



Sustainability-linked derivatives: will India be a world leader in the next stage of green finance?

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Sustainability is one of today's most pressing concerns, as it helps determine the global environment future generations stand to inherit. This has also affected the financial sector, as there is a growing movement to align the global financial system with sustainable development. All known risks of the financial system (ie, credit risk, market risk, liquidity risk and operational risk) also contain a sustainability dimension. Sustainability risks arise due to climate change, resource depletion, environmental degradation, social matters, the introduction of new public policies, and it can significantly affect entities at an existential level.

Sustainability-linked derivatives (SLDs) create an environmental social governance (ESG) -linked cashflow that is a component of, or relates to, a conventional derivatives instrument. This is done by using key performance indicators (KPIs) to monitor compliance with declared ESG targets. Both KPIs and the corresponding pricing and cashflows are very diverse and can take a number of forms. For example, meeting a KPI can result in an increase or decrease in payments, payment of a rebate or fee, a margin or spread amount or a payment to an agreed charity.

The current position

In India, ESG-led investing has grown year-on-year at a massive rate of 184 per cent in 2021. This has not gone unnoticed by the regulatory bodies, as they have signalled not only their seriousness regarding the goal of sustainability but also their commitment towards crafting the critical enabling policy infrastructure focused on this goal. ESG reporting is still evolving in India. From the next financial year, the Securities and Exchange Board of India's Sustainability Reporting standards will be applicable to the largest one thousand listed companies, enabling a comparison of ESG performance across companies and sectors. Meanwhile, the Reserve Bank of India (RBI) has published a comprehensive paper highlighting the challenges and the roadmap for the future trajectory of sustainable finance.

The RBI paper acknowledges the challenges in the development of green finance and also highlights certain issues that need to be rectified to establish new and expand existing ESG markets. Issues such as greenwashing (false eco-friendly advertising), and the absence of a standardised broad framework while dealing with these new products, may need to be dealt with as a priority.

The International Swaps and Derivatives Association (ISDA), an association of derivatives dealers and other entities concerned with over-the-counter derivatives has undertaken several efforts to contribute to the development of ESG derivatives. This includes developing standardised approaches, taking steps to uphold market integrity and publishing KPI guidelines. KPIs are essential while assessing fulfilment of the ESG objectives. KPIs, what they measure, and how they are verified, are critically important to the effectiveness and integrity of the SLDs to which they relate. The saying that 'not everything that can be measured is important and not everything important can be measured' is equally applicable to ESG and related KPIs.

Drafting accurate KPIs that: (1) can be objectively verified; and (2) provide legal certainty over their operation and impact on cashflows, should enhance the credibility of the corresponding SLD and, the wider sustainability-linked market.

A lack of transparency in KPIs could contribute to a shortage of available observable market information, which could create challenges including ones from an accounting perspective.

The key point

While these steps taken by the regulators are laudable in their own right, a derivatives framework that is inclusive of ESG products is essential for: offering clarity to market participants; attracting global capital as a hub for sustainable investments; fostering financial innovation; and, most importantly, for guiding India towards a greener future. Further developments will be interesting to watch.

Sources

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