ISDA Safe, Efficient Markets

evidence.gfs@beis.gov.uk

22 June 2022

Response to UK Government's Green Finance Strategy Call for Evidence

The International Swaps and Derivatives Association (**ISDA**) welcomes the opportunity to respond to the UK Government's Call for Evidence to support the development of an update to its Green Finance Strategy. ISDA lends its support to responses submitted by the Futures Industry Association (FIA) and the Association for Financial Markets in Europe (AFME).

1. Executive summary

- Derivatives can play a very important role in achieving the goals outlined by the UK Government in its Green Finance Strategy.
- 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.
- One particular area of growth is sustainability-linked derivatives (SLDs). SLDs embed or create a sustainability-linked cash flow using KPIs that are designed to monitor compliance with environmental, social and governance (ESG) targets.
- ISDA has published guidance that 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.
- Facilitating trading in carbon credit derivatives that serve as a hedge for climate mitigation projects will contribute to the development of deep and liquid voluntary carbon credit markets.
- Providing legal certainty of the treatment of carbon credits under English law is instrumental to establishing the UK as a carbon-trading hub. The UK authorities/industry should establish a clear mechanism for driving this work forward, which may require an authoritative legal statement, targeted legislative amendments and/or regulatory guidance.
- ISDA recommends that taxonomy-alignment KPIs applying to credit institutions such as the Green Asset Ratio, as foreseen under the EU's Taxonomy framework, would negatively impact active derivative dealers and should therefore not be considered in the context of the UK's Green Finance Strategy.

2. Responses

Question 6: What areas for potential growth – for example emerging financial products and instruments – are there in green finance for the UK financial services sector?

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.

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 Government in its 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").[1]

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. While conventional derivatives can certainly be used to hedge green instruments such as green bonds, a new wave of sustainability-linked derivatives and exchange-traded ESG derivatives has also 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.[2]

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.

As interest in such ESG-related derivatives products gains momentum, standardisation will be more important than ever because it is only through robust standards that products and markets can scale efficiently. In this context, please note ISDA's publication of a white paper outlining key performance indicators (KPIs) guidelines for SLDs.[3]

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

[1] https://www.isda.org/a/KOmTE/Derivatives-in-Sustainable-Finance.pdf

[2] https://www.isda.org/a/qRpTE/Overview-of-ESG-related-Derivatives-Products-and-Transactions.pdf

[3] https://www.isda.org/a/xvTgE/Sustainability-linked-Derivatives-KPI-Guidelines-Sept-2021.pdf

and so they can be objectively verified. 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 paper is intended to provide further information to market participants on the types of transactions that have been executed to date, along with guidance on the overarching principles that need to be considered when structuring KPIs. The 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 help address greenwashing by encouraging adequate disclosure of how SLDs help attain sustainability objectives, therefore supporting the integrity of this developing market. The guidance also seeks to promote greater use of SLDs, which will help to build liquidity and provide an effective tool for counterparties to participate in the transition to a green economy.

As market participants make greater use of SLDs to further their sustainability goals, it is important for the effectiveness and integrity of the SLD market to assess whether and how these nascent contracts fit into existing derivatives regulatory regimes. This is why ISDA published another white paper which explores the regulatory implications of SLDs, including whether they could be classified as swaps under US regulations and/or over-the-counter (OTC) derivatives under EU and/or UK rules and, if so, what exemptions or exclusions might be available.[4] The paper also considers the impact of sustainability-linked cashflows on derivatives that would otherwise be excluded or exempt from certain requirements under those regulatory regimes as well as compliance issues that market participants should consider if SLDs are classified as swaps and/or OTC derivatives.

Increasing awareness surrounding these novel products and providing thought pieces on how these products can potentially operate under various legal and regulatory frameworks may

[4] https://www.isda.org/a/58ngE/Regulatory-Considerations-for-Sustainability-linked-Derivatives.pdf

ultimately encourage more trading in SLDs. In this regard, the UK authorities should help in this effort (i.e., host roundtables/ provide a forum for discussion) as SLDs can serve as another tool in the global fight against climate change.

Question 22: How can the UK best support the development of high integrity voluntary markets for carbon and other ecosystem service markets?

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 a 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). Please note ISDA's white paper on this subject, published in December 2021.[5] 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 channelled towards emissions-reducing projects.

[5] https://www.isda.org/a/38ngE/Legal-Implications-of-Voluntary-Carbon-Credits.pdf

Providing legal certainty of the treatment of carbon credits under English law is instrumental to establishing the UK as a carbon-trading hub. The UK authorities/industry should establish a clear mechanism for driving this work forward, which may require an authoritative legal statement, targeted legislative amendments and/or regulatory guidance.

ISDA notes that, in the United States, the Commodities Futures Trading Commission (CFTC) has recently confirmed that VCCs are commodities. Since VCCs are commodities, the Commission has the authority to police fraud and manipulation in VCC spot markets. In order for these markets to flourish, there can be no room for greenwashing, double-counting of credits or any other types of fraud and manipulation and thus, ISDA is supportive of the Commission's intent to use its enforcement authority to address these issues.

Question 30: What steps can the UK government take to support a robust investment data ecosystem to attract green finance flows?

Computation of Taxonomy-alignment KPIs

The introduction of the Green Asset Ratio (GAR) through Article 8 of the EU Taxonomy Regulation poses both operational challenges for banks to report and is potentially misleading for investors. This is primarily because the ratio (the denominator) refers to total assets, includes asset classes that will never be covered by the Taxonomy's criteria, while the numerator refers to eligible assets. In essence, there is a mismatch between the numerator and denominator. Therefore, the resulting reportable metrics are primarily driven by the operating model of the bank, rather than accurately highlighting taxonomy aligned financing activities. In particular, we are of the view that taxonomy-alignment KPIs applying to credit institutions such as the GAR would negatively impact active derivative dealers and should therefore not be considered in the context of the UK's Green Finance Strategy.

The GAR is defined as the proportion of the credit institutions' assets invested in taxonomy-aligned economic activities as a share of total covered assets. While the European Commission and the ESAs have acknowledged that they may be legitimate cases for derivatives to be recognised for directly contributing to taxonomy-aligned economic activities, out of an abundance of prudence, they have excluded derivatives from the GAR's numerator in the

absence of clear methodologies to assess their sustainability alignment and have promised to reconsider this issue in the future once there may be more evidence in this area to allow a different conclusion.

The inconsistent treatment of including derivatives in the denominator while they are excluded in whole or in part from the numerator for credit institutions is not optimal from a methodological consistency standpoint as it could potentially lead to banks having structurally poor GARs due to under reporting of derivatives. This in turn would make GSIBs less attractive issuers and counterparties for GAR-sensitive investors, and accordingly undermine their capital and funding costs at the very same time as global policymakers are relying on those same banks to provide financing for the transition to a net zero economy.

It is thus important that consistent methodological practices to assess the taxonomy alignment of the credit institutions' assets should first be developed before such KPIs are agreed upon as differing interpretations could create confusion for investors or result in fragmented outcomes, thereby limiting the potential for evolution of risk management practices in the ESG space.

We thank you for taking the time to consider our views on this issue. If you have questions on any of the issues addressed in this letter, we are happy to discuss them with you at your convenience.

Yours sincerely,

Toby Coaker

Assistant Director, UK Public Policy
International Swaps and Derivatives Association

Annex

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 960 member institutions from 77 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 @ISDA.