April 17, 2020

ISDA response to the revised draft Technical Report v2.0 with Criteria Proposals on the Development of an EU Ecolabel for 'Financial Products'

(Second proposal for Criterion 1: investment in green economic activities).

Introduction

The International Swaps and Derivatives Association ("ISDA") thank the European Commission's Joint Research Centre ("JRC") for the opportunity to comment on the second draft technical report on the development of the EU Ecolabel criteria for Financial Products.

The comments in this response reflect the membership of ISDA, which represents 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, ISDA members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearinghouses and repositories, as well as law firms, accounting firms and other service providers.

Representing the global derivatives market, ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. Our focus is to be the source for global industry standards and legal documentation, an advocate for effective risk and capital management, a strong proponent for a safe, efficient derivatives market structure for derivatives trading, clearing and reporting, and the pre-eminent voice of the global derivatives market.

Over the past year, ISDA has put in place a Sustainable Finance Working Group that deals with relevant issues affecting the derivatives industry. Since July 2019, ISDA has also become a member of the Ad-Hoc Working Group (AHWG) on the EU Ecolabel Criteria for Retail Financial Products.

As a general comment, ISDA is of the view that the Ecolabel criteria and various portfolio thresholds should allow sufficient flexibility in order to promote and support a wide future uptake of the Ecolabel. Otherwise, the end goal might be jeopardized if only a handful of funds are considered eligible to obtain the Ecolabel. The various thresholds should be calibrated progressively and in coordination with the other EU sustainability initiatives with a view to avoiding potential duplications that could create unnecessary administrative burden for market participants.

ISDA welcomes the opportunity to provide feedback to JRC. We hope that the feedback below is timely and helpful to JRC in preparing its final report on the subject. We look forward to engaging in a dialogue with JRC on the issues addressed in this response and stand ready to discuss our views in more detail and consider providing further information if useful to JRC.

Social Utility of Derivatives

As a general remark, it is important to note that derivatives are **a risk management tool**. They can be used to hedge against interest rate, currency, credit risk and a wide-variety of other risks and are an essential tool for investment funds.

In particular, derivatives allow the risks of variable costs and risks of production, such as the price of raw materials, interest rates, foreign exchange rates, and default risks, to be transferred from those who cannot afford them or do not have the expertise to manage them to those who can and have the expertise and appetite to take them on. Derivatives serve the needs of society to help moderate prices, supply and other risks to free up capital for economic growth and job creation. For example, derivatives allow farmers to hedge production costs and expected delivery prices. They help stabilize prices of consumer goods, they influence the price and availability of energy to heat homes and run factories, the interest rate borrowers pay on their mortgages and the return workers earn on their retirement savings.

In many occurrences, especially when markets are illiquid, subject to trading platform outages or simply closed, derivatives constitute the reference for price determination. The reference role is well known for physical commodities markets. Many pricing models also rely on the reference to derivatives market prices for the computation of present price estimates when cash markets are illiquid. This is especially true for bonds where, absent this pivotal derivatives reference, many cash trades would simply not be done.

In addition, derivatives contribute to the generation of information and the dissemination of that information to the public. For example, farmers can observe the price set for derivatives to determine whether they are getting a fair price for their crop.

In short, derivatives are an important contributor to price transparency and information dissemination.

Draft Technical Reports and Use of Derivatives

ISDA have thoroughly examined all relevant documentation in the context of JRC's work on the Ecolabel to date and would like to express its support to the following statement made in the context of the first draft report[1]:

"In terms of the scope of assets that could be verified within a portfolio, financial derivatives were considered in the PR to this study and by the stakeholders (questionnaire response Q5.5) to be technically complicated to be addressed within the framework of the EU Ecolabel, especially in the context of their verification. This is because their return is based on the value of other assets. ***So whilst an EU Ecolabelled financial product might necessarily still include derivatives within the portfolio it may not be necessary to verify their greenness****."*

The second draft technical report[2] published in December 2019 incorporates comments received from stakeholders during and after the 1st Ad Hoc Working Group Meeting (AHWG) meeting directed at various aspects of criterion 1 including: the EU Taxonomy, assessment and verification of other assets, trading practices applied in particular to derivatives, as well as the greenness thresholds.

ISDA is also supportive of the following comments: *"Those opposed to the inclusion of assets (e.g. cash, derivatives, etc.) for which verification of greenness is not required argued that the conditions are already too strict. This is because, depending on the investment strategy and liquidity conditions, investment funds might have to hold larger amounts of cash over a longer period of time or extend their use of derivatives for hedging purposes. This will therefore provide the portfolio managers more flexibility to construct a portfolio. Therefore, it was suggested to either relate the portfolio threshold only to the cumulative value of assets for which the degree of greenness could be assessed. An alternative proposal was to lower the overall portfolio threshold (to 51% as an example)".*

However, ISDA questions the subsequent judgement made to include derivatives in the calculation of a fund's total portfolio value, despite being excluded as an eligible green asset class, only because it

1 https://susproc.jrc.ec.europa.eu/Financial_products/docs/20190315%20TR%201.0%20EU%20EL%20Financial%20Products_Final%20consultation.pdf

2 https://susproc.jrc.ec.europa.eu/Financial_products/docs/20191220_EU_Ecolabel_FP_Draft_Technical_Report_2-0.pdf

was felt that excluding these assets from the total portfolio asset value could potentially result in a portfolio with only a very small portion of qualifying green assets in line with the EU Ecolabel. Clarity is needed in this regard especially since national labels have adopted varying approaches to derivatives (e.g. derivatives are not considered part of the portfolio total asset value for funds for the purpose of the French Greenfin label).

Requirements for the use of derivatives by UCITS and Retail AIFs, Chapter 5.1 (p. 32)

The second draft technical report proposes a number of requirements for the use of derivatives by UCITS and AIFs. ISDA would like to make the following observations:

Derivatives have an important role to play in a sustainable finance context as they could contribute to the achievement of the EU's long-term sustainable investment strategy goals by:

- facilitating capital raising of the amounts needed to finance the transition to a low-carbon economy (consider the important role of interest rate swaps in risk management in bond investments, for example, and of cross currency swaps in sustainability-linked bonds)
- helping firms manage financial risks related to ESG issues
- helping firms manage their businesses risk for the long-term by smoothing volatility from a variety of factors that may occur in the short term

Derivatives are an efficient low-cost tool for investment firms to manage their portfolio risks and they enable capital to be freed up for investments. Therefore, investment firms are more likely to make longer-term investments if they are able to efficiently hedge the risks of such investments. From an economic perspective, it is perfectly acceptable and appropriate for a fund manager or asset manager to take on an exposure with derivatives even when there is no underlying risk to hedge. They are sophisticated investors and have the ability to appropriately assess the various risks. This should not be confused with the notions of long-termism / short- termism. Derivatives are a tool that can support both long-term and shorter-term investment strategies, rather than an indicator of the type of strategy undertaken.

At present, the ESG investments generally represent a limited fraction of the bond or stock markets. With the upcoming taxonomy of EU sustainable activities, it is anticipated that this selection could become even more restrictive. As a consequence, institutional and retail investors are expected to opt for portfolio diversification solutions that will allow them to hedge risks and/or limit trading costs through the use of derivatives. It is important to note that the long-term sustainability of their involvement in ESG markets is highly dependent on their capacity to hedge their positions via the use of derivatives.

In view of the above, ISDA considers it is essential that investment managers are not prevented or excessively restricted from using derivatives as the use of derivatives can bring benefits, such as increased liquidity and supply of credit to the market. We note that short-term market liquidity is an important factor in allowing long-term investors to value their assets appropriately and to invest and disinvest efficiently. At product level, the risk mitigation offered by derivatives should support performance and suitability from the perspective of investors.

In particular, restricting investment firms' use of derivatives would result in:

- reduction in the overall liquidity in the cash and derivatives markets; hampering price-discovery; making it more difficult for firms to hedge risks; this would potentially reduce the likelihood that firms will lend money/make investments and would in turn disproportionately affect ESG assets that are generally long term in nature
- reduction in the ability of investment firms to hedge their portfolio risks

- negatively impacting the on-going development of useful benchmark ESG indices, that are key for enhancing the access to ESG strategies to the public at large with sufficient liquidity and appropriate portfolio diversification; as for other assets; the successful adoption of ESG index tracking strategies is highly dependent on the simultaneous development of ESG-index derivatives allowing managers to hedge their risks.
- making markets less efficient
- increasing funding costs
- hindering long-term growth in the economy

More specifically:

- ISDA would like to express its concerns in relation to the suggested requirement for the use of derivatives to be in line with the funds environmental investment policy. Whereas the fund itself could have various environmental objectives, such as channeling money into the green energy sector, derivatives are predominantly used to hedge against risks. In a sustainable finance context, sustainability-linked derivatives are currently being offered by financial intermediaries with a view to supporting positive contribution to one or more of the three pillars of sustainable development (economic, environmental and social) and mitigating any potential negative impacts. For example, a cross-currency or interest rate swap could be used for the purpose of an ESG-linked / SDG-linked bond to hedge against the exchange rate and interest rate risks created by the different denomination of the bond repayments and the source of repayments. It is thereforecrucial that investors are not discouraged to invest in green assets without having the opportunity to neutralize common risks.

- ISDA would like to highlight that there are situations an investment fund may face which would justify a longer-term exposure resulting from a derivative trade. For example, bond markets, including green bond markets, may only be traded in markets characterized by shallow liquidity; investors may use the more liquid CDS market by selling CDS protection rather than trading in an illiquid and fragmented bond market. This practice could be used until the relevant bond market is more liquid, however, it may be possible that liquidity does not pick up for a significant amount of time and the CDS exposure would hence continue to be on the investors' book. Moreover, if an investor buys a 10-year-bond from a company's 100%-subsidiary and hedges this position by buying insurance via, for example, a long 5 year CDS protection, his/her credit exposure would not amount to zero as there would be a mismatch between maturities. Also, that investor would be exposed to two different legal entities (subsidiary through the bond and parent company through the CDS position). Such derivatives exposures are crucial to fund diversification and generally increase liquidity in the derivatives market which benefits hedgers of risk and facilitates long-term growth.

- In the case of investment funds, hedging with derivatives (under the criteria proposals) is permissible in relation to currency risk, duration risk, market risk and/or sensitivity to changes in interest rate structures. ISDA believes that asset and fund managers should be permitted more freedom to choose hedging strategies if they view that these support the green economic aims of the product. Use of derivatives should be permissible for any reason pertaining to a change in the value of assets, including, but not restricted to fluctuation of interest rates, inflation rates, equity prices, foreign exchange rates or credit risk. It should also be permissible for hedge accounting purposes under International Financial Reporting Standards (IFRS) adopted in accordance with Article 3 of Regulation (EC) No 1606/2002 of the European Parliament and of the Council.

ISDA observes that the proposed requirement on the applicant to provide documentation on how the use of derivatives is in line with the fund's environmental policy and how the derivatives comply with the EU Ecolabel criteria is somewhat prescriptive. Assuming that derivatives can be used by applicants to manage risks or in other ways supporting the product's green economic activities, it should be sufficient for fund or asset managers to explain the reasoning behind their use of derivatives for this purpose.

- On the proposed prohibition on the use of derivatives for the short selling of securities, ISDA observes that a hedge via derivatives can often look like a short position, economically. It should suffice for the asset or fund manager to be able to explain the reason for the use of the derivative, qualitatively or quantitatively. To illustrate this point, we draw your attention to the advice[3] of the Securities and Markets Stakeholder Group's (SMSG) on ESMA's short-termism survey in August 2019, according to which:

  "43. Derivatives are instruments that permit users to gain exposure to or to hedge against a market segment or risk/. Rolling derivatives is quite often a way to maintain a position for a longer term. The use of CDS to buy or sell credit protection by investment funds does not necessarily contribute to short-termism in markets. For example, this strategy may be adopted to address the issue of scarcity or mispricing in the bond market. Market liquidity for a specific bond the fund manager is trying to buy may be poor at the time the fund manager elects to increase exposure, making it difficult to find an acceptable price or to find a market for the full size. In this case the fund manager could turn to the CDS market, selling protection on the relevant reference entity, and gain credit exposure on the relevant bond. Selling protection can be viewed as essentially identical to the credit exposure from taking a long bond position. When the bond is tradable on more favourable terms the fund manager can then choose to switch exposure from CDS exposure into the specific bond.

  44. As far as the risk side is concerned, Regulation (EU) No 236/2012 on short selling and certain aspects of credit default swaps has already provided a regulatory response by banning naked short selling as well as naked sovereign CDSs. In addition, the aforementioned regulation introduced mandatory transparency in respect of net short positions."

[3] https://www.esma.europa.eu/sites/default/files/library/smsg_advice_short-termism.pdf