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# Regulatory Framework for Sustainability-linked Derivatives: Singapore Analysis

# INTRODUCTION

Singapore is taking a number of steps to achieve its ambition of net-zero carbon emissions by approximately 2050, including the progressive raising of carbon taxes from 2024[1] and the launch of the Singapore Green Plan 2030[2], which sets sustainability targets to be achieved over the next 10 years.

The Monetary Authority of Singapore (MAS) has complemented these initiatives by setting out a strategy to strengthen the resilience of the financial sector to environmental risks, and to position Singapore as a leading center for sustainable finance[3].

A number of financial products linked to environmental, social and governance (ESG) factors have emerged globally to help firms achieve their sustainability objectives and hedge climate risk. This includes sustainability-linked derivatives (SLDs), which embed a sustainability-linked cashflow in a derivatives structure and use key performance indicators (KPIs) to monitor compliance with ESG targets. However, it is necessary for users to understand how these instruments fit into existing regulatory regimes.

This paper focuses on the regulation of over-the-counter (OTC) derivatives in Singapore. The intention is to describe potential regulatory approaches to OTC SLDs[4] and provide guidance to help market participants develop their own assessments[5].

Two categories of SLDs are covered in this paper[6]:

- Category 1 SLDs: The KPIs and related cashflows are embedded within the derivatives transaction. An example of a Category 1 SLD is a cross-currency interest rate swap (IRS) that provides additional payments, spread ratchets or a preferential exchange rate when a KPI is met.

- Category 2 SLDs: The KPIs and related cashflows are set out in a separate agreement that references underlying (generally vanilla) derivatives transactions for setting the reference amount to calculate the KPI-linked cashflow. The terms (including pricing) of the underlying transactions (which may include transactions with other affiliates of the parties) would generally not be affected. An example of a Category 2 SLD is an agreement to make a payment if a counterparty meets its KPIs, calculated as a percentage of the notional amount of unrelated, separately documented derivatives transactions.

[1] Singapore Will Raise Climate Ambition to Achieve Net Zero Emissions By or Around Mid Century, and Revises Carbon Tax Level from 2024, February 18, 2022, www.nccs.gov.sg/media/press-release/singapore-will-raise-climate-ambition

[2] Singapore Green Plan 2030, www.greenplan.gov.sg/

[3] Monetary Authority of Singapore (MAS) Sustainability Report 2021/2022, July 2022, www.mas.gov.sg/publications/sustainability-report/2022/sustainability-report-2021-2022

[4] A sustainability-linked derivative (SLD) may potentially also be an exchange-traded derivatives contract, a debenture or other type of regulated product in Singapore. This paper does not consider the regulatory considerations for SLDs that are a type of regulated product other than over-the-counter (OTC) derivatives contracts

[5] The discussions in this paper are not intended to be legal advice or definitive guidance and market participants should seek their own independent legal advice if required

[6] There are likely to be other types of SLDs for which different regulatory issues may arise

# REGULATION OF OTC DERIVATIVES IN SINGAPORE

Singapore regulations on OTC derivatives are primarily set out in the Securities and Futures Act 2001 (SFA). Notably, market participants dealing OTC derivatives are subject to licensing requirements. There are also regulatory requirements for the reporting, central clearing and trading of OTC derivatives, alongside margin and risk mitigation obligations.

Under the SFA, a derivatives contract[7] is defined as any contract or arrangement under which:

- Obligations are or may be discharged at some future time; and
- The value of the contract or arrangement is determined by reference to one or more of the following underlying things[8]:
  - A unit in a collective investment scheme;
  - A commodity;
  - A financial instrument (ie, any currency, interest rate, securities or index thereof);
  - The credit of any person; or
  - Any other prescribed thing[9].

OTC derivatives contracts are derivatives that are not exchange traded[10]. An exchange-traded derivatives contract[11] is one that is:

- Executed on an organized market;
- Centrally cleared or settled; and
- Traded on standardized terms.

An OTC derivatives contract based on a reference asset that does not fall within the list of specified 'underlying things' will therefore not be a regulated OTC derivatives contract under Singapore rules.

The Singapore regulations on OTC derivatives generally apply to any OTC derivatives contract. A key question for SLDs is therefore whether they would be considered OTC derivatives contracts under the SFA.

[7] See section 2(1) of the Securities and Futures Act 2001 (SFA) for the definition of derivatives contract

[8] See section 2 (1) of the SFA for the definition of 'underlying thing' in relation to a derivatives contract

[9] Currently, payment tokens and any intangible property are prescribed as 'underlying things' in relation to futures contracts and derivatives traded on certain organized markets that are regulated in Singapore under the Securities and Futures (Prescribed Underlying Thing) Regulations 2020. Accordingly, derivatives of payment tokens or intangible property may also be subject to the Singapore regulatory regime for derivatives when they are traded on certain exchanges, trading facilities or other organized markets that are regulated in Singapore. 'Payment token' is defined for this purpose to mean any digital representation of value: (a) that is expressed as a unit; (b) the value of which is determined in any way, other than being permanently fixed by the issuer of the digital representation of value at the time it is issued to either a single currency or two or more currencies; (c) that is, or is intended to be, a medium of exchange accepted by the public or a section of the public as payment for goods or services or for the discharge of a debt; and (d) that can be transferred, stored or traded electronically

[10] See regulation 2 of the Securities and Futures (Licensing and Conduct of Business) Regulations for the definition of over-the-counter derivatives contract and OTC derivatives contract

[11] See section 2(1) of the SFA for the definition of exchange-traded derivatives contract

## WOULD A CATEGORY 1 SLD BE CLASSIFIED AS AN OTC DERIVATIVES CONTRACT UNDER SINGAPORE REGULATIONS?

If the instrument underlying a Category 1 SLD (ie, independent of the KPI elements) is classified as an OTC derivatives contract under the SFA, then the inclusion of cashflows linked to KPIs or the addition of new KPI elements is unlikely to change the classification.

For example, if parties enter into an IRS (which is an OTC derivatives contract under the SFA), then inserting a provision that requires the spread to increase or reduce depending on whether sustainability-linked KPIs are met would not change the classification of the IRS as an OTC derivatives contract.

## WOULD A CATEGORY 2 SLD BE CLASSIFIED AS AN OTC DERIVATIVES CONTRACT UNDER SINGAPORE REGULATIONS?

Most Category 2 SLDs are unlikely to be classified as OTC derivatives contracts under the SFA. This assumes the payout on the Category 2 SLD is linked to a KPI that does not directly relate to the value of any ‘underlying thing’ – ie, a unit in a collective investment scheme, a commodity, a financial instrument (ie, any currency, interest rate, securities or index thereof), the credit of any person or any other prescribed thing. For example, a Category 2 SLD that is linked to a market participant’s greenhouse gas emissions or ESG rating is unlikely to be classified as an OTC derivatives contract.

However, if a Category 2 SLD is linked to a KPI that references any ‘underlying thing’ (such as a commodity), then the Category 2 SLD could be classified as an OTC derivatives contract under the SFA.

There is a potential issue over whether derivatives relating to carbon credits (either compliance carbon credits or voluntary carbon credits)[12] should be regarded as commodity derivatives, on the basis that carbon dioxide (or any other emission) is a physical item or article and hence a commodity[13]. Nonetheless, carbon dioxide should not be regarded as a commodity in this context because the derivative relates to the contractual or legal right to produce carbon dioxide or other emissions, which is an intangible right rather than a physical item. However, there is no Singapore case authority or regulatory guidance on this[14].

In the event a Category 2 SLD is linked to a commodity and hence is prima facie a commodity OTC derivatives, it could still be excluded from regulation if it is physically settled by delivery of the commodity and certain other conditions are satisfied.

[12] Whether carbon credits are intangible property or contractual rights under Singapore law would depend on the terms of the particular carbon credit. A carbon credit with appropriately drafted terms is likely to be classified as intangible property. The Singapore courts are likely to determine whether carbon credits are intangible property based on the definition of a property right as something that is “definable, identifiable by third parties, capable in its nature of assumption of third parties, and have some degree of permanence or stability”. This definition is from the English case of National Provincial Bank v Ainsworth [1965] AC 1175, which has been applied in Singapore case law, most notably in recent decisions on whether cryptocurrency assets are capable of giving rise to property rights

[13] ‘Commodity’ is defined in section 2(1) of the SFA to mean any produce, item, goods or article, or any index, right or interest in any produce, item, goods or article

[14] Futures contracts relating to carbon credits that are traded on approved exchanges or recognized market operators that are regulated under the SFA would be exchange-traded derivatives contracts, as intangible property is prescribed as an ‘underlying thing’ in relation to futures contracts traded on approved exchanges or recognized market operators, according to the Securities and Futures (Prescribed Underlying Thing) Regulations 2020. See also footnote 9

Commodity OTC derivatives that are used for day-to-day business operations and are physically settled are excluded from the definition of a derivatives contract[15] and are therefore not subject to Singapore OTC derivatives regulations. However, cash-settled OTC derivatives used to hedge financial risks would not satisfy this condition for day-to-day business operations[16]. It therefore seems unlikely that a Category 2 SLD would benefit from this exclusion, although it will depend on the specific facts and circumstances of each case.

## IMPACT ON UNDERLYING DERIVATIVES OF CATEGORY 2 SLDS CLASSIFIED AS OTC DERIVATIVES CONTRACTS

The potential classification of a Category 2 SLD as an OTC derivatives contract would not affect any separate underlying transaction. A Category 2 SLD would be assessed distinctly from any other related derivatives, assuming it does not form part of the same agreement as the related derivatives and does not directly amend their terms.

## COMPLIANCE ISSUES IF CATEGORY 1 AND 2 SLDS ARE CONSIDERED OTC DERIVATIVES CONTRACTS

### Licensing

A person that deals OTC derivatives contracts must be licensed under the SFA or rely on an applicable licensing exemption to deal[17].

There is a licensing exemption for those persons who deal OTC derivatives contracts for their own account with a licensed broker or intermediary and do not derive a spread or other remuneration from dealing[18]. End users of derivatives that enter into OTC derivatives contracts for risk management or hedging purposes (and are not acting as professional dealers, market makers or liquidity providers) should not be regarded as deriving a spread or other remuneration from dealing, even if they make gains from changes in the value of the OTC derivatives contracts.

There is a separate licensing exemption for persons dealing commodity OTC derivatives contracts with accredited investors, expert investors or institutional investors[19] only[20]. When relying on the licensing exemption for dealing commodity OTC derivatives with accredited investors, the accredited investor will have to consent to being treated as such in accordance with the requirements of the accredited investor opt-in regime[21]. A person relying on this licensing exemption is also obliged to provide MAS with all information it may reasonably require concerning the business of dealing commodity OTC derivatives contracts.

[15] See the Securities and Futures (Prescribed Excluded Derivatives Contracts) Regulations 2018

[16] See the MAS Frequently Asked Questions on the Securities and Futures (Reporting of Derivatives Contracts) Regulations 2013

[17] See section 82 of the SFA

[18] See paragraph 3A(1)(a) of the Second Schedule to the Securities and Futures (Licensing and Conduct of Business) Regulations

[19] See section 4A of the SFA and the Securities and Futures (Classes of Investors) Regulations 2018 for the definitions of accredited investor, expert investor and institutional investor

[20] See paragraph 3A(1)(b) of the Second Schedule to the Securities and Futures (Licensing and Conduct of Business) Regulations

[21] See regulation 3 of the Securities and Futures (Classes of Investors) Regulations 2018

## Reporting

If SLDs are classified as OTC derivatives contracts, then a party to the SLD that is a licensed financial institution or significant derivatives holder is required to report details of the SLD to a trade repository, absent an exemption[22]. A significant derivatives holder is any person that is a tax resident in Singapore and has an annual gross notional amount of regulated derivatives booked or traded in Singapore that exceeds a prescribed reporting threshold amount[23].

## Mandatory Clearing

Certain banks with an annual aggregate outstanding notional amount of derivatives that exceeds a specified level are required to ensure that certain fixed-to-floating IRS are cleared through a regulated clearing facility[24]. If a Category 1 SLD (independent of the KPI elements) is a type of fixed-to-floating IRS that is subject to mandatory clearing, the SLD-specific characteristics (for example, the KPI-related cashflows) are unlikely to take the Category 1 SLD outside the scope of the requirements, although this would depend on the specific terms of the Category 1 SLD (eg, whether the tenor or notional amount will change if the KPIs are met or not met or there is optionality involved).

## Mandatory Trading

Certain banks with an annual aggregate outstanding notional amount of derivatives that exceeds a specified level are required to ensure that certain fixed-to-floating IRS are executed through a regulated exchange or market operator[25]. If a Category 1 SLD (independent of the KPI elements) is a type of fixed-to-floating IRS that is subject to mandatory trading rules, the SLD-specific characteristics (for example, the KPI-related cashflows) are unlikely to take the Category 1 SLD outside the scope of the requirements, although this would depend on the specific terms of the Category 1 SLD (eg, whether the tenor or notional amount will change if the KPIs are met or not met or there is optionality involved).

## Margin

Licensed banks and merchant banks that enter into non-cleared OTC derivatives with other banks or merchant banks are required to exchange margin with their counterparties[26].

## Certain Risk Management and Documentation Requirements

In Singapore, certain licensed financial institutions (ie, banks, merchant banks and finance companies) are required to put in place risk mitigation measures when entering into OTC derivatives contracts that are not centrally cleared. The risk mitigation measures relate to:

[22] See Part 6A of the SFA and the Securities and Futures (Reporting of Derivatives Contracts) Regulations 2013

[23] See regulation 6 of the Securities and Futures (Reporting of Derivatives Contracts) Regulations 2013 for the definition of significant derivatives holder

[24] See Part 6B of the SFA and the Securities and Futures (Clearing of Derivatives Contracts) Regulations 2018

[25] See Part 6C of the SFA and the Securities and Futures (Trading of Derivatives Contracts) Regulations 2019

[26] See the MAS Guidelines on Margin Requirements for Non-Centrally Cleared OTC Derivatives Contracts, www.mas.gov.sg/regulation/guidelines/guidelines-on-margin-requirements-for-non-centrally-cleared-otc-derivatives-contracts

- Having written trading relationship documentation with the counterparty;
- Confirming the material terms of each OTC derivatives contract by way of sending or exchanging written trade confirmations;
- Agreeing the methodology for valuation;
- Portfolio reconciliation;
- Portfolio compression; and
- Dispute resolution[27].

Licensed financial institutions in Singapore are expected to have sound risk management practices, including for credit risk, liquidity risk and market risk[28]. These market participants would likely already have procedures for risk management in place. In general, these institutions would need to identify any risks associated with KPI-linked cashflows.

## Disclosure

In Singapore, licensed banks, asset managers and insurers are expected to disclose on at least an annual basis their approach to managing environmental risks, in accordance with international reporting frameworks such as the Financial Stability Board's Task Force on Climate-related Financial Disclosures[29]. Transactions in SLDs should be considered when making these disclosures.

Retail funds presented as ESG funds are also subject to new disclosure and reporting guidelines from January 1, 2023[30]. Retail ESG funds that disclose their transactions in SLDs will need to ensure they are consistent with the disclosure and reporting guidelines.

Companies listed on the Singapore Exchange are also subject to mandatory sustainability and climate reporting[31]. Singapore-listed companies should consider their SLD transactions when disclosing sustainability policies and practices.

Further regulations on mandatory environmental risk disclosures for Singapore-licensed financial institutions are expected.

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[27] See regulation 54B of the Securities and Futures (Licensing and Conduct of Business) Regulations and the MAS Guidelines on Risk Mitigation Requirements for Non-Centrally Cleared Over-the-Counter Derivative Contracts, www.mas.gov.sg/regulation/guidelines/guidelines-on-risk-mitigation-requirements-for-non-centrally-cleared-otc-derivatives-contracts

[28] For example, see regulation 35 of the Banking Regulations, MAS Notice 125 to Insurers on Investments of Insurers, the MAS Guidelines on Risk Management Practices – Credit Risk (www.mas.gov.sg/regulation/guidelines/guidelines-on-risk-management-practices--credit-risk), the MAS Guidelines on Risk Management Practices – Liquidity Risk (www.mas.gov.sg/regulation/guidelines/guidelines-on-risk-management-practices--liquidity-risk) and the MAS Guidelines on Risk Management Practices – Market Risk (www.mas.gov.sg/regulation/guidelines/guidelines-on-risk-management-practices--market-risk)

[29] See the MAS Guidelines on Environmental Risk Management for Banks (www.mas.gov.sg/regulation/guidelines/guidelines-on-environmental-risk-management), the MAS Guidelines on Environmental Risk Management for Insurers (www.mas.gov.sg/regulation/guidelines/guidelines-on-environmental-risk-management-for-insurers) and the MAS Guidelines on Environmental Risk Management for Asset Managers (www.mas.gov.sg/regulation/guidelines/guidelines-on-environmental-risk-management-for-asset-managers)

[30] See the MAS Circular No. CFC 02/2022 on Disclosure and Reporting Guidelines for Retail ESG Funds

[31] See Rule 711A of the Singapore Exchange Mainboard Rules and www.sgx.com/regulation/sustainability-reporting

## Benchmark-related Considerations

Under the SFA, a financial benchmark[32] is defined as any price, rate, index or value that is:

- Determined periodically by a formula or other method of calculation;
- Made available to the public; and
- Used for reference to determine the sums payable on deposits or credit facilities, or the price or value of investment products.

KPIs could fall within the definition of a financial benchmark because the cashflows under SLDs are determined by whether the KPI is met.

The SFA regulates designated financial benchmarks and imposes obligations on their administrators and the submitters that provide information on designated financial benchmarks[33]. Currently, the only designated financial benchmarks are SIBOR and the Singapore Dollar Swap Offer Rate[34]. The regime for designated financial benchmarks is not likely to apply to any sustainability KPI.

Manipulation of any financial benchmark (including financial benchmarks that are not designated financial benchmarks) is a criminal offence[35]. Market participants that deal SLDs should therefore be careful to ensure they do not do anything that may be regarded as manipulation of financial benchmarks.

## Recovery and Resolution

When entering into SLDs, market participants should consider requirements related to recovery and resolution for financial institutions under Singapore regulations[36]. These regulations provide specific protections and safe harbors that only extend to certain arrangements. Market participants should therefore consider whether the SLD-specific characteristics affect the application of these safe harbors to their transactions.

In Singapore, there is a safe harbor for set-off and netting arrangements under the resolution regime for financial institutions[37]. To qualify, the arrangement is required to relate to rights and liabilities that arise from one or more derivatives contracts or other financial contracts[38]. A financial contract is defined to include derivatives contracts. A derivatives contract is defined for this purpose to mean derivatives with one or more of the following 'underlying things':

[32] See section 2(1) of the SFA for the definition of financial benchmark

[33] See Part 6AA of the SFA

[34] See the Securities and Futures (Designated Benchmarks) Order 2018

[35] See Division 2 of Part 12 of the SFA

[36] The recovery and resolution regime applicable to financial institutions is additional to and separate from considerations relating to the enforceability of netting arrangements under general corporate insolvency laws, which will also need to be considered. The safe harbors for set-off and netting arrangements for the purposes of the general corporate insolvency regime are set out in regulations under the Insolvency, Restructuring and Dissolution Act 2018 of Singapore. Please refer to the ISDA netting opinion for Singapore for more information

[37] See regulations 11 and 16B of the Monetary Authority of Singapore (Resolution of Financial Institutions) Regulations 2018

[38] Financial contract is defined in regulation 9 of the Monetary Authority of Singapore (Resolution of Financial Institutions) Regulations 2018 to mean a securities contract, derivatives contract, securities lending or repurchase agreement or spot contract

- A unit in a collective investment scheme;
- A commodity;
- A financial instrument;
- The price of transporting goods as freight or hiring vessels for the purpose of transporting goods;
- The credit of any person;
- A numerical indicator, model or statistic relating to weather;
- A numerical indicator, model or statistic relating to the emission of pollutants;
- Real property; or
- A numeral indicator, model or statistic that is a measure of economic performance or economic conditions.

The scope of derivatives that are financial contracts protected by the safe harbor under the bank resolution regime is therefore broader than the scope of derivatives contracts under the SFA regulatory regime for OTC derivatives. To the extent an SLD is an OTC derivatives contract, its SLD-specific characteristics (for example, the KPI-related cashflows) should not affect compliance with this requirement and the normal recovery-and-resolution-related considerations and safe harbors should apply.

Derivatives relating to carbon credits or emissions should be protected under the safe harbors even if they are not OTC derivatives contracts under the SFA regulatory regime, given the broader scope of derivatives contracts under the resolution regime for financial institutions.

Separately, certain Singapore-licensed banks that are incorporated in Singapore and their subsidiaries are required to ensure their financial contracts governed by foreign laws (ie, laws other than Singapore law) contain enforceable contractual provisions suspending termination rights in the event of resolution[39]. To the extent an SLD is an OTC derivatives contract, a Singapore-licensed bank subject to the contractual stay requirement would need to ensure compliance with these requirements when entering into SLDs.

[39] See regulation 27A of the Monetary Authority of Singapore (Resolution of Financial Institutions) Regulations 2018 and sections 83 and 84 of the Monetary Authority of Singapore Act 1970 of Singapore

## 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.