HOW GREEN IS THE FED?

U.S. Supplement to The Green Central Banking Scorecard

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March 29, 2021

PUBLIC CITIZEN

ACKNOWLEDGMENTS

This report was written by Yevgeny Shrago, Policy Counsel in Public Citizen's Climate Program. It was edited by David Arkush, director of the Climate Program. I would like to thank David Barmes (Positive Money), Brett Fleishman (350.org), Gregg Gelzinis (Center for American Progress), Alexis Goldstein (Americans for Financial Reform), Alex Martin (Americans for Financial Reform), and Marcus Stanley (Americans for Financial Reform) for the contributions and feedback they provided.

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Cover art designed by Shauna Burton.

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Climate Justice at Boston College
Colorado Businesses for a Livable Climate
SoCal 350 Climate Action
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Texas Campaign for the Environment

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Introduction

President Joe Biden's recent executive order has renewed the United States' commitment to aligning financial flows with the Paris Agreement. Positive Money's Green Central Banking Scorecard gives the U.S. a D−, lagging peer jurisdictions with similar commitments.[1]

The Federal Reserve System (Federal Reserve), consisting of 12 regional banks overseen by a Board of Governors, is the U.S. central bank. It shares authority to regulate banks with a number of other federal and state regulators. The Federal Reserve specifically oversees bank holding companies, as well as non-bank financial companies that have been designated for enhanced supervision as systemically important financial institutions.

This supplement reviews the Federal Reserve's role in U.S. monetary and financial systems and the opportunities it has to align the financial system with U.S. climate commitments. The Federal Reserve's mission and preferred approach do differ in certain respects from those of other central banks. To provide additional context, this supplement reviews the Federal Reserve's role and existing authorities for each of the monetary and financial policy areas discussed in the scorecard. The review shows that the Federal Reserve can use most of the policy tools discussed, though it does not have direct credit allocation authority and does not use monetary tools like asset purchases, collateral frameworks, and reserve requirements in the same fashion as many other central banks.

To date, the Federal Reserve's only actions have been discussing climate risk in several speeches, including it in both the November 2020 Financial Stability Report and Supervision and Regulation Report, and creating a Supervision Climate Committee. This inaction in the face of a building crisis amply justifies the low marks on the scorecard.

[1] David Barmes and Zack Livingstone (2021). The Green Central Banking Scorecard: How Green Are G20 Central Banks And Financial Supervisors? Positive Money. https://positivemoney.org/publications/green-central-banking-scorecard/

Monetary Authorities

The Federal Reserve's monetary policy mandate requires it to maintain long run growth of the money and credit supply in a way that promotes maximum employment, stable prices and moderate long-term interest rates.[2] The Federal Reserve also has operational independence from political and fiscal authorities. Unlike peer institutions like the Bank of England,[3] it has no explicit mandate to coordinate its operations with specific policy goals. But the Federal Reserve has sometimes taken the government's fiscal policy into account to minimize disruption when conducting monetary policy.[4] To the extent permitted, the Federal Reserve should exercise its monetary authorities in ways that align with the United States' climate commitments.

Asset Purchases

Unlike many other central banks, the Federal Reserve does not, outside of emergencies, purchase assets other than U.S. Treasuries or the securities of government-sponsored agencies.[5] However, the Federal Reserve used its emergency powers to launch private asset purchase programs designed to stabilize financial markets from the economic fallout of COVID-19.[6] The security for emergency purchases must be sufficient to protect taxpayers from losses.[7] But despite the long term economic trend toward decarbonization, these programs disproportionately benefited fossil fuel companies.

The Federal Reserve purchased about $1 billion in fossil fuel company bonds via the Secondary Corporate Credit Market Facility. These purchases were overweight

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[2] Federal Reserve Act, Section 2.

[3] Bank of England Act of 1998, Section 11(b).

[4] For instance, there is a long history of the Federal Reserve and Treasury coordinating on debt management. By not operating at cross-purposes with the Treasury, the Federal Reserve achieves its own objectives while minimizing disruptions to the economy and fiscal policy. Robin Greenwood, Samuel Hanson, Joshua Rudolph, Lawrence Summers (30 September 2014) "Government Debt Management at the Zero Lower Bound." Brookings Institution. https://www.brookings.edu/wp-content/uploads/2016/06/30_government_debt_management_zlb.pdf.

[5] Federal Reserve Act, Section 14.

[6] Board of Governors of the Federal Reserve System (23 March 2020). "Federal Reserve announces extensive new measures to support the economy." Press Release. https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm.

[7] Federal Reserve Act, Section 13(3).

relative to equity, bond, and employment benchmarks, violating the Federal Reserve's stated principle of market neutrality.[8] Similarly, the Main Street Lending Program disproportionately benefited fossil fuel companies. Fossil fuel loans make up 13% of the portfolio to date, with an average loan size of twice the program average.[9] These backstops left the Federal Reserve holding fossil company assets with an elevated risk of becoming worthless as the green transition pushes fossil fuel companies into insolvency.[10] It also enabled record debt issuance by those companies in the primary debt markets.[11]

Although both asset purchase programs have been suspended by subsequent legislation, the Federal Reserve should commit now to decarbonizing both its current portfolio and future asset purchases. Market neutrality should not be a bar to this commitment, as it is not statutorily required for asset purchases and has not actually been implemented to date. The Federal Reserve could align its fossil fuel asset purchasing with the United States' Paris Agreement commitments, or at a minimum, limit its purchases to actually market neutral levels. The Bank of England has already committed to decarbonizing its corporate bond purchase scheme, and the ECB is discussing similar restrictions on its own much larger corporate bond buying program. The Federal Reserve is falling behind.

Collateral frameworks

The Federal Reserve also lends to commercial banks via the "discount window," though such borrowing is generally limited in size and frequency during non-emergencies.[12] Such borrowing must be backed by collateral, which is subject to a haircut based on its riskiness. The current collateral framework permits

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[8] Necessary Intervention or Excessive Risk? Corporate Bond Risk Before and After COVID-19 Amid the Fed's Buying Programs, InfluenceMap (June 2020) (online at https://influencemap.org/report/Necessary-Intervention-or-Moral-Hazard-5e42adc35b315cc44a75c94af4ead29c). See also, Influence Map's September update: https://content.influencemap.org/report/Is-the-Fed-Being-Sector-Neutral-3a1294e4de3b6275fae9370d6f68cc70.

[9] Bailout Watch, "Oil & Gas Dominates in 'Main Street' Lending Program" (16 Dec 2020) https://bailoutwatch.org/analysis/mslp-november-analysis

[10] Paul Takahashi, "Over 100 oil and gas companies went bankrupt in 2020" *Houston Chronicle* (20 Jan 2021) https://www.houstonchronicle.com/business/energy/article/More-than-100-oil-and-gas-companies-filed-for-15884538.php

[11] Lukas Ross, Alan Zibel, Dan Wagner, and Chris Kuveke, "Big Oil's $100 Billion Bender" (30 Sept 2020) https://www.citizen.org/article/big-oils-100-billion-bender/

[12] Ennis, Huberto M. and Ho, Sara and Tobin, Elliot, Recent Borrowing from the U.S. Discount Window: Some Cases (2019). Available at SSRN: https://ssrn.com/abstract=3697643

investment grade U.S. corporate debt to be posted as collateral with a uniform haircut. The Federal Reserve should use its authority to adjust this framework to take the added riskiness of assets backed by high emission activities into account when setting eligibility requirements and haircuts.[13]

Reserves

Since the pandemic began, the Federal Reserve has abolished reserve requirements.[14] When reserve requirements are in effect, the Federal Reserve pays interest on those reserves. The level of interest is a function of the federal funds rate, not based on a bank's score on the macroprudential assessment, as it is in China. Incorporating climate risk into interest paid on reserves in the U.S. would therefore require restructuring the entire interest on required reserves framework to achieve goals better pursued via the Federal Reserve's financial authorities.

Targeted lending and credit allocation

The Federal Reserve does little to target monetary support or to direct private credit allocation. It does have an opportunity to follow through on updates to the Community Reinvestment Act and encourage banks to take climate considerations into account in fulfilling their lending obligations to low and moderate income communities.[15] Additional credit allocation and targeted lending would be better achieved by creating a separate green public bank without conflicting mandates. Lending and other activity limits should be pursued via the Federal Reserve's financial authorities.

[13] Section 10B of the Federal Reserve Act permits the Federal Reserve Board of Governors to prescribe rules and regulations for the provision of advances to borrowing banks.

[14] Board of Governors of the Federal Reserve System (15 March 2020). "Federal Reserve Actions to Support the Flow of Credit to Households and Businesses." Press Release. https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315b.htm

[15] Board of Governors of the Federal Reserve System (19 October 2020). "Community Reinvestment Act" https://www.federalregister.gov/documents/2020/10/19/2020-21227/community-reinvestment-act

Financial Authorities

The Federal Reserve's financial mandates include ensuring stability of the financial system and the safety and soundness of individual banks. It has several tools that can reduce the climate riskiness of banks and the impact of the financial system on the climate. The Federal Reserve's unwillingness to exercise these authorities to date puts it far behind peer regulators with similar authorities in Europe and China.

Supervision

The Federal Reserve can use supervision to address the threat that climate risk poses to the safety and soundness of individual banks, but has declined to go beyond commitments. In the 2020 edition of the *Supervision and Regulation Report* the Federal Reserve said it would seek to better understand, measure and mitigate climate risk.[16] It has since convened a Supervision Climate Committee (SCC) to develop a program for improving the resilience of supervised firms, but actual requirements have not yet followed.[17]

Supervisory solutions within the Federal Reserve's authority include providing guidance on addressing the impact of both physical and transition risk, including guidance on aligning activities to anticipate progress on national net zero targets; incorporating climate risk into its CAMELS and Large Financial Institution ratings; setting concentration limits on exposure to high carbon emissions activities; and restricting unsafe and unsound investments in high emissions sectors.[18] The Federal Reserve should also begin updating its supervisory guidance for non-banks to incorporate climate risk, in anticipation that designation of systemically important financial institutions will resume.

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[16] Federal Reserve Board of Governors (November 2020) "Supervision and Regulation Report." https://www.federalreserve.gov/publications/files/202011-supervision-and-regulation-report.pdf

[17] Federal Reserve Governor Lael Brainard (18 Feb 2021) "The Role of Institutions in Tackling the Challenges of Climate Change." Speech. https://www.federalreserve.gov/newsevents/speech/brainard20210218a.htm

[18] David Arkush, et al. (31 Mar 2021). "Climate Roadmap for U.S. Financial Regulation." Public Citizen and Americans for Financial Reform. Report. https://www.citizen.org/wp-content/uploads/Climate-Financial-Reg-Report.pdf

Disclosure and stress testing

Federal Reserve Governor Brainard has also flagged scenario analysis as a potentially helpful tool for assessing the implications of climate risk,[19] but no plans have been announced to mandate such analyses. If scenario analyses are required, the Federal Reserve should disclose the scenarios and results, much as it does the results of its capital adequacy stress tests. Banking regulators can also update the call reports banks must file to include additional climate risk information.

Capital and Liquidity Requirements.

The Federal Reserve can increase risk weights and capital surcharges for carbon intensive assets to reflect the physical and transition risks inherent in those assets.[20] It can also increase the countercyclical capital buffer or GSIB surcharge requirement for large banks to account for the elevated risk of future losses from climate change as well as the contribution of large bank's investments to those losses. Importantly, that an investment is "green" should not be the basis for relaxing macroprudential requirements without further development of standards and safeguards.

Conclusion

The Federal Reserve has a range of activities it can undertake in order to address the climate crisis. Unfortunately, it has used the magnitude of the problem as a call to gather facts and wait for development of better modelling of climate financial risk instead of deploying its authorities to address the issue and learn by doing. Given the renewed commitment of the U.S. government to its Paris commitments, we expect that Federal Reserve leadership will move faster in the coming years, earning improved scores in future editions of the scorecard.

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[19] Brainard 2021.

[20] Graham Steele (Jan 2020) "A Regulatory Green Light: How Dodd Frank Can Address Wall Street's Role in the Climate Crisis." *The Great Democracy Initiative*. https://greatdemocracyinitiative.org/wp-content/uploads/2020/01/Final_Greenlight_Steele.pdf

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