ESG and Derivatives – Virtual Event
September 30, 2020

Opening Remarks
Scott O'Malia, ISDA Chief Executive

Hello everyone, and welcome to the ISDA *ESG and Derivatives* conference. Thanks to all of you for joining us today, and thanks to all of our speakers. I'd also like to take this opportunity to thank Eurex for sponsoring this virtual event.

It seems there's not a day that goes by in which we don't see some sort of news on environmental, social and governance (ESG) issues. Earlier this week, for example, it was water futures being approved by the US Commodity Futures Trading Commission. A US Securities and Exchange Commission commissioner published an op-ed on climate risk disclosures. And the Financial Times published an article by the chief investment officer of a large investor arguing that going green on global bonds is the best way to change behavior.

One of the most interesting – and most challenging – aspects to ESG and sustainable finance is that there are so many different facets to the conversation about these issues. In particular, there is a lack of comparable and consistent ESG data, as well as standards describing products or specific outcomes. I'm not disparaging the effort but highlighting the challenges ahead of us.

There are a number of important questions we need to answer. For example:

- How do you set, define and implement meaningful ESG standards?
- How do you ensure ESG data disclosed by companies is of the utmost quality?
- How do you accurately and consistently measure and benchmark progress on achieving ESG goals?
- How can you effectively compare various sets of ESG ratings?
- How do you ensure global convergence of various ESG standards and definitions?

Adding to all of this complexity is that each constituency – whether it be policy-makers, banks, insurers, asset managers, pension funds, individual investors, corporations, standard-setters or others – brings its own perspectives and requirements to the discussion.

There is obviously a lot of work going on in a number of jurisdictions on these issues, and our event today will help shed some light on them.

We'll begin with a panel of policy-makers from the EU and the US, who will discuss current regulatory issues and the future direction of ESG-related policy initiatives.

We will then focus on ESG derivatives products – including the instruments issued by exchanges and sustainable swaps, where the price of the hedge goes up or down depending on the counterparty's ESG performance. A panel of market participants will share views on transactions that have emerged, and how derivatives trades within the ESG space are being structured.

Finishing the event, we will discuss the future of ESG derivatives. In particular, we will consider the issues that need to be addressed to enable the development of an ESG derivatives market.

So, in short, we'll be discussing the regulatory, legal, product development, product structuring, disclosure, documentation and other aspects of sustainable finance. That's clearly a lot of ground to cover. But while ISDA is a global organization with a deep talent pool, it's important given resource constraints that we stay very focused on those aspects of the discussion that are most relevant to derivatives.

In my mind, there are three important derivatives-related considerations to the ESG discussion.

The first is simply that derivatives will be vital to the sustainable finance and ESG goals of the EU and other jurisdictions.

As we know, the European green deal will attempt to mobilize €1 trillion to shift to a carbon-neutral economy. The EU's new 55% emissions-reduction goal by 2030 will require as much as €438 billion per year over the next decade in energy system investment alone.

The response to the COVID-19 pandemic has put the green deal at the heart of the EU's recovery plan. A recent European Commission announcement that the financing of 30% of the recovery fund will be through EU green bonds is indicative of the significant levels of investment risk that will have to be managed.

This makes the role of derivatives vital in several ways.

For one thing, the capital issuance requirements of the green finance transition mean market participants will need to hedge the risks of issuing or investing in that capital. This really goes to the core reason why derivatives exist in the first place – to align risks appropriately between and for firms.

Another way that derivatives will play a vital role is in their potential ability to hedge climate-related risks for investors and to incentivize firms to advance their ESG plans. They also facilitate price discovery and foster greater market transparency.

Finally, derivatives can contribute to long-termism by mitigating the impact of short-term market fluctuations, thereby enabling firms to stay focused on their strategic goals and plans.

It is very important for the market to develop and evolve the products and services that can be helpful to investors, liquidity providers and those firms that are making the long-term capital expenditure.

Policy-makers also have a role in aligning standards and targeted outcomes across borders so we focus on the climate, risk management and supporting capital investment, and aren't wasting time arguing over different and inconsistent standards and metrics.

It is also vitally important that policy-makers – working with market participants – develop a sensible approach to both defining the exposure of the financial sector to climate risk, and undertaking a data-driven scenario analysis.

With a dose of humility and practicality, we can all work together to define climate risk exposures and establish targets, and a monitoring framework that can be adjusted as facts and data steer us on this complicated journey.

The second derivatives-related consideration reflects the growth and evolution of our market. That growth was – and is – based in large part on our ability to agree on documentation and definitions that provide a common language for all users of these risk management tools.

We at ISDA are big believers in standardization and digitization – not just in documentation but in market practices, operational processes and wherever it makes economic sense.

Today, standardization is more important than ever for financial market participants because of the need to reduce risk, lower costs and operate more efficiently. Digitization goes hand in hand with that standardization, as it improves transparency and comparability of ESG data by ensuring open and centralized access, while avoiding duplication of data collection efforts.

The use of technological innovations like artificial intelligence and machine learning can also help identify and assess to what extent a company's activities or a financial institution's assets are sustainable.

Standardization in ESG finance and markets comes in several different forms. The taxonomy is one. Common disclosure approaches are another. Consistent analysis and metrics to measure ESG progress are yet another.

And while it is still early days, we are beginning to look at whether ESG derivatives might be helped by developing standard terms and definitions in this space.

Let me be clear and state that our current documentation and definitions can and are currently being used to document ESG transactions. For example, swaps that are linked to a client's performance against a set of sustainability targets have been documented under the 2006 ISDA Definitions.

In other areas where specific documentation may be required or desirable to increase trading efficiency, we have already done substantial work. This includes the US and EU annexes for emissions trading published over a decade ago.

As ESG derivatives continue to gain traction, and as market participants seek greater levels of contractual standardization in specific areas, we will work with our members to identify and address emerging needs to facilitate the development of this marketplace.

The third derivatives-related consideration has to do with risk and how it is analyzed and managed.

We believe it is vitally important that risk is analyzed accurately, priced correctly and managed appropriately.

The lessons when we fail to do so are clear. Market distortions can occur and the ensuing corrections can be quite painful. Which is why it is critical that financial market participants are not prevented or excessively restricted from using derivatives in an ESG context, as this could lead to decreased liquidity and supply of credit to the market.

The transition by markets, companies and governments in response to climate change is creating areas of innovation and growth opportunities in the risk management space. The important role that standardization and digitization can play in fostering that innovation, and the need for a sound, appropriate risk management approach – these are the parameters that frame our work in the ESG area.

In a relatively short period of time, that work has become significant. Last year, we formed our first sustainable finance working group in the EU, and our team has been very busy. In the course of this work, we have reached out to collaborate with other trade associations and constituencies, thereby extending our reach and strengthening our message.

Our recent collaboration with the Center for European Policy Studies, or CEPS, is a case in point. With our support, CEPS published a report on Derivatives and ESG and held a webcast to launch it.

The paper stresses that derivatives are an essential part of financing the transition to a greener economy and that any efforts to limit or restrict derivatives usage will adversely affect the EU's green deal and related initiatives. We're happy to note that the paper has been well received.

I firmly believe this industry can be a powerful force to help meet the challenge of mitigating both climate risk and market risk in the financial services sector. We will contribute to defining product standards linked to cash products, supporting risk mitigation of the enormous capital investments that will be required, creating new and innovative hedging tools and contributing to the development of a data-driven, risk-appropriate capital structure.

Let me close by thanking all of you once again for joining our virtual conference today. Thanks also to our panelists, and our sponsor, Eurex, for supporting the event.