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ISDA®

The Way Forward For Sustainability-linked Derivatives

INTRODUCTION

With the growth of sustainable investing, there is emerging demand for derivatives products that are linked to environmental, social and governance (ESG) goals. Although a nascent market, these products – sustainability-linked derivatives (SLDs) – have the potential to contribute to the green transition.

Since the first SLD was executed in August 2019, an increasing number of market participants have expressed an interest in transacting these derivatives. SLDs embed or create a sustainability-linked cashflow using key performance indicators (KPIs) designed to monitor compliance with ESG targets. In simple terms, they are typical derivatives transactions with an ESG add-on that affects payment flows. These transactions are highly customizable and the KPIs can range from emissions reductions to renewable energy capacity.

In response to the growing focus on these products and the likely acceleration of ESG-related financial transactions, ISDA has published several SLD papers, including one that sets out best practices for drafting KPIs to ensure legal certainty and enforceability[1]. Others examine the potential regulatory treatment of SLDs under the derivatives regulatory regimes of key jurisdictions[2]. These papers generated interest among ISDA's membership for the development of certain standardized terms and contractual provisions related to SLDs to improve trading efficiency.

In April 2022, ISDA launched a survey to assess the current state of SLD documentation. The survey was made available to both ISDA members and non-members. Sixty-nine respondents indicated they engaged in SLD transactions. The results and analysis in this paper are based on the information provided by these respondents.

Figures 1 and 2 below show the geographic location and business nature of the respondents, respectively.

Figure 1: Respondents by Country

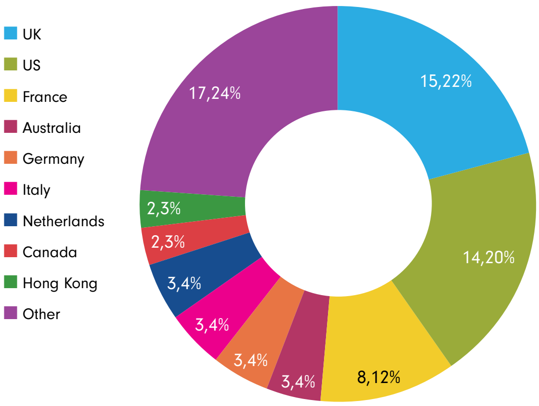
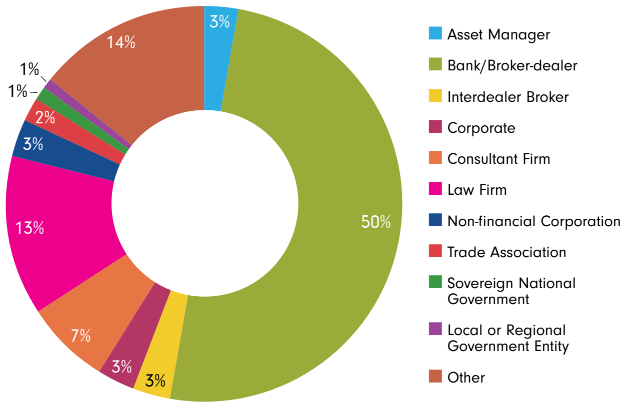


Figure 2: Respondents by Institution Type



This report summarizes responses relating to: (i) SLD structure and defining KPIs for ESG targets; (ii) achieving the ESG target, including payment, sustainability premium and non-payment; (iii) early termination of the underlying derivatives transaction; (iv) contractual provisions involving third-party verification entities; and (v) contractual provisions related to ESG rating entities. The paper then proposes a path forward for standard SLD documentation that aims to strike an appropriate balance between enhancing trading efficiency and maintaining the ability to tailor transactions to meet specific sustainability objectives.

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

[2] www.isda.org/a/58ngE/Regulatory-Considerations-for-Sustainability-linked-Derivatives.pdf; www.isda.org/2022/09/26/regulatory-framework-for-sustainability-linked-derivatives-hong-kong-analysis/

SURVEY RESULTS

SLD Structure and Defining KPIs for ESG Targets

Interest rate swaps (IRS) were identified as the underlying product for the majority of SLD transactions[3], followed by foreign exchange (FX) swaps and cross-currency swaps[4]. When asked what sectors ISDA should focus on if it develops standardized documentation, respondents highlighted IRS as the priority, followed by cross-currency swaps and FX derivatives[5]. Respondents noted that SLDs linked to credit default swaps, equity derivatives or commodity derivatives are not common[6].

In terms of structuring transactions, the majority of respondents indicated it is common to include ESG-related KPI terms in trade confirmations[7]. Others pointed out that it is also usual to see KPI terms in a separate agreement referenced in trade confirmations[8].

When asked what ESG metrics or targets they have observed as KPIs in SLDs, respondents said targets related to greenhouse gas emission reductions are most common[9]. This was followed by targets related to ESG ratings provided by third-party rating companies (eg, the KPI would require a counterparty to achieve a certain score by an independent ESG rating company)[10]. Some respondents also noted that KPIs can be tied to the ratio of a counterparty's renewable energy capacity to total capacity[11].

Achieving the ESG Target

ISDA asked respondents about the contractual impact of achieving or failing to achieve an ESG target. Most respondents said the impact would be an adjustment to the spread[12] – ie, a positive or negative adjustment would be made to the spread component of the floating rate paid by the counterparty if targets are met (or are not met)[13].

[3] Twenty-four respondents said interest rate swaps (IRS) are most common and 18 said they are common

[4] Sixteen respondents said FX is most common and 10 stated it is common. Eleven respondents said cross-currency swaps are the most common and 15 said they are common

[5] In developing standard contractual terms, 44 respondents said it would be very important for ISDA to address IRS first, 29 pointed to cross-currency swaps and 27 highlighted FX

[6] Thirty-eight respondents said it is not common to see sustainability-linked derivatives (SLDs) linked to credit default swaps, 33 stated it is not common to see SLDs linked to equity swaps, and 23 said it is not common to see SLDs linked to commodity derivatives

[7] Twenty-two respondents stated it is most common to see key performance indicators (KPIs) documented in trade confirmations, and an additional 15 said this is common

[8] Six respondents said it is most common to see KPIs documented in a separate agreement referenced in trade confirmations, while an additional 18 said this is common. One respondent said "[w]e typically see SLD Category 2 trades documented by a separate agreement and SLD Category 1 documented either by a separate agreement or within the trade confirmation. We rarely see this captured in the ISDA agreement, although acknowledge that some loan-linked hedging transactions (eg, project finance) may take this approach"

[9] Thirty-two respondents said KPIs related to greenhouse gas emission reductions are the most common and 19 said they are common

[10] Eleven respondents said KPIs related to environmental, social and governance (ESG) ratings are the most common and 27 said they are common

[11] Thirteen respondents stated KPIs related to renewable energy ratios are the most common and 18 said they are common. Twenty respondents said KPIs related to a counterparty's new ESG-rated investments are not common and 16 stated they are somewhat common. Fifteen respondents said KPIs tied to diversity targets are not common and 20 said they are somewhat common

[12] This term is understood to mean the defined term 'spread' under the 2021 ISDA Interest Rate Derivatives Definitions. Under the 2021 Definitions, 'spread' means the per annum rate (which may be negative), if any, expressed as a decimal, specified as such for the transaction or the party (or determined pursuant to a method specified for that purpose)

[13] Twenty-seven respondents said this approach is most common and 18 stated it is common

Others suggested that achieving or failing to achieve the ESG-related KPI would result in the payment or non-payment of a particular premium, as defined in the agreement (ie, a sustainability premium or 'greenium')[14]. Some respondents said a common outcome would be for failure to satisfy an ESG target to result in an increase to a fixed rate – either until the transaction is terminated or for a specified period after which it returns to the original agreed fixed rate. Under this scenario, satisfaction of an ESG target would result in the fixed rate remaining unchanged[15].

Payment

In terms of ESG-related payments, a significant majority said payment frequency is tied to payments on the underlying transaction[16]. For example, adjustments to the spread are made on each payment date. Alternatively, the payment of a premium is made on each payment date or the final payment date[17]. It is less common to see payment frequency tied to the dates on which KPIs are assessed[18], calendar year intervals (ie, monthly, quarterly or annually) or as one-off payments[19]. In the context of periodic payments based on the calendar year, a few respondents noted that annual observations are typical to match annual reporting schedules and to ensure there is sufficient time for data to be externally reviewed.

ISDA asked respondents whether SLDs contain terms requiring any funds earned to be directed towards a specified ESG initiative. Most respondents indicated that it is either rare to see such a requirement or they have only observed this requirement occasionally[20].

Sustainability Premium

As a general point, ISDA documentation does not create standards or particular definitions related to pricing as firms prefer to negotiate these terms bilaterally. However, as a sustainability premium or 'greenium' is a new concept in derivatives trading, ISDA asked members how such premiums are generally determined.

The majority indicated they did not know how these premiums are determined[21]. Some said they are typically a percentage of the notional amount of the transaction[22]. One respondent noted that notional amount is a factor, but other elements such as tenor can be taken into account. Respondents also said it is less common to see a premium that is a percentage of the combined notional amount of multiple derivatives transactions or a portfolio of derivatives[23].

[14] Ten respondents said this approach is most common, 16 stated it is common and 15 said it is somewhat common

[15] Eight respondents said this approach is most common, 15 said it is common and 10 said it is somewhat common. One respondent noted it is more common for meeting a KPI to result in a decrease to a fixed rate. The survey did not ask how counterparties determine the particular spread adjustments or to what extent fixed rates are typically increased or decreased, as this depends on how respondents are pricing particular SLDs

[16] Twenty-four respondents said this approach is most common and 12 said it is common

[17] These were the examples provided as an answer option, which 36 respondents selected as either the most common or common. The terms 'spread' and 'payment date' refer to those defined in the 2021 ISDA Interest Rate Derivatives Definitions

[18] There are typically set dates on which counterparties agree to assess whether a particular KPI has been met. There are often third-party verification entities that are assigned to assess whether a KPI has been met

[19] In terms of frequency of payments being tied to KPI assessments, seven respondents said this is most common, seven said it is common, 11 stated it is somewhat common and 18 said it is not common. With respect to frequency of payments being tied to periods within the calendar year, four respondents said this is most common, eight said it is common, 10 said it is somewhat common and 22 said it is not common. With respect to one-off payments, six respondents said this is most common, seven stated it is common, 14 said it is somewhat common and 14 said it is not common

[20] Nineteen respondents stated it is very rare for the agreement to contain a requirement for proceeds earned from an ESG-related premium to be used for an ESG-related purpose, including charitable donations. Seventeen said they have observed this occasionally and 12 said it is common. Fifteen answered 'other', noting they did not know or it is not applicable to their firm

[21] Collectively, 45 respondents answered 'don't know'

[22] Sixteen respondents said this approach is most common and 14 stated it is common

[23] Fifteen respondents said this approach is not common, nine said it is somewhat common, seven stated it is common and seven said it is most common

Non-payment

When a counterparty pays its obligations under the derivatives transaction but does not satisfy obligations under the ESG component of the agreement (eg, non-payment of ESG premium), most respondents said this may constitute a default under the entire agreement[24]. Based on the comments, it appears at least some respondents view this as an event of default, as defined under the ISDA Master Agreement[25].

Others said failure to satisfy ESG obligations would not affect the underlying transaction[26], with some characterizing this type of event as non-material. One respondent suggested the outcome of such non-payment is not uniform across transactions and listed the following provisions as common:

- Failure to satisfy the KPIs – the SLD condition – would not constitute an event of default (ie, the result is limited to the condition not being met, with a corresponding impact on payments – for example, an increase to a fixed rate or any other penalty payment or premium);

- Failure to serve a KPI notice[27] would not constitute an event of default. Instead, the KPIs would be deemed to be failing; and

- A failure to pay any amount due (eg, an ESG premium or increased payment due to the SLD condition) would then trigger a failure-to-pay event of default[28].

Where this has been observed, the respondent noted that these terms have been included in the relevant trade confirmation (which also has provisions that switch-off relevant events of default for the SLD condition).

Early Termination of the Underlying Derivatives Transaction

Most respondents said they did not know how the early termination of the underlying derivatives transaction[29] would affect ESG payments. Some noted that if a trade terminates early, then the KPIs are deemed not to have been met for the purpose of close-out payment calculations, with no premium payable[30].

One respondent noted that some banks offer to treat the KPIs as having been met for the purpose of close-out payment calculations (therefore lowering the potential early termination fee for corporate counterparties). A few respondents said counterparties have agreed to terms addressing this scenario, which would result in partial payments of the premium following early termination[31].

[24] Nineteen respondents said it would be a default under the entire agreement

[25] Section 5(a) of the 2002 ISDA Master Agreement

[26] Seventeen respondents said non-payment related to a KPI would not impact the underlying derivatives transaction

[27] Based on discussions with members and other feedback, ISDA believes that KPI notice refers to a party's obligation to notify its counterparty that it has met its KPI obligation while simultaneously providing any verification documentation required

[28] Section 5(a)(i) of the 2002 ISDA Master Agreement

[29] Early termination refers to the processes outlined in Section 6 of the 2002 ISDA Master Agreement, where one party may have the right to terminate the derivatives transaction prior to its set expiration under certain circumstances

[30] Ten respondents said this approach is most common and 11 said it is common

[31] Four respondents said this approach is most common and four said it is common

Other respondents highlighted a possible moral hazard issue if KPI payments are unaffected by early termination. In other words, if there are no consequences to the KPI payment in the event of early termination, or if KPIs are automatically deemed to have been met, it may incentivize parties to trigger early termination as a way of avoiding their ESG obligations under a particular transaction. It therefore appears that the relationship between KPI payments and early termination may warrant further industry discussion.

Contractual Provisions Related to Third-party Verification

For those agreements that rely on an independent third-party entity to assess whether an ESG target has been met, most respondents indicated that some or all of the following terms are commonly present:

- A requirement to exchange documentation that certifies or verifies an ESG target or KPI has been met[32];
- Specified terms in the trade confirmation or Master Agreement that outline the role of the verification entity and process, including specified dates (eg, the KPI test dates)[33];
- The verification/certification is produced by the third-party entity and the counterparty has the obligation to deliver the required documentation on the specified date[34];
- Terms that state failure to provide verification would result in the target not being met[35]; and
- Terms that include a right to request additional information or clarification if the verification/certification documentation appears insufficient[36].

The responses also suggest that failure to provide verification is unlikely to be included as an additional termination event (ATE)[37] under the SLD agreement[38]. Only a few respondents have observed agreements that allow self-certification (ie, the counterparty can self-certify that KPIs have been met and there is no third-party verification involved)[39].

When asked whether SLD agreements contain provisions to handle disputes over whether a particular KPI has been met, most respondents said there are no such terms because disputes are not common. That's due to counterparties' reliance on third-party verification[40].

Some respondents noted that if KPI certification turns out to be inaccurate, misleading or incomplete, then there are terms that provide a process for resolution, including how to address the consequences on payment flows[41].

32 Forty respondents said they have observed such a requirement

33 Thirty-seven respondents said they have observed such terms

34 Thirty-four respondents said they have observed this obligation in SLD agreements

35 Twenty-eight respondents have observed this condition in SLD agreements

36 Twenty respondents said they have observed the right to request additional information on KPI verification in SLD agreements

37 Under a swap transaction documented using an ISDA Master Agreement, an additional termination event (ATE) is negotiated by the parties. It is not one of the standard termination events set out under the ISDA Master Agreement. ATEs are typically specified in the ISDA Schedule or in a trade confirmation

38 Eleven respondents said they have observed these terms in SLD agreements

39 Twelve respondents have observed agreements that permit the achievement of KPIs to be self-certified. One respondent said self-certification that is publicly disclosed (eg, in an annual report) may be permitted by their firm in certain circumstances if they are satisfied with the self-certification process

40 Twenty-four respondents

41 Fourteen respondents

Contractual Provisions Related to ESG Rating Entities

For SLDs that have KPIs linked to ESG ratings provided by a third-party rating company, most respondents stated there are provisions in the agreement that address situations where:

- There is a methodology change in the relevant rating(s);
- There is an identity change of the ESG rating entity;
- The rating is not available; or
- The ESG rating entity fails to provide a report that contains the relevant rating(s)[42].

A few respondents stated that some or all of these scenarios may qualify as ATEs[43] under the agreement.

One respondent stated that a replacement entity and/or replacement rating would be applicable if either the ESG rating entity and/or the rating no longer exists[44].

Another respondent said they expect agreements to have restrictions on the use of a replacement ESG rating company given methodologies between ESG rating companies are highly variable. One respondent noted that standardized fallback provisions for ESG ratings would be helpful, while another said the listed scenarios would be covered under a market disruption clause to allow parties to amend terms related to the rating or rating entity.

[42] Thirty-one respondents said SLD agreements that reference ESG ratings contain these provisions

[43] Under a swap transaction documented using an ISDA Master Agreement, an ATE is negotiated by the parties. It is not one of the standard termination events set out under the ISDA Master Agreement. ATEs are typically specified in the ISDA Schedule or in a trade confirmation

[44] The respondents provided the following sample contractual language: "[i]f the ESG Rating Entity no longer assigns and/or calculates the ESG Rating or no longer issues the ESG Rating Report, following the effective replacement of the ESG Rating by a new system of rating published by the ESG Rating Entity, then this new rating shall replace the ESG Rating, and the terms of this transaction relative to the ESG Rating shall apply, mutatis mutandis, to the new rating. Otherwise, the ESG Rating will be considered […]"

PATH FORWARD FOR SLD DOCUMENTATION

Based on the survey results, a number of observations can be made on the current state of SLD documentation.

- Firms are using the existing ISDA documentation structure to incorporate SLDs into documentation for fixed-floating IRS and other derivatives, and the ESG-related terms are typically included in trade confirmations.
- The ESG-related contractual provisions reference terms set out in the ISDA Master Agreement and ISDA definitions, as well as new terms that are defined by the counterparties in the confirmation. It is common to see terms from the 2021 ISDA Interest Rate Derivatives Definitions and the ISDA Master Agreement referenced in SLD agreements.
- Some of the new terms included in SLD confirmations appear to be consistent in purpose across firms and therefore may be suitable for further industry standardization (eg, KPIs, sustainability premiums and ESG ratings).
- Some SLD agreements set out consequences if ESG-related payments are not made when due or if there is a KPI-related failure (ie, a failure to provide verification that a KPI has been met). These consequences may be similar to those observed in traditional derivatives trading (eg, viewed as an event of default or listed as an ATE).
- Some SLD agreements describe the impact on ESG-related payments when there is an early termination of the underlying derivatives transaction (eg, whether such payments would be included or excluded for purposes of close-out payment calculations).
- Reliance on third-party verification for determining whether a particular ESG-related KPI has been met is a key theme across respondents. There may be an opportunity to create standard terms that address the relationship and obligations of the counterparties with regards to the third-party verification entity.
- SLD agreements that use ESG ratings for KPIs often have provisions relating to when the rating is not available. This may benefit from further standardization.

The strong member interest in the survey[45] and the various common features identified by respondents mean ISDA will consider whether it is appropriate to draft standardized terms for documenting SLD trades.

For example, ISDA could produce a standalone confirmation template with its own set of ESG terms, possibly in a clause library format. This would allow members to create SLDs for different asset classes. As most SLD trading appears to related to interest rate derivatives, firms would use terms from the 2021 ISDA Interest Rate Derivatives Definitions in the template, alongside ESG terms and/or confirmation templates.

While standardization of certain key terms and contractual provisions would enhance efficiency in the trading of SLDs, ISDA recognizes that there continues to be a need for contracts to be customizable to suit a particular client need or sustainability objective. While evolving at a fast pace, the SLD market is still relatively nascent, so any standardized documentation will likely evolve over time to reflect future advancements.

[45] A number of members have reached out to ISDA directly about the survey and results

In considering when to begin work on standardized terms, ISDA will balance the objective of enhancing efficiency through having standardized terms and maintaining the necessary flexibility to allow SLDs to be tailored to meet firms' particular sustainability goals.

ABOUT ISDA