bonds issued by companies assessed to comply with international standards and norms for sustainability.

In this Economic Commentary we describe the background to the decision to give consideration to sustainability when purchasing corporate bonds through so-called norm-based negative screening. We also describe the legislation and principles that

¹ The authors would like to thank Dag Edvardsson, Marianne Nessén and Marianne Sterner for their valuable comments. The opinions expressed in Economic Commentaries are those of the authors and are not to be seen as the Riksbank's standpoint.

² For background information, see Sveriges Riksbank (2020a).

³ See, for instance, Weidmann (2019) and Schnabel (2020).

⁴ The aim of the ECB's strategy review is to ensure that its monetary policy strategy is fit for purpose, both today and in the future, see <https://www.ecb.europa.eu/home/search/review/html/index.en.html>.

⁵ See, for instance, Monnin (2018) for a description of climate-related risks for bond owners.

are relevant in this context. Finally, we describe which international norms the negative screening is based on and how the screening is implemented in practice.

1 Central banks and sustainability

The world's central banks analyse how climate risks affect economic developments and how one can take sustainability into account in the areas of monetary policy and financial stability.

Sustainability and climate issues are today being discussed more often by central banks around the world and there are several good reasons for this. Climate change affects economic developments in different ways, which the Riksbank and other central banks need to take into account to be able to meet their objectives in the areas of monetary policy and financial stability.⁶ The Riksbank has recently published a sustainability strategy that describes the principles for the Riksbank's work regarding sustainability.⁷

The Riksbank is taking part in the discussions on the role that central banks can and should have with regard to limiting climate change.⁸ There is general agreement that the most effective measures for managing climate change fall within the remit of other policy areas.⁹ But central banks can nevertheless contribute to the extent for which they have scope within their respective mandates, as a complement to other policy.

One concrete question being discussed is whether central banks should give consideration to sustainability and climate when making asset purchases for monetary policy purposes and, if so, how this can be done. Central banks that manage assets with the aim of generating good return, that is, not for monetary policy purposes, can give consideration to sustainability in a way similar to other asset managers.¹⁰ However, the conditions are different with regard to the management of portfolios that are the result of transactions made for monetary policy purposes, such as the Riksbank's corporate bond purchases.

⁶ See NGFS (2020) and Breman (2020).

⁷ Sveriges Riksbank (2020b). The sustainability strategy includes the Riksbank, through its membership of the Network for Greening the Financial System (NGFS), which is a global collaboration between central banks and financial supervisory authorities, making an active contribution to strengthening the resilience of the financial system.

⁸ See, for instance, Flodén (2019) and Breman (2020).

⁹ There is consensus among economists that the most effective solution for dealing with the negative external effect of greenhouse gas emissions is a uniform price on carbon emissions all over the world (2020).

¹⁰ For instance, some central banks manage pension portfolios or so-called own portfolios that do not have a monetary policy purpose.

2 Law and risk management

The Riksbank's method of taking sustainability into account when purchasing corporate bonds is based on law and legal principles, whereby the Riksbank takes into account the risks that the purchases entail.

The Riksbank needs legal support for its operations¹¹ and pursuant to the Instrument of Government must take into account that everyone is equal before the law, and observe objectivity and impartiality.¹² Constitutional law states what are known as the equality principle and objectivity principle and in general covers all decisions taken by a public authority. Another important principle that applies to the Riksbank is the principle of proportionality.¹³ This means that there shall be proportionality between objective and means and it can be said to regulate the intensity of the Riksbank's actions.

The legal principles are to some extent reflected in the monetary policy framework, which also specifies the monetary policy tools at the Riksbank's disposal.¹⁴ One such monetary policy tool is the possibility to buy, sell and mediate securities.

Monetary policy measures shall be competition neutral in relation to the Riksbank's counterparties.¹⁵ This is an expression of the equality principle and can be summarised in a principle of market neutrality that concerns state market interventions not being allowed to distort competition without objective grounds.

Chapter 9 of the Sveriges Riksbank Act states that the Executive Board of the Riksbank shall ensure that operations are conducted efficiently and in accordance with the applicable laws and that the Riksbank shall manage central government funds prudently. Furthermore, the Executive Board shall ensure that there is internal governance and control, including risk analysis, follow-up and documentation. This means, for instance, that the Riksbank must manage any risks that arise from a monetary policy measure. It is therefore that the Riksbank, for the purpose of limiting credit risk, shall

¹¹ Chapter 1 of the Sveriges Riksbank Act (1988:1385) states that the Riksbank may only conduct or participate in such activities for which it has been authorised by Swedish law, which is an expression of the administrative law principle of legality.

¹² Pursuant to Chapter 1, Section 9 of the Instrument of Government, the Riksbank shall take into account that everyone is equal before the law, and observe objectivity and impartiality when carrying out its public administration tasks. With regard to the Riksbank, the principles are applicable to decisions within monetary policy and mean in brief that similar cases shall be treated in the same way and not arbitrarily. A related principle is what is known as the principle of equality, which means that special treatment is not allowed, unless there are objective grounds for it.

¹³ The principle applies primarily to cases administered in accordance with the Administrative Procedure Act, but is also a guideline for other parts of the Riksbank's operations.

¹⁴ Pursuant to Chapter 9, Section 13 of the Instrument of Government, the Riksbank has responsibility for monetary policy. The objective of maintaining price stability is stated in Chapter 1, Section 2 of the Sveriges Riksbank Act. Chapter 6 of the Sveriges Riksbank Act contains provisions on the Riksbank's monetary policy operations and Chapter 6, Article 5 specifies tools that the Riksbank has at its disposal for monetary policy purposes.

¹⁵ See Government Bill 1986/87:143 p. 48.

purchase only bonds issued by companies with a credit rating equivalent to Baa3/BBB– or higher.

One source of financial risk that has been increasingly discussed recently is the risks linked to climate change.¹⁶ These include extreme weather events that may, for instance, cause disruptions to production chains (physical risk) or companies that do not adapt to the new conditions that the transition to a less fossil-based economy entails (transition risk). These climate-related risks can give higher costs and lower income, that is, affect companies' future cash flows and thereby their credit ratings.¹⁷

The Riksbank and other central banks limit credit risk when purchasing bonds and then rely on external assessments. However, it is not certain that sustainability and climate risks are sufficiently incorporated into the rating agencies' assessments.¹⁸ Therefore, the Riksbank needs to also take these new risks into account, in addition to the rating agencies' credit ratings, when purchasing corporate bonds.

One means could be to entirely avoid certain companies or sectors that are judged to be too risky from a sustainability and climate perspective. This method is called negative screening and means that companies are excluded on the basis of certain predetermined criteria. Another method could be to purchase more bonds issued by companies that are judged to perform well from a sustainability perspective and less of those with a poorer performance.¹⁹ Regardless of the method, the purpose is to reduce exposure to companies with larger sustainability risks, which are for instance due to a failure to adapt sufficiently well to climate change.

However, there are many challenges to deal with in this context. Firstly, it is difficult to measure sustainability and climate-related financial risks and there are as yet no standardised methods. Secondly, the financial information on companies' climate-related risks is at present insufficient, incomplete and inconsistent.²⁰

¹⁶ See NGFS (2019).

¹⁷ See Monnin (2018).

¹⁸ See NGFS (2018).

¹⁹ This method is known as best-in-class, and can be applied to the entire purchase universe or per sector when one wishes to avoid a distorted sector allocation.

²⁰ See ESRB (2020).

3 The Riksbank applies norm-based negative screening

Compliance with international standards and norms is an important part of sustainability assessments, and the Riksbank therefore applies norm-based negative screening when purchasing corporate bonds.

When assessing whether a company has sustainable operations, one important aspect is to investigate whether the company complies with international standards and norms. The Riksbank therefore applies, as of January 2021, a norm-based negative screening when purchasing corporate bonds. This means that the Riksbank only offers to purchase bonds issued by companies that are assessed to live up to the principles for sustainability formulated in international standards and norms.

The Riksbank's negative screening is based on it being riskier to purchase bonds issued by companies that are in breach of these principles. The purpose of the screening is thus to limit the Riksbank's financial risk linked to sustainability.

Applying negative screening allows the Riksbank to manage government funds prudently and contributes to good management based on the state's core values²¹, as well as safeguarding the Riksbank's reputation.

3.1 International standards and norms

The Riksbank conducts the negative screening in accordance with the principles behind the UN Global Compact, the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights. These standards span across the areas of human rights, labour conditions, environment and anti-corruption. The principles are well known and universally accepted and together they are judged to be a good reflection of the state's core values.

The UN Global Compact is a network in the sustainability field that was launched in 2000 at the initiative of the then UN Secretary General, Kofi Annan. Companies that are members of the network are expected to act to attain the UN's objectives regarding the 2030 Agenda and the 17 sustainable development goals. Based on international declarations, ten principles have been produced which the companies should live up to.²²

The OECD Guidelines for Multinational Enterprises are joint recommendations from around 50 countries' governments that express what behaviour is expected of these

²¹ The state's core values are based on the Instrument of Government's fundamental requirements and consist of the six principles of democracy, legality, objectivity, free formation of opinion, respect, and efficiency and service.

²² The ten principles span the areas of human rights, labour law, environment and anti-corruption.

companies. The Guidelines were adopted in 1976, and they have been regularly updated since then to ensure that they are up-to-date and encourage companies to conduct their business in a responsible manner.²³ The UN Guiding Principles on Business and Human Rights have a similar content and emphasise the importance of companies following laws and respecting human rights.

3.2 Sustainability considerations in practice

To enable the Riksbank to be able to assess whether a company is complying with international norms, it has engaged an external supplier, Sustainalytics, which carries out sustainability assessments. The Riksbank then makes its own assessments based on the analyses produced by the external consultant.

The Riksbank also needs to take into consideration the public law principles, which mean for instance that companies that are alike shall be treated equally and that departures or exemptions from this may only be made on objective grounds. Moreover, the positive effects of a decision to exclude a company must be in reasonable proportion to the potential damage the measure can cause. The consideration of sustainability must also aim to avoid distortion effects on the Swedish market for corporate bonds.

In purely practical terms, the Riksbank has been applying this negative screening since January 2021, affecting which corporate bonds the Riksbank can purchase. If a company whose bonds the Riksbank has already purchased were to be assessed as in breach of the norms in the future, the Riksbank would take a stance on how to handle this taking into account the customary monetary policy considerations. For instance, it might be appropriate to refrain from making further purchases, or to sell the bonds purchased earlier.

²³ The most recent update of the OECD Guidelines for Multinational Enterprises was in 2011.

4 Concluding comments

Central banks around the world are working on analysing how climate change affects the economy, and what role central banks can play with regard to sustainability and the transition to a less fossil-based economy.

The Riksbank has been giving consideration to sustainability in its purchases of corporate bonds since January 2021 by applying norm-based negative screening to limit the risks entailed in the purchase. Like other central banks, the Riksbank traditionally has an obligation to manage financial risks, which means that this stance is by no means new. What is new, however, is that sustainability and climate risks are now classified as sources of financial risk.²⁴

The stance taken by central banks on questions arising with reference to climate-related risk and to what extent they can give consideration to sustainability in their monetary policy is under consideration. The Riksbank's decision to take sustainability into account when purchasing corporate bonds is a step towards greater consideration of these risks and comprises part of the Riksbank's overall work on sustainability.

²⁴ See, for example, the classification in the Regulation on the establishment of a framework to facilitate sustainable investment and the technical criteria that the European Commission has been assigned to adopt under the regulation.

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