Derivatives Trading Forum: Trading ESG Products
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Opening Remarks
Scott O'Malia, ISDA Chief Executive

Hello everyone, and welcome to the Derivatives Trading Forum. Thank you for joining us today, and thanks to Tradeweb for sponsoring the event.

We started this series back in April with an event that looked at how regulatory change is affecting the derivatives trading environment. Our June event focused on the impact of political change and the pandemic. Today, we're turning to another major issue that is driving new trends in trading – climate change.

It's clear that financial markets have a major role to play in efforts to reduce carbon dioxide emissions, providing access to the trillions of dollars of capital that is needed to invest in emissions-reducing businesses and infrastructure. Derivatives will be critically important in facilitating access to that capital and enabling issuers and investors to manage their risks.

Over the past year, there has been a major global initiative to develop a voluntary carbon market, which is widely recognized to be critical to the reduction of emissions. We have also seen the emergence of a new breed of sustainability-linked derivatives, which link payment obligations with environmental, social and governance (ESG) performance and impact, helping companies to meet their sustainability objectives.

The rapid emergence of these new trading markets is a promising development that will be essential in supporting the reduction of emissions. As these markets continue to grow, it is critical that there is a robust legal framework in place, as well as clear standards and best practices to ensure they remain safe and efficient.

In my remarks today, I will set out how ISDA is working to support the development of carbon markets, the importance of an appropriate regulatory treatment for carbon credits, and our work to develop standards and best practices.

Carbon Markets

Setting a price on carbon and developing a voluntary market for the trading of carbon credits are going to be fundamental to the success and speed of decarbonization.

We already have regulated emissions trading systems in several markets, including the EU, UK, China and New Zealand, as well as the US at state level, but voluntary trading is needed to complement the regulated schemes. Voluntary carbon credits allow businesses to compensate for the emissions they might struggle to reduce organically. As the price of carbon rises, it will incentivize greater investment in carbon reduction initiatives and infrastructure.

A year ago, the US Commodity Futures Trading Commission's climate-related market risk subcommittee produced a seminal report on managing climate risk in the US financial system, recommending that the US should establish a price on carbon as the single most important step in managing climate risk and driving the appropriate allocation of capital.

The Taskforce on Scaling Voluntary Carbon Markets, which convened in late 2020, has moved at pace to develop a blueprint for this market. It estimates the market needs to grow 15-fold by 2030 to support the objectives of the Paris Agreement. Central to the work of the taskforce is the development of a set of core carbon principles and an independent oversight body to protect and maintain the integrity of the market.

It is also important that there is a solid legal foundation for carbon credits, including robust documentation. ISDA is developing a paper that addresses the legal and documentation issues that need to be tackled before contractual terms can be drafted, and we will then work to develop standard documentation templates.

Creating legal certainty through documentation is in ISDA's DNA, and we have already published templates to support the trading of emissions and some environmental derivatives. This will continue to be a very active area of work for ISDA as the diversity and popularity of green transactions increases.

Regulatory Treatment

As well as ensuring legal certainty, we must also make sure that the regulatory treatment of green products is appropriate for the underlying risk. If capital requirements are too stringent for a particular product, financial institutions may find themselves unable to commit to that business, which would slow the scaling of the market. Rigorous and ongoing analysis is needed to make sure the regulatory framework is appropriately calibrated to avoid such an outcome.

Unfortunately, our analysis has shown that the new Basel III market risk rules would set disproportionately high capital requirements for carbon certificates. Under the Fundamental Review of the Trading Book (FRTB), carbon certificates would attract a 60% risk weight – twice that of crude oil. Our analysis of volatility during periods of stress suggests the risk weight should actually be closer to 37%. The FRTB also applies a lower correlation between spot and forward positions than is warranted by analysis of data on EU allowance trades.

The combined effect of these findings, which we set out in a paper in July, means capital requirements for carbon certificates will be well in excess of what is justified by their risk. While we recognize this very conservative treatment may not have been intentional, we are also clear that it needs to be addressed urgently as the FRTB is due to be implemented in 2023.

The need for appropriate treatment extends to the accounting framework, too. Under US Generally Accepted Accounting Principles, the ESG component of a green bond or loan could be classified as a derivative, requiring it to be reported at fair value. This is problematic because a lack of observable data means ESG features are currently hard to value, leading to information that may not be useful to users of financial statements. We published a paper on this issue last month that proposes two possible solutions and recommends ESG-related issues would be best covered through qualitative disclosures.

As we engage with regulators and accounting standard setters on the issues we have identified, we have also worked to develop standards for sustainability-linked derivatives.

Standards

Since the first sustainability-linked derivative was executed in 2019, these products have emerged rapidly, allowing firms to embed a sustainability-linked cashflow using key performance indicators (KPIs) that monitor compliance with ESG targets. This is a market with real potential, but the transactions and the KPIs they use are very bespoke and customized to the needs of the counterparties.

The lack of standardization in KPIs makes it difficult to accurately and consistently measure performance across different products and will ultimately prevent the scaling of the market. In response, ISDA has developed a set of KPI guidelines for sustainability-linked derivatives, with the aim of boosting the transparency and credibility of these instruments. Our aim is to promote widespread adherence to KPIs that are specific, verifiable and transparent.

This is still a niche and nascent market, but experience has shown that standards and best practice are critical in promoting greater use of new products and building liquidity. Sustainability-linked derivatives may be an important way for many companies to meet their climate and development goals, so we hope market participants will review the guidance and adopt it for new transactions.

Conclusion

ISDA has always been dedicated to the promotion of safe and efficient derivatives markets, and we are very actively applying this expertise to green finance. As new trading markets and products emerge, the potential for real transformation increases. We look forward to supporting our members and the broader industry in successfully realizing the transition to a carbon-neutral economy in the years ahead.