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ISDA submission to UK's Climate Change Committee Call for Evidence on Carbon Offsets

Questions

1. What are the main risks and opportunities presented by voluntary carbon offsets?

A robust voluntary carbon market plays an important role in delivering a reliable, market-based approach for investment opportunities that reduce greenhouse gas emissions and remove carbon from our atmosphere.

As a derivatives trade association, we have a strong interest in the development of a robust voluntary carbon offset market that will strengthen the functioning of the carbon credit derivatives markets and enable the continued development of liquidity in derivatives products so that market participants can appropriately manage their business risks. Facilitating trading in carbon credit derivatives that serve as hedge for climate mitigation projects will contribute to the development of deep and liquid voluntary carbon credit markets.

One of the main obstacles to advancing voluntary carbon trading is a lack of clarity about the legal nature of voluntary carbon credits (VCCs). Specifically, very few jurisdictions provide legal certainty about how credits can be created, bought, sold, and retired, thus making it unclear what type of security may be taken and enforced against VCCs and how that can be achieved, as well as how VCCs would be treated following an insolvency (including with regards to netting). Such determination may also have an impact on broader considerations, including the regulatory, tax and accounting treatment of VCCs. In short, understanding the legal treatment of VCCs is necessary to create robust voluntary carbon credit markets, which, in turn, will enable the development of a clear price signal for carbon and allow funds to be efficiently channeled towards emissions-reducing projects.

ISDA also supports the use of market-based mechanisms, including a price on carbon that supports long-term decision-making. As highlighted in the Principles for a U.S. Transition to a Sustainable Low-Carbon Economy, published by the US Climate Finance Working Group in February 2021, carbon pricing can also spur development of climate-related financial products, promote transparent pricing of climate-related financial risks, and inform and help scale key initiatives like voluntary carbon markets.[1]

Finally, as a global financial hub, and home to many of the trading desks, liquidity providers, banks, and advisory firms who participate in the established global derivatives markets for voluntary carbon credits, the UK is well-positioned to lead in climate action and in the trading of voluntary carbon offsets.

Quality and duration of offsets

We plan to assess the quality of various voluntary carbon offsets bought by UK companies, or 'produced' in the UK. A range of activities are considered part of voluntary carbon offsetting, from shorter-term emissions reduction measures to long-term removals of carbon.

2. What data/evidence is there on the scale, range, pricing and quality of offset activities that are being purchased in the UK, and are being produced in the UK? How can we expect this to change in future? What are the data gaps?

N/A (As a global derivatives trade association, we do not collect this data).

Voluntary offset market regulation and standards

We plan to assess how well current standards and policies are working and to evaluate different options for how current standards or policies can be improved. In some of the following questions we mention several existing standards as illustrative examples; this is done to clarify what kind of standard we are referring to and does not indicate any preference for certain standards over others.

3. What is your assessment of the various standards relating to offsets (including UK specific standards such as the Peatland Code, and international verification standards

[1] Principles for a U.S. Transition to a Sustainable Low-Carbon Economy, https://www.isda.org/a/qXITE/Financing-a-USTransition-to-a-Sustainable-Low-carbon-Economy.pdf

such as Gold Standard and Verified Carbon Standard), including those in development (including UK specific standards such as the UK Farm Soil Carbon Code, and international standards/principles such as the Core Carbon Principle)? What more is needed?

Voluntary carbon credit markets are global in nature. Thus, it is important that national standard setting bodies ensure that any approach taken locally is consistent with global standardization efforts, such as those undertaken by the Integrity Council for Voluntary Carbon Markets (ICVCM).

In this regard, we support the ICVM in its work to increase market confidence in the quality of voluntary carbon credits and address market participants' concern related to environmental and reputational risks associated with trading voluntary carbon credits.

Global legal standard setters (for example, UNCITRAL and UNIDROIT) have a good track record in working with other intergovernmental bodies and regulators in producing legislative guidance on a range of substantive law issues related to a wide variety of commercial transactions for states across all regions. Given that the UK is a member of both UNCITRAL and UNIDROIT, it could facilitate decision making regarding environmental products across all jurisdictions. This, in turn, will encourage industry organizations to issue positive legal opinions and associated contractual documentation to support the voluntary carbon market.

ISDA also supports the work of the UK Voluntary Carbon Markets Forum (VCM) that will implement the framework recommended by the ICVCM, thus ensuring that UK-based firms and branches of global firms based in the UK possess critical tools in corporate emission reduction efforts. Additionally, providing legal certainty of the treatment of carbon credits under English law is instrumental to establishing the UK as a carbon-trading hub.

Separately, we note, in the established secondary markets, there are various levels of oversight depending on whether a voluntary carbon credit derivative is traded on a designated contract market or is executed bilaterally between eligible contract participants. Listed carbon derivatives traded on a designated contract market are subject to oversight (such as trade practice surveillance and enforcement actions) and bilateral carbon derivatives are subject to margin requirements and reporting regulations.

4. What are the strengths and weaknesses of monitoring, verification and reporting (MVR) for offsets produced in the UK and globally? What more is needed?

The ICVCM's focus on the governance around standards for voluntary carbon credit issuance, validation and verification is crucial to developing of a strong primary market in voluntary carbon credits, which will provide a solid foundation for carbon credit derivatives markets. As noted in our other responses, further success of both primary and derivatives markets will depend on the validity and legal status of carbon credits across jurisdictions.

5. What does the evidence indicate are the key areas of voluntary offset markets that could benefit from regulation or intervention?

Establishing clarity around the legal nature of voluntary carbon credits is fundamental to the drafting of standardized documentation and supporting legal opinions for derivatives transactions. In order to make informed decisions on entering into and structuring derivatives transactions, market participants will require certainty as to the treatment of the underlying voluntary carbon credits, including for purposes of netting, insolvency, and taking security analysis in all relevant jurisdictions.

Standardized documentation is the cornerstone of safe and efficient derivatives markets. It allows market participants to transact with confidence, using clearly defined provisions for business-as-usual execution and settlement and setting out mechanisms to resolve different asset and market related risk scenarios. Documentation standards also help to minimize unintended basis risk in otherwise similar products and reduce counterparty credit risk (with corresponding reductions in regulatory capital) by providing the contractual ability to net exposures. In this way, standardized documentation promotes greater liquidity, better efficiency and reduced market and credit risk.

Since its inception, ISDA has worked with the derivatives industry to develop global standards and documentation for multiple asset classes. This includes emissions, and ISDA has published several template documents for use in the mandatory carbon market. In order to progress standard OTC derivatives documentation for secondary market trading in voluntary carbon credits, ISDA is currently working to identify the best approach for creating template documentation and to consider the provisions and elections market participants require.

The exchange-traded market has also contributed to the development of derivatives markets in these markets, by enabling firms to hedge using exchange contracts. ISDA, as a global derivatives organization, supports the development and trading in various types of carbon derivatives contracts, including standardized offset contracts listed on exchanges (e.g., the N-GEO and GEO futures contracts jointly developed by Xpansiv and CME Group in 2021 and other futures contracts expected to be listed by ICE this year[2]).

Harnessing Financial Flows

The growing market for voluntary carbon offsets, and appetite from businesses to support climate objectives, may present an opportunity for significant financial flows to be directed towards priority sustainability outcomes such as biodiversity, nature-based solutions and scaling technologies for carbon removals. We plan to assess this potential opportunity, as well as the associated risks

6. What is the scale and potential impact of voluntary offset activity on land use and on wider social, environmental and development outcomes, both positive and negative? How would this differ between UK-based and international projects?

Our members are continuing to develop innovative new products including green loans and mortgages, exchange-traded funds, climate risk insurance and risk financing instruments for low-carbon innovations, as well as mitigation strategies and tools such as carbon credit derivatives to manage or hedge climate exposure. By building out the climate-aligned investment universe, financial institutions and markets can help drive cutting-edge, world-changing solutions.

7. Are there specific activities or regions where directing funds for offsetting might have a particularly positive impact? Please consider the UK and/or the international context, depending on experience.

Most projects generating offsets are located in the Global South. Thus, in order for carbon credits to be viable underliers (or reference assets) in the secondary market, including the UK's carbon credit derivatives market, legal and regulatory frameworks in those jurisdictions need to be certain.

[2] We note that ICE is expected to launch nature-based solutions carbon credit futures in the first quarter of 2022. *See* https://www.businesswire.com/news/home/20211105005535/en/ICE-to-Launch-its-First-Nature-Based-Solutions-Carbon-Credit-Futures-Contract. ICE also currently offers futures on offsets that can be used for ETS compliance. *See* https://www.theice.com/products/71544060/California-Carbon-Offset-Futures.

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8. What could help concentrate private investment in offsets towards the most effective activities? What role, if any, is there for public funding?

From ISDA's perspective, as noted above, a key first step to increasing private investment in offsets requires establishing clarity about the legal nature of voluntary carbon credits across jurisdictions.

Company Transparency and Targets

We plan to assess the role voluntary offsets play in company and financial institution emissions reduction targets, and in consumer and investor decisions.

9. What do UK companies, financial institutions and/or other institutions (or specifically, your company or institution) consider when making purchasing decisions about offsets? What evidence/information do they/you draw on, and what more information would be useful?

As a global derivatives trade association, we do not have this information; however, from a financial markets perspective, UK firms share the same concerns regarding the legal nature of carbon credits across jurisdictions.

10. What is the evidence on the scale of reliance on offsets for Net Zero targets, for businesses, financial institutions, and/or other institutions and the role that offsets play in affecting emissions reduction ambition? If you are a business/financial institution/other institution with a Net Zero target, what role do voluntary carbon offsets play in your Net Zero target and emissions reduction ambition?

N/A (Each of our members are taking various approaches to incorporating voluntary carbon offsets into their individual net-zero strategies.)

11. What would be the strengths/weaknesses/considerations of:

1. Regulation, guidance and/or incentives which could encourage and/or require businesses to only use offsets where emitting activities cannot currently be reduced?

The establishment of robust regulatory frameworks for the certification of carbon removals is an important part of global discussions around the governance and scaling of voluntary carbon markets. Financial market participants play a crucial role in offering liquidity, increasing transparency, providing certification assessment, and developing trading infrastructure and standardized contracts. To this end, ISDA supports the European Commission's intention to create a sound carbon removal certification framework next year.

2. Consumer protection standards for low-carbon products and offset purchases that accompany products?
3. Regulation on business Net Zero targets' reliance on offsets?
4. Including specification of offset use for investment product labelling?
5. Any other interventions?

Article 6 and GHG accounting

At COP26, guidelines were agreed for an international carbon market for carbon credits, under Article 6. As we set out on page 8 of our COP26 briefing, this included new guidance for how to avoid double counting through 'corresponding adjustments'. We will analyse the risks and opportunities the new guidelines pose to the role of voluntary carbon offsets in reducing global emissions and assess what role UK policy and company action can play in navigating this.

12. What is the evidence on the key risks and opportunities to sustainability and development outcomes that the updated guidance for voluntary offsetting in relation to Article 6 presents to Net Zero?

From ISDA's perspective, one of the main challenges to achieving Net Zero as outlined by the updated COP26 guidance for voluntary offsetting is the likelihood that multiple regional certification mechanisms will be developed under Article 6, creating inconsistences with international requirements. In addition, verification and confirmation that offsets actually deliver the environmental and emission benefits they promise would be key to environmental integrity of offsets. This issue highlights the need to ensure "additionality" (i.e., the assurance that the reduction in emissions resulting from a project is additional to what would have occurred if the project had not been implemented) and "permanence" (i.e., ensuring that offsetting activities will last) of carbon offset projects.

Other challenges include the rigidity of definitions and the scope of the certification mechanism, as well as the design of the calculation, reporting and verification methodologies that is the cornerstone one of any certification scheme.