ISDA ESG Forum 2022
November 21, 2022

Opening Remarks
Scott O'Malia, ISDA Chief Executive

Good morning, and welcome to the ISDA ESG Forum. Thank you for joining us today, and special thanks to our sponsors – CME Group, Allen & Overy, Clifford Chance, Linklaters and Santander. It's encouraging to see such strong interest in environmental, social and governance (ESG) issues and the important role derivatives can play in the transition to a green economy.

The scale and urgency of this challenge couldn't be clearer. We've been living through extreme weather events that have caused devastating loss of life. At the COP27 climate summit in Sharm el-Sheikh this month, the warning was stark – 1.5 degrees of warming could be breached within a decade.

Time is running out. We need to accelerate efforts to eliminate greenhouse gas emissions, implement cleaner energy generation and transport solutions, and build more energy efficient buildings. But to achieve this, we have to unlock the trillions of dollars of private sector investment needed to drive the transition to a more sustainable economy.

What gives me hope is the mindset change within companies, investment firms and governments, with so many now supporting transition efforts. We've seen companies and countries across the globe commit to reaching net zero emissions over the coming decades. At the same time, ESG investing has grown rapidly, as firms look to put their capital to work in a more sustainable way.

At ISDA, we've been working hard to support the transition by developing robust legal and risk management standards to ensure these markets function safely and efficiently. Ultimately, a robust hedging market will help firms commit the massive amounts of capital needed to finance the shift to greener solutions and infrastructure.

I'll talk this morning about three specific parts of this work – voluntary carbon credits, climate-related risk management and sustainability-linked derivatives.

Carbon

I'll start with voluntary carbon credits.

The voluntary carbon market is a vital channel for companies to offset those emissions they can't reduce organically, as well as channel financing to green infrastructure and technology. We're very supportive of the efforts that have been made to scale this market in a robust and transparent way, from the Taskforce on Scaling Voluntary Carbon Markets to the Integrity Council for the Voluntary Carbon Market (ICVCM). The ICVCM has developed a proposed set of Core Carbon Principles aimed at setting a global benchmark for high-integrity carbon credits with verifiable impact on climate change.

Initiatives like these are critical in the quest to minimize greenwashing and ensure carbon credits enable genuine, verifiable offsetting projects. It's also important we develop a robust legal and regulatory framework so market participants have confidence to use the voluntary carbon market to meet their carbon reduction targets.

Last year, we published a whitepaper that explored the key legal issues associated with this market and recommended steps to create greater legal certainty. That analysis focused on the UK, US and Germany, and we will soon publish supplementary analysis covering France, Japan and Singapore. As suggested in the original paper, we have subsequently worked with two global standard setters that have agreed to develop standards for the legal treatment of voluntary carbon credits.

The market response to the paper indicated strong demand for ISDA to develop standard documentation for secondary trading of carbon credits, and that's exactly what we've done. We recently completed the drafting of the 2022 ISDA Verified Carbon Credit Derivatives Definitions, together with template confirmations for spot, forward and options contracts. These definitions and templates have been drafted with the flexibility to support trading of carbon credits across jurisdictions and registries. They will be available in digital format on our MyLibrary electronic documentation platform, allowing for seamless updates as market practices evolve in the future.

Risk management

In addition to drafting legal documentation, we are also acutely aware that capital requirements for carbon trading must be risk-appropriate. We've previously identified a flaw in the Basel III market risk framework that would assign a disproportionately high risk weight to carbon credits, and we've published detailed analysis to show why recalibration is needed. We've also been considering how risk management practices need to evolve to mitigate the impact of climate-related risks.

In the past, banks have sought to assess the impact of climate risk on longer-dated assets held in the banking book, but it is increasingly clear that extreme weather events and initiatives to support the green transition can also drive short-term volatility in asset prices. It's therefore important that banks evolve their trading book risk management framework to address those risks.

We recently undertook a survey together with EY that showed climate risk scenario analysis for trading book assets is at a relatively early stage, but most banks have prioritized this as a key area of focus. Some scenarios have already been developed by the regulatory community, but more work is needed to make sure the scenarios adequately capture climate-related financial risk.

It's still early days and there is little consensus on the methodology for identifying and defining climate risk shocks and mapping those shocks to market risk factors. There's also a need for consistent, granular and reliable data to support robust scenario analysis – banks have indicated greater standardization of data would be a welcome step.

This survey was an important starting point in the development of market risk management practices to address climate risks. We've been pleased to share our findings with policymakers and now look forward to working with market participants to develop best practices.

Sustainability-linked derivatives

Before finishing, I'd like to briefly cover our work on sustainability-linked derivatives (SLDs).

By embedding a sustainability-linked cashflow in a derivative structure and using key performance indicators to monitor compliance with ESG targets, SLDs incentivize parties to meet their sustainability objectives. The market is still small, but with SLDs now emerging in multiple jurisdictions, we've been focusing on how standardization could support the development of this product.

Over the past year, we have published guidance on how to draft key performance indicators to ensure the legal certainty of contracts. We have also published whitepapers that explore key regulatory issues for SLDs in the EU, UK, US, Hong Kong and Japan. The ISDA Future Leaders in Derivatives program also contributed to this literature with a valuable paper that set out the trade lifecycle of SLDs.

We're now thinking about what comes next. Earlier this year, we surveyed members and non-members to find out how they're engaging in this market and how trades are being documented. The results of that survey were published today – in general, we found firms are using adapted versions of existing ISDA documentation, and that additional standardization in some specific areas would be beneficial.

Based on the survey, we will now move forward with creating a set of standardized key terms and clauses that are used to document SLD transactions. These will be available from the ISDA Clause Library so members can pick which terms or clauses best suit their objectives when drafting their SLDs. This will be an important step in improving the efficiency of this market and allowing it to reach its potential.

Conclusion

I started these remarks by observing the urgency of shifting to a green economy and the need for every sector and business to play a part in driving the trillions of dollars in capital that is required to achieve our goals. At ISDA, our climate-related work is very tightly focused on the areas where we know we can make a real difference – standards, documentation and risk management. You can count on us to continue to develop this work in the years ahead.

Moving the needle on climate change also requires continuous and constructive dialogue with market participants and policymakers. We've brought together a great range of subject matter experts today, and I'm really looking forward to hearing their insights during the panels and presentations.

Thank you.