

CLASSIFICATION OF SUSTAINABILITY LINKED DERIVATIVES IN INDIA

January 18, 2023 > [India](#) > Derivatives

JURIS CORP | [VIEW FIRM PROFILE](#)

Sustainability Linked Derivatives (“SLDs”) are emerging as a powerful new instrument in the toolkit of financiers globally in the context of the growth of use of Environmental Social and Governance (“ESG”) factors in the financial world. For an orderly evolution, a suitable regulatory framework suited for this type of derivative contract is a must. SLDs require robust standardisation with respect to Key Performance Indicators (“KPIs”) and ESG linked metrics in order to ensure the success of such derivative contracts.

At the COP 26 conference, India committed to meeting 50% of India’s energy needs via renewable sources by 2030 and achieving net-zero emissions by 2070. In light of the same, a consultation paper on Climate Change and Sustainable Finance was released by the banking regulator, the Reserve Bank of India (“RBI”) [1]. It highlights the key areas of interest for RBI regarding policy and regulatory initiatives to combat climate change risks. The aim is to assist the Government of India in meeting their climate change commitments.

India has not reported an SLD transaction between major market participants as of yet and there is a lack of a regulatory framework regarding SLDs. In fact, the Deputy Governor of RBI, M. Rajeshwar Rao, recently made a statement calling for a clear taxonomy or a classification system and a formal definition of ‘green finance’ in order to prevent greenwashing by the industry and establishing a list of environmentally sustainable economic activities. In his words: *“There is a need for regulated entities to develop and implement comprehensive frameworks for understanding and assessing the potential impact of climate-related financial risks in their business strategy and operations. A taxonomy would also help banks and financial institutions in better assessing the climate risk in their loan portfolio, scaling up green and sustainable finance and mitigating the risk of greenwashing.”*

Along with RBI, the capital market regulator, Securities and Exchange Board of India (“SEBI”) has also taken the issue of climate change seriously. SEBI has already introduced norms in 2022 [2] for green bonds. Green debt security is a debt security issued for raising funds that are to be utilised for projects falling under any of the following categories:

- renewable and sustainable energy;
- clean transportation;
- sustainable water management;
- climate change adaptation;
- energy efficiency;
- sustainable waste management; and
- sustainable land use. [3]

Although a nascent market, SLDs have tremendous potential to help institutions meet their climate change objectives. The first SLD was executed in August 2019. Since then, global market participants are increasingly turning to SLD instruments as tools to hedge the climate risks faced by them. SLDs are derivative products with an ESG component added on, affecting the payment flows from one party to the other. KPIs are instrumental for structuring such SLD products.

On 21st November 2022, the International Derivatives and Swaps Association Inc. (“ISDA”) published a survey conducted by them covering the SLD market globally, to understand the needs and growth areas of the freshly sprouting market. The survey identified interest rate swaps as the underlying product for a majority of SLD transactions, followed by foreign exchange swaps and cross-currency swaps. 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. 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). Some respondents also noted that KPIs can be tied to the ratio of a counterparty’s renewable energy capacity to total capacity.

The over-the-counter (“OTC”) derivative market in India is regulated by the RBI. Recently, on 16th September 2021, the RBI published the RBI Market-Maker Directions, delineating guidelines for institutions that act as market-makers in the OTC derivative market in India. The definition of the term “derivative” is referenced to, from the Reserve Bank of India Act, 1934 and is defined as the following

an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called “underlying”), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by RBI from time to time.

This definition is fairly broad and could be construed to be inclusive of SLDs. And it would be appropriate in the India context, to explicitly frame the permissible structures of SLDs in India. Further, there is a need to formulate (if not regulate) a robust classification structure for KPIs and KPI providers in India.

SLDs are bound to play a key role in shaping the OTC derivatives market moving forward, both globally and in India. Market participants will increasingly look towards SLDs as the preferred instruments for mitigating and hedging their portfolios against climate related risks. Globally, the standard setting bodies such as ISDA need to continue to provide documentation support to SLDs. Thus, it is imperative that the authorities in India take the lead in supporting this burgeoning, positive development in the OTC derivative space.

Authors:

Jayesh H

Co-Founder, Juris Corp

Email:

jayesh.h@jclcx.com

Smrithi Nair

Partner, Juris Corp

Email: smrithi.nair@jclcx.com

Yash Sangani

Associate, Juris Corp

Email:

yash.sangani@jclcx.com