ISDA ESG Forum
March 7, 2023

Introduction and Welcoming Remarks
Scott O'Malia, ISDA Chief Executive

Good morning, and welcome to ISDA's ESG Forum. I'd like to thank all of you for coming along today.

With more and more companies across the globe pledging to reduce their emissions of greenhouse gases and support the transition to a green economy, there has been growing interest in how financial markets and products – including derivatives – can help.

For me, this boils down to a single critical reason: without financial markets, we have very little hope of achieving the trillions of dollars of investment needed to finance new projects that will reduce or capture carbon. That's what markets do – they allow capital to move from those entities that have it to those that need it, as well as enabling investors and lenders to manage their risk.

The good news is that investment is growing. According to recent research from BloombergNEF, investment in global energy transition reached a record level of $1.1 trillion in 2022, up 31% from the previous year. That covers a wide range of sectors, including renewables, energy storage, electric vehicles, hydrogen, nuclear, sustainable materials and carbon capture.

Notably, for the first time ever, the amount invested in energy transition was the same as the amount invested in fossil fuels, suggesting we're on the cusp of a paradigm shift.

The bad news is that we're still way off what's needed to reach net zero by 2050. The BloombergNEF research suggests that investment would need to triple to $4.6 trillion per year from now until 2030. That amount would need to further rise to $6.9 trillion per year between 2031 and 2040 and $7.9 trillion per annum from 2041 to 2050 – a seven-fold increase on the 2022 figure.

It's difficult to see how this can be achieved without mobilizing financial markets and a variety of investment and hedging tools.

The voluntary carbon market could be part of the answer. For companies unable to immediately transition fully from fossil fuels, the voluntary carbon market offers the opportunity to meet their sustainability objectives by offsetting those emissions they can't cut now. This in turn channels capital to those projects that generate credits by reducing or removing greenhouse gases from the atmosphere – providing an alternative source of revenue that could support further growth and development of innovative technologies.

This market could see strong growth in the coming years, with BloombergNEF predicting it could reach $1 trillion by 2037 versus an estimated $2 billion now. As well as getting us closer to the annual investment target needed to reach net zero by 2050, the voluntary carbon market would help establish a price for carbon in those jurisdictions where compliance markets are fragmented or don’t exist.

But there is a fly in the ointment – concern about greenwashing. Doubts over credit quality and environmental value, as well as concerns over a lack of transparency, have undoubtedly affected trust in this market and could hamper growth.

According to BloombergNEF, the number of offsets purchased fell by 4% last year, which it attributes to fears of reputational risk from purchasing low-quality credits. An overabundance of poor-quality credits that don’t reflect permanent carbon removal will keep prices low, discouraging investment in new technologies like direct air capture. In this scenario, carbon credits would just be a cheap way for companies to meet their net zero targets without genuinely contributing to overall carbon reduction.

For this market to reach its full potential and make a real difference, we need greater standardization and transparency, so market participants can be confident the projects they are supporting when they buy carbon credits have a genuine and verifiable impact on carbon reduction.

In a recent response to papers by the International Organization of Securities Commissions on the voluntary and compliance carbon markets, ISDA and the Institute of International Finance recommended four key action points:

1) To focus guidance on how regulators can use their authority to enhance market functioning, trust and overall market integrity;
2) To consider interactions between voluntary and compliance markets as they develop further;
3) To clarify the legal and regulatory treatment of carbon credits; and
4) To leverage the work of independent governance bodies to support greater standardization.

On the last point, the Integrity Council for the Voluntary Carbon Market has developed a set of core carbon principles due to be finalized in the coming weeks, which will establish standards for firms to identify high-quality credits that have a permanent, additional and verifiable impact on emissions. We believe initiatives like these are absolutely critical to the future success of the voluntary carbon market.

This needs to go hand in hand with a robust legal and regulatory framework – and this is an area that ISDA has been working to address. We published two whitepapers in 2021 and 2022 that explored the key legal issues associated with the voluntary carbon market and recommended steps to create greater legal certainty, which included the development of standard documentation.

We followed that up last December with the launch of the 2022 ISDA Verified Carbon Credit Transactions Definitions, which bring greater legal certainty and consistency to the trading of carbon credits. Having a single contractual framework for spot, futures and options contracts that can be used for any carbon standard or registry will allow firms to trade carbon credits more easily and globally – in turn, enhancing liquidity.

Of course, we recognize the voluntary carbon market is not the only channel available to firms to meet their sustainability objectives and support the green transition. There are a range of other financial instruments that have a valuable role to play, including sustainability-linked derivatives (SLDs). We’re currently developing standardized terms and clauses for this product, which will help to bring greater efficiency to the trading of SLDs.

But we do think the voluntary carbon market has an important role to play – which is why it’s so important that regulators and market participants work together to ensure this market has the transparency, integrity and legal certainty it needs to function safely and efficiently.