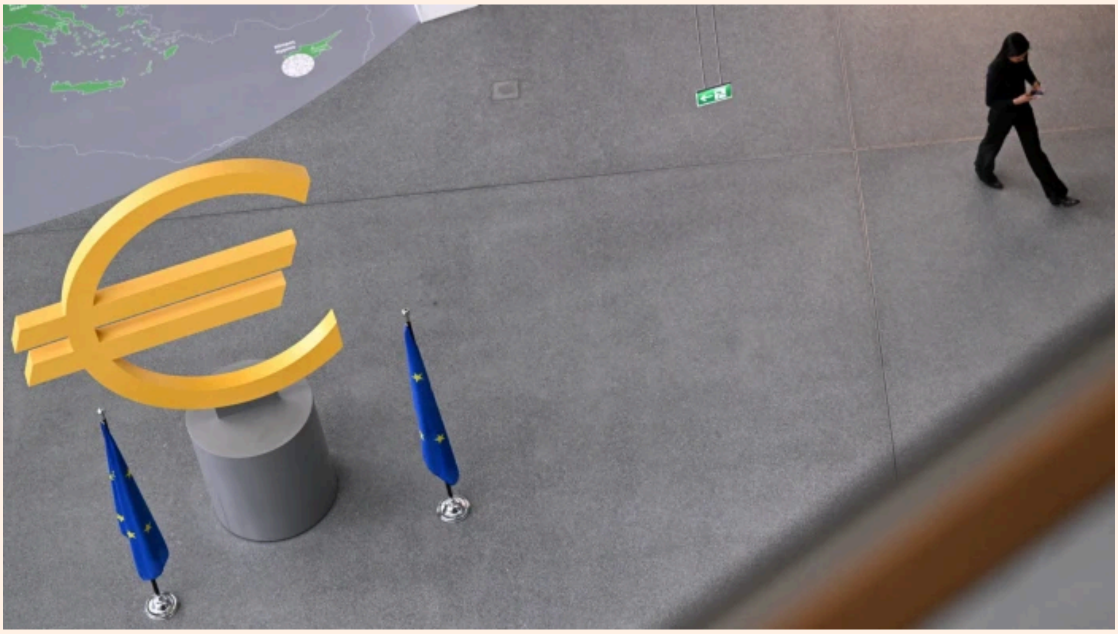
Moral Money **Sustainable capitalism**

Polluters are paying higher interest rates, ECB finds

Study suggests high-emitting companies are treated as riskier borrowers



Eurozone banks are already charging higher interest rates to 'brown' companies than to greener ones, according to a paper published by the ECB. © AFP via Getty Images

Lee Harris 9 HOURS AGO

This article is an on-site version of our Moral Money newsletter. Premium subscribers can sign up here to get the newsletter delivered three times a week. Standard subscribers can upgrade to Premium here, or explore all FT newsletters.

Visit our Moral Money hub for all the latest ESG news, opinion and analysis from around the FT

Welcome back.

The question of when markets will start "pricing in" climate volatility and the energy transition is a perennial debate in environmental policy circles. Climate experts have argued that lenders and asset managers may systematically misprice climate-linked risks. But many of those risks remain far off or hard to quantify.

For today's newsletter, I looked at a study finding that Eurozone banks may already be pricing in some amount of climate-linked risk. Furthermore, the authors found, periods of monetary tightening may be tougher on higher-emitting companies than on greener ones, due to the "climate risk premium" banks attach to polluters.

Thanks for reading.

Transition finance is a growing part of bank lending and a strategy increasingly used by multi-billion-dollar investment funds. Yet there is little agreement on what a transition finance strategy should involve. This will be the focus of our next Moral Money Forum deep-dive report — and we want to hear your views. Fill out this short survey to have your say.

CENTRAL BANKS

'Brown' companies already pay higher interest rates, ECB study finds

Europe's monetary policymakers have long flirted with the idea of setting lower "green" interest rates for certain loans to commercial banks, to incentivise climate-friendly economic activity.

One European Central Bank policymaker said earlier this year that green interest rates "could be considered when monetary policy needs to become expansionary again". With more interest rate cuts in the offing, however, there is not much movement on the dual rates idea, which Zehra Munir deftly explained here.

But Eurozone banks are already charging higher interest rates to "brown" companies than to greener ones, according to a paper published last week by the ECB.

The companies that emitted the most carbon were paying rates about 0.14 percentage points higher than those charged to the ones emitting the least, the authors found. In addition to actual emissions, the authors looked at whether companies had committed to cut emissions, and how this affected the interest rates they pay. They found that companies that signal plans to reduce future emissions also consistently access cheaper credit.

Ben Caldecott, leader of the sustainable finance group at Oxford university, who has pushed for integrating climate risks into financial regulation, told me that he expected this spread between green and brown companies to widen.

“Climate-related risks are increasingly being priced by banks. But is this happening quickly enough?” he said in response to the study. “I think there is still a long way to go and [climate] risk premia will continue to increase for a number of reasons: the risks are increasing non-linearly, financial regulation is tightening and the capacity of banks to observe, price, and then manage these risks is constantly improving.”

The ECB paper also tackled a second question. Who suffers more during periods of monetary tightening: green or brown companies?

You could imagine that tighter interest rates might cut either way. On one hand, low-carbon technologies are often newer than fossil fuel incumbents, so perhaps they are riskier — and would be penalised during periods of monetary tightening. Also, younger companies, including renewable power developers, are often more reliant on debt finance. On the other hand, banks might perceive high-emissions companies as riskier, due to reputational concerns or anticipated regulations cracking down on polluters.

Which dynamic turns out to be most visible?

“During a monetary restriction, banks tend to penalise brown firms, just in the same way as they tend to penalise riskier borrowers,” Marco Pagano, an economist at University of Naples Federico II who co-authored the paper, told me in an interview. When the ECB raises interest rates, the authors found, the “climate risk premium” charged to high-emission companies also rises; greener companies typically suffer smaller increases in the cost of their debt.

“It would be easy to misread our conclusions as saying that jacking up interest rates is good for the environment,” he added, but “it is simply relatively less damaging to the investment of green firms than to that of brown firms.”

The study was based on four years of data, ending in December 2022, from an ECB database of loans above €25,000 for euro-area countries. The study excluded Scope 3 emissions — the emissions from a company’s supply chain — because the data on this was less reliable, the paper said.

One challenge in the study was zeroing in on climate risk, as opposed to other factors that may also impact the rate at which banks lend. Carbon-intensive businesses might have systematic differences from greener ones — they might be more capital-intensive, for example, more cyclical, or in more highly regulated industries.

To help pinpoint risk stemming from carbon emissions, the authors used so-called fixed effects modelling to control for company-specific characteristics that remain constant over time, such as sector and location.

But that could also cause the study to overlook some types of climate-linked risk at companies, such as extreme weather threats to their buildings and operations. As a result, Pagano said, “you could say that, by including fixed effects in our regressions, our results provide a lower bound to the effect of emissions on lending rates". The real premium paid by climate laggards, in other words, might well be even higher.

Smart read

Energy-guzzling tech giants such as Amazon are working behind the scenes to rewrite the rules on how pollution from power use is disclosed, Kenza Bryan, Camilla Hodgson and Jana Tauschinski report.