Feature

KEY POINTS

- There has been significant innovation in the market for ESG derivatives over the past few years.
- New transactional structures have been developed which incorporate financial incentives for the relevant company to meet its ESG-related objectives.
- These structures raise new legal issues for companies (such as whether the increase in the rate of interest payable amounts to a penalty), as well as questions as to how such structures should best be drafted.

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ESG derivatives: a look at recent developments

This article reviews some of the latest innovative structures in ESG derivatives, as described in ISDA's recent paper *Overview of ESG-related Derivatives Products and Transactions* of January 2021 and considers some of the legal and drafting issues which those structures raise.

INTRODUCTION

"ESG" refers to "environmental, social and governance" and is one of today's hottest financial catchwords. Whilst the idea of combining private finance with environmentally sustainable objectives has existed for some time, it has not been a significant feature of the business and investment strategies of the largest companies, funds and financial institutions until recently. The last few years have seen a significant growth in interest, culminating in 2020 with record levels of investment in ESG-oriented funds. Consequently, ESG is becoming a topic of increasing importance for practitioners in all areas of finance and lately for derivatives practitioners. ISDA's recent paper *Overview of ESG-related Derivatives Products and Transactions* of January 2021 provides summaries of some of the key terms of a selection of recent over-the-counter ESG derivative transactions. ISDA's paper provides an illuminating snapshot of what would otherwise be a private market and describes a number of innovative new structures. This article will review and consider some of the legal and contractual issues relating to some of those structures.

RECENT INNOVATION

It should first be noted that whilst innovative new structures have been introduced to the market, those structures complement a number of existing products which serve certain specific environmental purposes. For example, standard documentation has existed for some time for the trading of derivatives based on emission allowances (ie the ISDA US Emissions Annex and the ISDA EU Emissions Annex) which assists companies subject to carbon cap-and-trade programs in managing their related obligations and risks. Derivatives have already been developed which allow investors to invest in a portfolio of "green" companies through the use of index-linked products referencing an index of companies screened for certain "green" criteria. Some issuers have also closed regulatory capital transactions involving issuances of credit-linked notes whereby the issuer commits to invest the regulatory capital released into green projects.

The ISDA paper describes a number of new structures which demonstrate that market participants have managed to convert what would otherwise be conventional vanilla products (eg interest rate swaps, cross-currency swaps and FX forwards) into environmentally sustainable versions of those products. Broadly speaking, each structure involves a particular test of the company's compliance with ESG-objectives and prescribes certain consequences if that test is not met. These tests and consequences can be broadly categorised as follows:

Tests

- **ESG ratings:** The company must meet a particular ESG risk rating set by the bank in relation to a ratings index that is published by an independent third party ESG rating provider.
- **Industry certifications:** The company must obtain/maintain ESG-related certifications which are awarded by industry associations.
- **Business opportunities:** The company must generate business-to-business integration opportunities that contribute to the United Nations Sustainable Development Goals.
- **Positive ESG contribution:** Making a positive contribution to the pillars of sustainable development (economic, environmental and social) and mitigation of any potential negative impacts to any of the pillars.
- **Commitment to reduce energy consumption:** The company must reduce its energy consumption by a particular amount and by a particular date.
- **Renewable energy target:** For an energy company, that company must reach a particular percentage of renewable generation within its total installed capacity by a particular date.

Consequences

- **Adjustment to rate payable by the company:** Positive or negative spread is added to the rate payable by the company based on whether the company meets or fails to meet the relevant ESG score.
- **Charitable donation:** If the company's ESG rating increases, the bank must donate an amount to a particular charity. If the company's ESG rating decreases, the company itself must donate an amount to a particular charity. There is no impact on the pricing of the derivative.
- **Bank's support for project:** If the company meets the relevant objectives, it is eligible to receive sponsorship to support certain social innovation projects.

The foregoing tests and consequences give rise to the following issues:

HOW WILL COMPLIANCE WITH ESG OBJECTIVES BE DETERMINED?

- **By reference to an external ESG risk rating?** Although it would seem like a fair bargain for both parties that an independent third party rating provider makes the determination, there equally may be issues for both parties with this approach.

  Where a test simply amounts to whether or not a particular numerical threshold is met, it will be very clear, on the face of it, whether the test is satisfied or not and a party will likely have limited room contractually to challenge a determination with its counterparty.

  Furthermore, it may be difficult or impossible for an aggrieved party to obtain any sort of redress from the rating provider for an inaccurate decision. It may be difficult to obtain any detail on the precise methodology or standards by which the relevant rating provider makes its determination. Even if the party were to obtain such information, the rating provider may have no contractual relationship with any of the parties and it is questionable whether the rating provider would owe any sort of duty of care for the purposes of a negligence claim.

  As such, it may therefore be difficult for an aggrieved party to challenge a determination, either with its counterparty, given the lack of any contractual rights to do so, or the rating provider itself, given the lack of available data, contractual relationship or duty of care on which the party could base such a challenge.
- **By the counterparty?** If specific ESG objectives are agreed between the contractual parties, it may be most appropriate for the party setting those objectives to determine compliance. The parties may decide to appoint an independent reviewer either to make the determination, to assist with it or to resolve any dispute which arises out of it. Where an independent reviewer is appointed, the same considerations would apply as for a third party rating provider, as described above.

  It would generally benefit both parties to be as clear as possible about what the ESG objectives should be and how they are to be fulfilled. The approaches described under the headings "Business opportunities" and "Positive ESG contribution" above, appear, on the face of it, to be framed relatively broadly and to allow for a more subjective determination by the bank as to whether or not the company is in compliance with those tests.

  A bank or independent reviewer may need to rely on data provided by the company in order to establish compliance rather than making enquiries and generating data itself. As such, the accuracy of the bank's or independent reviewer's determination will depend significantly on the frequency and the quality of the data it receives from the company. Where available, banks may also decide to take into account ESG-related statutory corporate disclosures (see further below).

COULD AN INCREASED PAYMENT THAT IS APPLIED WHERE A PARTY FAILS TO COMPLY WITH THE RELEVANT ESG REQUIREMENTS AMOUNT TO A PENALTY?

This is an untested issue as the approach to incentivise compliance with ESG objectives financially has not typically been used for other ESG-related financial instruments. For example, in the case of green bonds, a failure by an issuer to apply the proceeds of issuance towards green objectives would not usually lead to an increase in the rate of interest payable to bondholders. The question of whether an increased rate of interest payable by a swap counterparty might be a penalty has not been addressed by the market previously and parties should seek advice in this regard.

Whether or not an increased payment amounts to a penalty may depend in part on whether the bank sustains a loss as a result of the breach by the company of its ESG objectives. Although a failure to meet ESG objectives may lead to adverse environmental consequences, it may be unlikely that such a failure would cause a loss to the bank. Whether or not an increased payment amounts to a penalty may depend on whether such an increase is proportionate to any legitimate interest which the party imposing such increase, has in the compliance of the company with its ESG objectives.

EVENTS OF DEFAULT

A failure to make a payment (including a payment arising pursuant to a party's ESG-related obligations) would constitute an Event of Default pursuant to s 5(a)(i) of the ISDA Master Agreement. Similarly, a failure to deliver agreed ESG-related reports would constitute an Event of Default pursuant to s 5(a)(ii) of the ISDA Master Agreement.

Parties should consider whether these consequences should apply to the relevant ESG-related items since a failure to comply with ESG-related obligations may not necessarily indicate a problem with the company's creditworthiness leading to an increase in the bank's credit risk. For example, where the derivative is structured such that the ESG-related component of a payment is received by the bank but simply paid on to an ESG-related charity, the bank takes no true credit risk relating to that payment. The parties may therefore decide, for example, that it is appropriate to provide for longer time periods to rectify any failure of ESG-related terms.

HOW WILL THE TRADE BE VALUED?

Where a transaction provides that the rate of interest payable by the company increases if it fails to meet certain ESG objectives, that amount of interest may be regarded as a contingent payment since it would only become due and payable where the relevant test is failed, which would be determined on a future date.

Contingent payments tend not to be regarded as falling within the definition of Close-out Amount in the 2002 ISDA Master Agreement. Whilst the definition of Close-out Amount assumes that the

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conditions precedent in s 2(a)(iii) are satisfied and specifically provides that any option rights of the parties in respect of the relevant Terminated Transactions are included within the valuation, neither of the foregoing would be sufficient to cause a contingent ESG-related payment to be included in the calculation of the Close-out Amount.

Conversely, if the ESG test is expressed as providing a discount to a company on a particular rate where such test is satisfied, the parties should consider to what extent it is appropriate that the relevant discount is reflected in the Close-out Amount, given that the Close-out Amount may not otherwise incorporate such discount.

Parties should note that given that market standard credit support documentation (eg ISDA's Credit Support Annexes) typically uses the Close-out Amount measure in order to calculate exposures to be collateralised, the above considerations would also be relevant in the context of collateral.

STANDARDISED CONTRACTS DO NOT YET EXIST FOR ESG DERIVATIVES

Whilst ISDA has announced that, if needed in the future, it will amend existing ISDA templates for transactions with particular relevance to ESG and sustainable finance, such as emissions allowances, weather and other commodities, standardised documentation for ESG derivatives of the types described in the ISDA paper does not yet exist. New documentation would therefore need to be negotiated for these types of new structures for which there may not be any sort of available market precedent.

It is worth bearing in mind that ICMA has published sets of principles for bond market participants for the issuance of Green, Social, Sustainability and Sustainability-linked Bonds which, although not template contracts, may provide useful guidance particularly in the areas of reporting and external review.

"ENVIRONMENTAL SUSTAINABILITY" IS NOW DEFINED IN EU LAW

In July 2020, the EU published legislation setting out an ESG disclosure regime for certain companies. Under Art 8(1) of the Taxonomy Regulation (Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088), undertakings that are required to publish non-financial information pursuant to Arts 19a and 29a of the Accounting Directive (Directive 2013/34/EU) are required to disclose information on how and to what extent their activities are associated with economic activities that qualify as environmentally sustainable. In order to avoid "greenwashing" (ie the claim that an activity is environmentally sustainable when in reality it is not), the Taxonomy Regulation sets out certain criteria by which environmentally sustainable activities may be identified. Although the Taxonomy Regulation has no direct application to over-the-counter derivatives, when framing ESG-related tests, parties may decide to align those tests more closely to the definitions set out in the Taxonomy Regulation and the concepts which underpin it.

The Taxonomy Regulation states that economic activities shall qualify as environmentally sustainable if they:

- make a substantial contribution to one or more of the following six environmental objectives:
  - climate change mitigation;
  - climate change adaptation;
  - sustainable use and protection of water and marine resources;
  - transition to a circular economy;
  - pollution prevention and control;
  - protection and restoration of biodiversity and ecosystems; and
- do no significant harm to the other environmental objectives; and
- meet minimum safeguards (for example, UN Guiding Principles on Business and Human Rights); and
- comply with technical screening criteria to be established by the Commission in delegated acts.

THOUGHTS FOR THE FUTURE

The application of financial incentives at a transactional level represents a significant development in how over-the-counter derivatives can be used by market participants to further ESG-related goals. Derivatives which incorporate these sorts of financial incentivises are further encouragement for companies in meeting their ESG objectives and help mitigate the adverse consequences of them failing to do so, by requiring increased payments which are donated to charities or applied towards ESG-oriented investments.

Work now lies ahead for industry associations to promote the standardisation of ESG derivatives products in order to ensure an efficient market and to reduce the risk and cost involved with such products.

The combination of a new global appetite for ESG investments, contractual innovation and legislation providing for transparency in relation to companies' compliance with ESG objectives will drive further growth in this segment of the market. It may be that in time, and if the market develops sufficiently, we will come to see counterparties that are prepared to provide transactional incentives to end users function almost like a group of shareholders, since they would routinely scrutinise the company's performance in meeting its ESG commitments and hold the company to account by means of those transactional incentives. ■

Further Reading:

- Comparing sustainable debt products and standards (2021) 4 JIBFL 296.
- ESG factors in loan finance: moving the needle on sustainable finance (2019) 10 JIBFL 677.
- LexisPSL: Financial Services: Checklist: Sustainable finance – timeline.