

Sustainability linked derivatives as the next stage of green finance: Will India lead the world?

Tuesday 31 May 2022

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Sustainability is one of the most pressing concerns of today, given its role in determining the state of the planet that future generations stand to inherit. This has had an impact on the financial industry, where there's 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 the climate crisis, resource depletion, environmental degradation, social matters and the introduction of new public policies, and can significantly affect entities at an existential level.

Sustainability linked derivatives (SLDs) create an environmental, social and governance (ESG)-linked cashflow that is a component of, or relates to, a conventional derivatives instrument. This is achieved by using key performance indicators (KPIs) to monitor compliance with stated 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 position in India

In India, ESG-led investing grew year-on-year at a staggering 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 1,000 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 in India.

The RBI paper acknowledges the challenges in the development of green finance and also highlights certain issues that need to be rectified to expand the ESG market. Issues such as greenwashing, ie, false eco-friendly advertising, and the absence of a standardised broad framework when 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 numerous efforts to contribute towards the development of ESG derivatives. This includes developing standardised approaches, taking steps to preserve market integrity and publishing guidelines on KPIs. KPIs are essential while assessing the fulfilment of 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, by extension, 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 from an accounting perspective.

The key takeaway

While the 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 shepherding India towards a greener future. Developments in this space will be interesting to watch!

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