Feature

**KEY POINTS**

- Governments globally are focused on climate change and reaching net-zero emissions by 2050, and a report published by the Intergovernmental Panel on Climate Change (IPCC) on 9 August 2021[1] has only served to bolster global resolve to reverse the impacts of climate change and reduce greenhouse gas emissions.
- Central to this mission is the financial services sector, as the transition to sustainable economies cannot be achieved without a significant amount of investment and funding. With funding, however, comes risk – derivatives will play an essential role in managing that risk whilst also facilitating and promoting sustainable investments.
- The derivatives market has benefitted from substantial innovation in recent years, with financial institutions offering bespoke sustainability-linked solutions to clients in order to enable companies to hedge their exposures whilst meeting their own environmental, social and governance (ESG) targets.
- Derivatives are important for the promotion of transparency and price discovery in the growing field of sustainable finance, and such transparency and price discovery depends on consistent reporting and disclosure of the ESG derivatives transactions that are being entered into. However, there is currently some uncertainty as to whether sustainability-linked derivatives transactions are disclosable transactions under the new EU ESG regulatory framework and whether they are transactions that promote environmental and/or social characteristics.

**Authors** Dean Naumowicz and Delyth Hughes

# The role of sustainability-linked derivatives in meeting global ESG goals

This article explores the role of ESG derivatives transactions in enabling companies, financial institutions and governments to meet their ambitious sustainability targets with a particular focus on bespoke, innovative sustainability-linked hedging solutions. This article highlights different ways in which sustainability-linked derivatives transactions can be, and have been, structured. In addition, this article explores the challenges currently faced by parties entering into such transactions stemming largely from a lack of regulation, resulting in limited transparency, standardisation and reporting.

The European Commission has proposed to cut greenhouse gas emissions by at least 55% by 2030, with a view to becoming climate neutral by 2050[2] as part of the European Green Deal (the growth strategy intended to enable the EU economy to transition to a sustainable economic model). Similarly, the UK government has committed to achieving net zero by 2050 whilst cutting emissions by 78% by 2035,[3] a target that was enshrined in law in June 2021[4] as part of the UK's Sixth Carbon Budget.[5]

"ESG" is no longer just a buzzword, and in order for governments to meet their ambitious targets, global financial institutions and the financial services sector as a whole will be vital in facilitating the transition to a sustainable economy. Trillions of euros worth of capital[6] will need to be issued in order for goals and targets to be met, creating resultant interest rate, foreign exchange and credit risks.

As with other previously nascent asset classes (such as weather-linked structures or Shari'ah-compliant lending), derivatives transactions can assist with global ESG goals in a multitude of ways, by: (i) allowing more capital from diverse sources to be channelled towards sustainable investments; (ii) helping parties hedge risks related to ESG investments; and (iii) facilitating transparency, price discovery and market efficiency.

## WHAT ARE ESG DERIVATIVES?

ESG is a broad term and certain classes of derivatives transactions that are categorised as "ESG derivatives" or "ESG-related derivatives" have been around for many years. These classes of derivatives transactions include emissions trading (which allows companies to trade carbon allowances as a means of supporting a reduction in pollution) and catastrophe/weather derivatives (which allow market participants to hedge risks associated with disasters or adverse/unexpected weather conditions).

Over the past few years there has been further growth and innovation in the types of derivatives transactions that are held up in the market as "ESG derivatives". Of particular note has been the development of ESG indices and associated equity index futures and options contracts as well as the development of CDS indices derived using ESG criteria, allowing market participants to gain exposure to or hedge general ESG corporate risk.

The main focus of this article, however, is on the more recent "sustainability-linked" derivatives transactions and hedging solutions that market participants are beginning to see as integral to many types of wider structures. The defining feature of many of these derivatives transactions is the addition of an ESG pricing component into otherwise conventional hedging instruments. These derivatives transactions will be crucial for facilitating the lending, investment and debt issuance required to meet the ESG ambitions of the EU and the UK.

## SUSTAINABILITY-LINKED DERIVATIVES

To date, sustainability-linked derivatives transactions have been based on conventional hedging instruments and have generally taken the form of interest rate swap transactions, cross-currency swap transactions or FX transactions whilst incorporating bespoke ESG components that impact the pricing and/or payment obligations of the parties. Therefore, in addition to the conventional risk management aspects of such transactions, sustainability-linked derivatives transactions have ESG at their core. The ESG components, which can take a number of forms, may be included to: (i) encourage one party to meet and maintain certain sustainability targets or obtain and maintain a particular ESG rating; or (ii) require either party to invest in specific sustainability initiatives.

The ESG components of most sustainability-linked derivatives transactions have generally been added: (i) as an adjustment to an interest rate or cross-currency transaction tied to an underlying financing arrangement (eg as part of the calculation of a floating rate under an interest rate swap transaction or the currency conversion rate in a cross-currency swap transaction); or (ii) to independent, typically FX, products not tied to an underlying financing arrangement.

While both types of products are similar, the incentives for an entity to enter into each are subtly different. Sustainability-linked derivatives transactions that are entered into to support an underlying financing arrangement are often structured so that a borrower achieves a better rate in the overall transaction, including under the underlying financing arrangement itself, if certain sustainability targets are achieved (conversely, the borrower may suffer a more onerous rate if such sustainability targets are not achieved). Sustainability-linked derivatives transactions that are entered into independently (to date, mostly FX products) are often structured to encourage a company to achieve its stated sustainability targets more quickly.

## Structures/transaction types

Typically, sustainability-linked derivatives transactions reference bespoke, highly customised key performance indicators (KPIs) or sustainable performance targets (SPTs) that encourage one or both parties to actively engage in environmentally sustainable activities. These KPIs/SPTs can take a variety of forms and may incentivise a party to: (i) meet and maintain an ESG rating or score (which may be set by the bank or an independent third party ratings provider); (ii) meet particular targets to reduce emissions/energy consumption; (iii) contribute to certain specified sustainable development goals; and/or (iv) obtain and maintain ESG-related certifications from relevant industry bodies.[7]

Satisfaction of the relevant KPI/SPT criteria will, in turn, impact the pricing and/or payments/deliverables made under the relevant transaction. The consequences of meeting or, indeed, failing to meet the KPIs/SPTs are highly negotiated and can include: (i) the addition of a requirement to pay a positive spread (where KPI/SPT criteria have not been met) or a negative spread (where KPI/SPT criteria have been met) for interest rate transactions; (ii) donations to sustainable/charitable organisations and/or initiatives (to be made by a bank counterparty where the KPI/SPT criteria has been satisfied and to be made by a corporate or borrower counterparty where the KPI/SPT criteria has not been met); (iii) discounted/preferential FX rates to be applied where KPI/SPT criteria are satisfied (with no change to the standard rate where criteria are not satisfied); (iv) ratcheting rates/spreads depending on the number of KPIs/SPTs that have been met; or (v) reinvestment of any additional premium into pre-agreed sustainability projects where KPIs/SPTs are met.

Sustainability-linked derivatives transactions are highly customisable. Parties can not only agree bespoke KPIs or SPTs but also negotiate the consequences of their satisfaction (or lack of achieving any relevant KPI or SPT). Whilst this flexibility is integral for the development of sustainability-linked derivatives transactions, greater standardisation will be needed for sustainability-linked derivatives transactions to evolve into an industry-recognised asset class of their own.

Notably, the addition of amounts to scheduled payments under sustainability-linked derivatives transactions can lead to questions regarding the characterisation of such increase and/or the incentives of one or both parties to the agreement. The development of sustainability-linked derivatives transactions needs to be considered in light of these additional concerns. For example, could an increase in the quantum of one or more scheduled payments be characterised as a penalty? Could receipt of an enhanced payment under a transaction raise conflicts as well as ethical and reputational issues for one or both parties, particularly if a party could be seen to be benefitting from its counterparty's failure to achieve a KPI or SPT? Should a party that receives an enhanced payment resulting from a failure by its counterparty to achieve a KPI or SPT be required to disgorge any such payment in a manner that reflects wider ESG principles?

## Role and purpose of sustainability-linked derivatives

Given the exponential growth of ESG-linked finance, it could be argued that the role of ESG derivatives in achieving sustainability goals is at worst illusory or at best limited, not least because such derivatives themselves are unlikely to raise additional funding directly to finance a transition to a sustainable economy. However, such arguments take too narrow a view with respect to the role of derivatives in supporting the financial products that can drive sustainability objectives. As the financial sector looks to assist global governments with their sustainability goals, and as those governments, in turn, seek to regulate and standardise the sustainable finance industry (see more detail in "Regulatory challenges"), sustainability-linked derivatives transactions are bound to play an increasingly important role in facilitating such goals.

Sustainability-linked derivatives transactions not only allow capital to be directed towards sustainable purposes by allowing market participants to accurately manage and mitigate the risk created by that sustainable financing, but also incentivise market participants to work towards and improve their own ESG goals and targets. Indeed, some banks may view ESG derivatives as a means of providing their clients with the ability to consider ESG in each step of their financing, including as part of the associated financial risk management, reflecting the role that derivatives transactions play in other sectors and asset classes.

## CHALLENGES FOR SUSTAINABILITY-LINKED DERIVATIVES

Until recently, the focus of most regulators was on other elements of sustainable financing, including ESG-linked bonds and funds. Sustainability-linked derivatives transactions are still in their infancy, and only a low volume of bespoke transactions have been entered into to date. As a consequence, what constitutes an "ESG derivative" and, more specifically, a "sustainability-linked derivative" remains open to interpretation. The following section details some of the challenges that derivatives market participants continue to face.

## Regulatory challenges

Over the past year, new ESG-based regulations and an EU directive have been proposed[8] and implemented.[9] Such legislation acts as an important step in improving the quality and availability of sustainability information and imposes obligations on certain market participants to undertake mandatory ESG reporting and disclosure.

How these legislative requirements will impact sustainability-linked derivatives transactions and whether these are in scope as

*Biog box*

Dean Naumowicz is a partner in the London office of Latham & Watkins and a member of the firm's Corporate Department and Capital Markets, Derivatives, and Structured Finance Practices. Email: dean.naumowicz@lw.com

Delyth Hughes is an associate in the London office of Latham & Watkins and a member of the firm's Corporate Department and Capital Markets, Derivatives, and Structured Finance Practices. Email: delyth.hughes@lw.com

reportable transactions is unclear (particularly where such transactions are not entered into to support an underlying financial arrangement). Initial guidance suggests that derivatives transactions are neutral activities for the purposes of the EU Taxonomy Regulation (ie they are considered to do "no significant harm" to specified environmental objectives). However, as more and more parties enter into sustainability-linked derivatives transactions, they may in fact be recognised as financial products that promote environmental characteristics. More guidance will therefore be needed for market participants to determine how, or whether, they will be subject to the new reporting and disclosure obligations in respect of their ESG derivatives transactions.

## Standardisation and transparency

In order to ensure that sustainability-linked derivatives transactions continue to be used as effective risk management tools whilst assisting market participants in sustaining their green credentials, greater standardisation and transparency would be welcomed.

To date, sustainability-linked derivative transactions have been governed by ISDA standard documentation, tailored on a per trade basis. Given the flexibility and widespread acceptance of the ISDA Master Agreements and supporting ISDA documentation, this is a sensible approach. Parties should consider in detail whether including sustainability-linked derivatives transactions with conditional adjustments to scheduled payments under an ISDA Master Agreement adversely impacts any of the key provisions, particularly with respect to close-out netting and tax. The very nature of such payment adjustments not only complicates valuations, but also raises more fundamental questions as to how to treat such payments for the purposes of close-out netting, tax representations and collateral calculations under related credit support documentation. As the market develops, standardisation of ESG terms and documentation will be necessary whether in the form of guidance, new ESG-related definitions or sustainability-linked template confirmations. Standardising documentation would have the added benefit of improving transparency, market efficiency and price discovery by allowing more consistent reporting and better comparisons between data.

## Hedging

As set out above, sustainability-linked derivatives transactions have generally been based on conventional hedging instruments with additional ESG components. The ability of parties to hedge these ESG components remains limited, however. As with other nascent asset classes, increasing volumes together with increased standardisation and transparency should enable parties to develop a broader range of hedging techniques to manage all elements of risk with respect to sustainability-linked derivatives transactions.

## Verification of KPIs/SPTs and ESG ratings

The International Organization of Securities Commissions (IOSCO) recently published a consultation report reviewing third party ESG ratings and data products providers[10] in the context of all ESG linked financial transactions.

Whilst IOSCO acknowledged the helpful role played by these third-party providers, it also noted a lack of transparency with respect to ESG ratings methodologies and data products more generally and a lack of regulatory oversight in respect to these private providers, both of which may raise concerns with respect to transparency, pricing and "greenwashing".

Notably, some of the sustainability-linked derivatives transactions that have been executed to date involve ESG ratings set by one of the counterparties to the transaction (typically a bank or financial institution) or KPIs/SPTs verified by a corporate end user. For a market in sustainability-linked derivatives transactions to develop fully, such ratings and/or verification must be able to be independently monitored and impartial. Sustainability targets that are difficult to monitor or that lack transparency, or that are seen to be too easy to achieve, will ultimately inhibit the development of these transactions as a new asset class of derivatives.

Greater regulation, standardisation and guidance is needed to ensure that KPIs/SPTs and ESG ratings are adequate in determining and monitoring sustainability goals, not just for sustainability-linked derivatives transactions but also for many of the sustainability-linked financing transactions they are hedging. The IOSCO consultation closed for comments on 6 September 2021, and further reform in the area of ESG ratings and data products is likely to follow.

On 7 September 2021, ISDA published a paper titled *Sustainability-linked Derivatives: KPI Guidelines* setting out the overarching principles to be used when drafting KPIs/SPTs for use in sustainability-linked derivatives transactions in a bid to encourage standardisation and to develop liquidity in the market. ISDA note, in particular, that KPIs should be used to meet certain specific objectives, including education, contribution to best practices and the promotion of safety and soundness of the market. ■

1 IPCC, "AR6 Climate Change 2021: The Physical Science Basis", https://www.ipcc.ch/report/ar6/wg1/

2 European Commission, "EU climate action and the European green deal", https://ec.europa.eu/clima/policies/eu-climate-action/2030_ctp_en

3 UK government, press release, 20 April 2021, https://www.gov.uk/government/news/uk-enshrines-new-target-in-law-to-slash-emissions-by-78-by-2035

4 The Carbon Budget Order 2021, 23 June 2021.

5 https://www.theccc.org.uk/publication/sixth-carbon-budget/

6 European Commission, "The European Green Deal Investment Plan", 14 January 2020, https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_24

7 ISDA, "Overview of ESG-related Derivatives Products and Transactions", January 2021, https://www.isda.org/a/qRpTE/Overview-of-ESG-related-Derivatives-Products-and-Transactions.pdf

8 Corporate Sustainability Reporting Directive (CSRD), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189

9 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (the Taxonomy Regulation), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32020R0852 and Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability–related disclosures in the financial services sector (the Sustainable Finance Disclosure Regulation or SFDR), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088.

10 IOSCO, Environmental, Social and Governance (ESG) Ratings and Data Products Providers, 21 July 2021, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD681.pdf