Consultation Response

CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels

25 January 2023

Introduction

The International Swaps and Derivatives Association (ISDA) welcomes the opportunity to respond to derivative-related aspects of the FCA's Consultation Paper on Sustainability Disclosure Requirements (SDR) and investment labels (CP22/20).

ISDA has been a keen contributor to the ongoing discussion regarding the calibration of the regulatory framework for derivatives from a sustainability perspective and has responded to the FCA's DP21/4 on Sustainability Disclosure Requirements and investment labels.[1] We are therefore pleased to provide input into the FCA's important work on addressing greenwashing risks. Actual or perceived misrepresentation of sustainability features may have a detrimental impact on investor and consumer perceptions of sustainable finance products and we strongly support efforts to enhance trust in the market. This is crucial to support the further development of sustainable finance and in turn the vital objective that it is seeking to achieve.

ISDA has only responded to relevant questions of the consultation from a derivative-related standpoint. Additionally, we would like to note our endorsement of the responses submitted by the Association for Financial Markets in Europe (AFME) and the Alternative Investment Manager's Association (AIMA) to this consultation.

The use of derivatives in sustainable investing

ISDA supports the approach the FCA is taking to the use of derivatives in sustainable investing, notably to avoid making rules specifically relating to derivatives in the first instance, recommending instead that, as the FCA has proposed, the FCA monitors developments in the market and implements guidance to increase transparency on the use of derivatives in sustainable investment products.

It is welcome that the FCA is taking a proportionate approach to the use of derivatives in sustainable investing. As ISDA argued in its response to DP21/4, the EU regulatory framework is overly prescriptive and likely to remain in flux for several years. It may therefore not be an appropriate reference against which to compare parallel regulatory initiatives in other jurisdictions in respect of derivatives, including the UK. ISDA advocates for the FCA to pursue a principles-based approach to setting out sustainability disclosure requirements and investment labels, bearing in mind the importance for firms of international coherence and interoperability of rules.

Current EU legislation on sustainable finance does not have a consistent approach towards derivatives. Financial institutions and investors face inconsistencies and uncertainties between, on the one hand (i) ESG regulatory classification obligations in MiFID II and SFDR but missing

[1] ISDA-Responds-to-FCA-on-Sustainability-Disclosure-Discussion-Paper.pdf

methodological instructions on how to tackle derivatives, and on the other hand, (ii) penalizing treatment within Taxonomy-alignment ratios (at fund level and entity level). More information on this is provided in ISDA's recent response to the ESA's Greenwashing Call for Evidence.

Overall, the EU's regulatory framework provides for an inconsistent treatment of derivatives and an unclear representation of derivatives' roles in sustainability, exposing them to unwarranted claims of greenwashing.[2] This is especially problematic for regulations that are already in application, such as MiFID II ESG and SFDR, which also cover the use of derivatives without clear instructions on how to deal with them, either as part of a fund or when sold directly to clients. In this latter case, the issue is of particular importance for equity and credit derivatives, which in ISDA's view can contribute to sustainability but whose sustainability assessments are currently being assessed in the context of the sustainability of the underlyings, proportionately to the exposure the derivative offers to the underlyings.

In light of the above, there is a pressing need for regulatory clarity on the treatment of derivatives from an EU sustainability perspective. We continue to encourage the industry to work on a methodology to assess derivatives so that their role in sustainability is appropriately reflected by regulation and derivatives are not subject to undue risks or penalization by regulation.

The application of the greenwashing concept to derivatives should be based on stable regulatory provisions, otherwise it could expose firms selling these products to a significant risk of litigation and reputation, thus jeopardizing the use of these products by investors and corporates and ultimately the development of these markets.

ISDA's members' activities in derivatives are of paramount importance for their ability to answer their clients' needs both in terms of financing and investing. ISDA has been working over the past year on the contributory role of derivatives to sustainable finance and had the opportunity to provide comments on this matter to the EU's Platform on Sustainable Finance (PSF) in relation to its work on how to account for them, in particular those with equity and corporate bonds as underlyings, in the Taxonomy disclosure KPIs for financial undertakings. ISDA therefore stands ready to continue their engagement with EU and UK policy makers to contribute to framing derivatives' contribution to sustainability and help test and calibrate the relevant options currently under examination.

The contributory role of derivatives in sustainable finance

Derivatives perform a critical role in economic activity by facilitating the raising and allocation of capital for green finance, helping businesses and investors better manage the risks to which they are exposed, and allowing market participants to more effectively align their exposures with risk tolerance and risk management requirements. The derivatives market also plays a major role in enhancing transparency through providing information on their underlying commodities, securities or assets. This can ultimately contribute to long-term sustainability objectives by bringing information about sustainability-related activities in the real economy into the financial markets, allowing investors to appropriately respond to economic actors' positive or negative contributions to the green transition.

[2] In its advice to ESMA on the ESA's Call for Evidence on Greenwashing, the Securities and Markets Stakeholder Group (SMSG) *"deems it important that that the ESAs acknowledge the need to encompass primary as well as secondary and derivatives markets, as well as the full spectrum of ESG strategies. Regulators should avoid adopting an excessively rigid framework which would curb the development of the ESG market. At the same time, there is a need for more clarity regarding the responsibility for greenwashing along the greenwashing "value chain"."*

ISDA® Safe, Efficient Markets

The financial sector is a key enabler of economic activity and plays a critical role in facilitating and accelerating the transition to a low carbon economy, and the transition to a sustainable economy will take a significant amount of long-term funding. ESG investments and the associated derivative instruments that help mitigate the risk of those investments and contribute to their financing will be critical in the transition to a green economy, enabling companies to meet their sustainability goals effectively and efficiently.

It is important to note that derivatives on equity and corporate bonds contribute to defining a company's cost of capital by mitigating its business risks. Hence, they contribute to its financing/refinancing costs similarly to when a critical mass of activist investors divest from certain types of companies/sectors that would result in these assets/sectors facing a higher cost of capital. These types of derivatives provide a clear signal / indication to the market which sector is likely to have higher or lower cost of funding.

The exponential growth of ESG markets over the past few years shows the need for forward prices for these assets and their related indices. Derivatives markets are a key component of mature secondary markets, and the recent growth in demand for listed and over-the-counter (OTC) ESG derivatives illustrates that these products are a core component of sustainable investment strategies, especially since the availability of liquid and transparent derivatives can fundamentally reduce funding and financing costs for share and bond issuers in the primary markets.

As markets for ESG investments develop and trillions need to be raised to finance the transition to a sustainable economy, the derivatives market will be critically important in facilitating the financing of green investments, including in their role as hedging tools to manage the associated risks. To this end, derivatives can play a very important role in achieving the goals outlined by the UK's Green Finance Strategy, and financial market participants should be able to use them freely.

The role of derivatives in sustainable finance is explored in greater detail in a July 2020 paper published by the Centre for European Policy Studies ("CEPS") and the European Capital Markets Institute ("ECMI").[3]

The financial sector is responding to the challenges in sustainable finance with a diverse range of product structures and transaction types in the derivatives market. A new wave of sustainability-linked derivatives and exchange-traded ESG derivatives has developed in recent years, alongside emissions trading derivatives, renewable energy and renewable fuels derivatives, and catastrophe and weather derivatives. In January 2021, ISDA published a research report that gives a valuable overview of such ESG-related derivatives products and transactions.[4][5]

[3] Derivatives-in-Sustainable-Finance.pdf (isda.org)
[4] Overview-ofESG-related-Derivatives-Products-and-Transactions.pdf (isda.org)
[5] As plenty of academia suggests, there are currently three channels by which cash securities and derivatives contribute to positive outcomes for the real world: a) Voting rights/engagement; b) Sharing business risk/economic exposure and c) Bringing cash:- A study by Eugene F. Fama and Kenneth R. French 'Disagreement, Tastes, and Asset Prices', https://papers.ssrn.com/sol3/papers.cfm?abstract_id=502605
- Paul Brest & Kelly Born: 'Unpacking the Impact in Impact Investing, https://ssir.org/articles/entry/unpacking_the_impact_in_impact_investing# and industry initiatives, including for example the Investor Contribution Strategies developed by the Impact Management Project: https://impactfrontiers.org/norms/investor-contribution/.
These channels are also described at section 4.10 of the FCA consultation for SDR: https://www.fca.org.uk/publication/consultation/cp22-20.pdf

Sustainability-linked Derivatives (SLDs)

Sustainability-linked products – whose liquidity, price transparency and attractiveness to investors can be further enhanced through the use of derivative instruments – can attract much-needed investment in the transition to a net zero economy. Such investments have long-term objectives and require a long-term orientation. One particular area of growth is sustainability-linked derivatives (SLDs), which have gained increasing prominence in the EU, UK and US. In this context, please note ISDA's publication of a white paper outlining key performance indicators (KPIs) guidelines for SLDs.[6]

Although SLDs are highly bespoke transactions typically entered in by sophisticated investors, it is important that the ESG-related KPIs are transparent and well-defined in order to ensure legal certainty and enhance the integrity of this new and emerging market. SLDs embed or create a sustainability-linked cashflow using KPIs that are designed to monitor compliance with environmental, social and governance (ESG) targets. KPIs are therefore critical to the effectiveness and integrity of the SLDs to which they relate. They need to be accurately defined in order to have legal certainty over how they operate and impact cashflows to be objectively verifiable. This will enhance the credibility of SLDs and the sustainability-linked market as a whole.

As SLDs are currently a niche and nascent market, the ISDA guidance seeks to establish a transparent, common framework of best practices that can be applied across KPIs and their related SLDs more widely in a way that is specific, verifiable and transparent. By establishing best practices and addressing key risks, the guidance seeks to address greenwashing concerns by encouraging adequate disclosure of how SLDs help attain sustainability objectives, therefore supporting the integrity of this developing market.

In April 2022, ISDA launched a survey to assess the current state of the SLD market[7]. Sixty-nine respondents indicated they engaged in SLD transactions and use existing ISDA documentation to do so. The survey report proposes a path forward for standard SLD documentation that aims to strike an appropriate balance between enhancing trading efficiency and maintaining the ability to tailor transactions to meet specific sustainability objectives.

As there is currently no single approach to documenting SLDs, having a range of standardized provisions will allow market participants the flexibility to document bespoke SLDs using standardized components, which will ultimately help counter greenwashing concerns by encouraging adequate and transparent documentation of SLDs transactions.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

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[6] Sustainability-linked-Derivatives-KPI-Guidelines-Sept-2021.pdf (isda.org)

[7] The-Way-Forward-for-Sustainability-linked-Derivatives.pdf (isda.org)