Safe, Efficient Markets

Sustainability-linked Derivatives: KPI Guidelines

September 2021

EXECUTIVE SUMMARY

Since the first sustainability-linked derivative (SLD) was executed in August 2019, market participants have entered into a variety of SLDs, mainly in Europe but more recently in Asia and the US. SLDs embed or create a sustainability-linked cashflow using key performance indicators (KPIs) that are designed to monitor compliance with environmental, social and governance (ESG) targets.

KPIs are therefore critical to the effectiveness and integrity of the SLDs to which they relate. KPIs need to be accurately defined in order to have legal certainty over how they operate and impact cashflows and so they can be objectively verified. This will enhance the credibility of SLDs and the sustainability-linked market as a whole.

This paper sets out proposed guidelines on KPIs for SLDs in order to meet the following objectives:

- **Educate:** As SLDs are currently a niche and nascent market, this paper is intended to provide further information to market participants on the types of transactions that have been executed to date, along with guidance on the overarching principles that need to be considered when structuring KPIs.

- **Contribute to best practices:** Although this is an area in which customization and bespoke innovation are important, the guidance seeks to establish a transparent, common framework of best practices that can be applied across KPIs and their related SLDs more widely.

- **Promote safety and soundness of the market:** By establishing best practices and addressing key risks, the guidance seeks to help address greenwashing by encouraging adequate disclosure of how SLDs help attain sustainability objectives, therefore supporting the integrity of this developing market.

- **Enhance liquidity:** By setting out a best practice framework, the guidance seeks to promote the use of SLDs. This will help build liquidity and ensure SLDs provide an effective tool for counterparties to participate in the transition to a green economy.

This paper provides an overview of SLDs, describes KPIs in the context of SLDs and sets out overarching principles for drafting KPIs for SLDs.

BACKGROUND

Although there has been awareness of sustainability and ESG issues for a number of years, the global focus has recently intensified in light of political movements, the COVID-19 pandemic and coordinated international action, including the UN Sustainable Development Goals[1] and the Paris Agreement.

The EU has been at the forefront of regulatory activity in this area through the 2018 Sustainable Finance Action Plan, the European Green Deal, the Renewed EU Sustainable Finance Strategy and the UK Green Finance Strategy. The UK has also played a role through projects like the UK Green Industrial Revolution.

Collectively, these initiatives have resulted in more than 80 individual policy workstreams that have the potential to affect the financial services industry directly or indirectly. Proposals and recently introduced regulatory requirements cover changes to a range of areas, including disclosure requirements, product classification, investment strategies and risk management.

There has also recently been greater attention and political interest in the US following the change of administration in January 2021. The reversal of the Trump Administration's withdrawal from the Paris Agreement and subsequent statements and executive orders[2] have increased momentum behind US regulatory initiatives related to sustainability.

Meanwhile, regulators in Asia and Australasia have also introduced new regulatory obligations to address environmental and sustainability-linked risks within their jurisdictions, such as embedding the Paris Agreement commitments into local law. Several have also promoted the development of sustainable finance using a range of regulatory tools.

From increased regulation globally to shareholder action and board-room-level focus on ESG issues, it is clear the transition to a green economy is becoming a key issue for participants in global financial markets. Nonetheless, achieving this transition will require significant financing over an extended period of time, as well as holistic action from a range of participants. According to one estimate, $6.9 trillion in annual investment is required until 2030 to meet climate and development objectives[3].

The financial sector as a whole, including the derivatives markets, will have a key role to play in supporting this transition by facilitating the raising and allocation of the requisite financing, hedging associated risks and contributing to long-termism and financial innovation. Although there are many ways in which the financial sector and derivatives markets can provide this assistance, this paper focuses on the use of SLDs.

[1] As contained in the 2030 Agenda for Sustainable Development, published by the United Nations

[2] See, for example, Executive Order No. 14030, 86 Fed. Reg. 27967 (May 20, 2021), www.govinfo.gov/content/pkg/FR-2021-05-25/pdf/2021-11168.pdf (requiring, among other things, that the US Financial Stability Oversight Council issue a report on efforts to integrate consideration of climate-related financial risk into financial regulators' policies and programs, including discussion of "the necessity of any actions to enhance climate-related disclosures by regulated entities")

[3] See Organisation for Economic Cooperation and Development, Financing Climate Futures (2018), www.oecd.org/environment/cc/climate-futures/policy-highlights-financing-climate-futures.pdf

What are SLDs?

SLDs create an ESG-linked cashflow that is a component of, or relates to, a conventional derivatives instrument by using KPIs to monitor compliance with 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 same or different KPIs can apply to one or both parties to a derivatives transaction.

While many ESG-linked financing transactions and some derivatives hedges focus on the use of proceeds for ESG-related purposes, this is generally not the case for the SLDs. The distinguishing feature is the KPIs that create or impact cashflows within conventional or vanilla derivatives. The use of proceeds is generally not affected or limited.

A variety of SLDs have emerged since the first transaction in August 2019[4]. Many were initially executed in Europe, but there have been a number of recent SLD deals in Asia-Pacific[5] and the US. These derivatives are bespoke bilateral instruments and, as such, there is limited publicly available information on their terms. Given the scope for customization and the ability for parties to add an ESG component or overlay to an otherwise vanilla standardized derivatives, there is an opportunity for such transactions to enhance the flow of private capital to achieve sustainability objectives. They can therefore play a role in encouraging the transition to a green economy.

The derivatives industry already plays an important role in the transition to a sustainable economy[6] via hedging arrangements for sustainable lending and capital markets transactions, as well as hedges for the rapidly developing renewable energy markets. SLDs are just one transaction type[7].

[4] The Sustainability Improvement Derivative was an interest rate derivative between ING and SBM, designed to hedge the interest rate risk of SBM's $1 billion five-year floating rate revolving credit facility. A positive or negative spread was added to the fixed rate set on execution based on SBM's environmental, social and governance (ESG) performance, as scored by Sustainalytics

[5] See, for example, www.koreaittimes.com/news/articleView.html?idxno=104935, describing the launch of the first ESG derivatives contract to reduce greenhouse gas emissions in Korea

[6] The derivatives market is not the only market in which sustainability-linked products are being developed, and KPIs are used in both the loan and bond markets. The sustainability-linked loan market is well developed. Industry guidance on KPIs, known as the Sustainability-Linked Loan Principles, was originally published in 2019 and was updated in May 2021. The sustainability-linked bond market is currently much less developed than the sustainability-linked loan and green bond markets, although it is expected to grow given industry demand. There is also industry guidance in this area, known as the Sustainability-Linked Bond Principles, which was published in June 2020. The European Commission, as part of its strategy for financing the transition to a sustainable economy, has announced its intention to work on further bond labels, such as transition or sustainability-linked bonds by 2022 in order to facilitate additional capital flows to interim transition efforts

[7] The ISDA white paper, *Overview of ESG-related Derivatives, Products and Transactions*, published in January 2021, provides an overview of the full range of products and transaction types that comprise the universe of ESG-related derivatives, www.isda.org/a/qRpTE/Overview-of-ESG-related-Derivatives-Products-and-Transactions.pdf

KPIs AND SLDs

KPIs, what they measure and how they are verified are critically important to the effectiveness and integrity of the SLDs to which they relate.

Drafting accurate KPIs that (i) can be objectively verified and (ii) have legal certainty over how they operate and impact 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 from an accounting perspective[8].

SLDs may take different forms. For example, they could be a vanilla derivatives transaction (such as an interest rate swap, cross-currency swap or forward) with a separate ESG pricing component included by reference to specific KPIs[9]. When used as a hedge, the underlying instrument may be ESG related but is not required to be. If not ESG related, the KPIs will be entirely separate from the underlying instrument[10]. However, some SLDs expressly link the KPIs to existing ESG structures in the underlying instrument being hedged[11]. In other cases, there may be a standalone agreement, where one or more cashflows are a function of both compliance with the KPIs and certain other factors, such as volume of other derivatives transactions entered into between the parties.

The SLD transactions executed to date have tended to be between financial institutions and non-financial institutions involved in sectors with substantial ESG-related pressures, including energy, construction, agriculture and transport.

These counterparty pairings drive one of the common trends in the market – use of unilateral KPIs. These unilateral KPIs allow one or both counterparties to benefit[12] or be penalized[13] depending on the non-financial institution's performance relative to specific targets. Any penalty arising from the non-financial institution missing its target may be linked to a charitable payment. This means the financial institution may not benefit directly from the non-financial institution's failure to meet its objectives[14]. In all cases to date, unilateral KPIs have only measured the non-financial institution's performance.

[8] *Accounting Analysis for ESG-related Transactions and the Impact on Derivatives*, ISDA, September 2021. The paper notes that, under existing US generally accepted accounting principles (GAAP), any feature within a contract that could impact the timing or amount of cashflows needs to be assessed as an embedded derivative. Currently, ESG features constitute an embedded derivative and therefore need to be bifurcated and accounted for at fair value separately from the host contract. This is operationally burdensome and may not result in useful information. The paper suggests potential solutions that are line with US GAAP to avoid the requirement to bifurcate and account separately for ESG features. See www.isda.org/2021/09/07/accounting-analysis-for-esg-related-transactions-and-the-impact-on-derivatives

[9] These are distinct from conventional derivatives transactions, such as interest rate swaps, which are used by market participants to hedge the risk arising from green bonds, or credit default swaps, which are used to decrease or increase exposure to credit risk

[10] For example, the interest rate derivative entered into between ING and SBM, which hedged the interest rate risk of SBM's $1 billion five-year floating rate revolving credit facility. In these circumstances, the underlying loan transaction was not ESG related. A positive or negative spread was added to the fixed rate set on execution based on SBM's general ESG performance, which was scored by Sustainalytics and was separate from the revolving credit facility

[11] For example, the sustainability-linked interest rate swap entered into by Natixis and Italo – Nuovo Trasporto Viaggiatori, which contains an incentive mechanism aligned with the sustainable performance indicators outlined in the financing agreement

[12] For example, from reduced payments, margin ratchets or preferential rates

[13] For example, through penalty payments or increased interest

[14] There is often a reputational aspect underpinning this structuring. Financial institutions may not wish to be seen to benefit from non-financial institutions' failure to achieve their KPIs. An example of a unilateral SLD incorporating charitable payments is the FX hedging contract entered into by BNP Paribas and Siemens Gamesa. This provides consequences for both parties by reference to Siemens Gamesa's performance only. When Siemens Gamesa meets its targets, BNP Paribas will reinvest premiums into reforestation projects and when Siemens Gamesa misses its targets, it will pay a premium to BNP Paribas, which the latter reinvests into reforestation projects

There have been a small number of transactions incorporating mutual KPIs, where the cashflows could be affected by either party meeting or failing to comply with the agreed KPIs. In these cases, the KPIs would be different and tailored to each party's specific sustainability-linked objectives. For example, while the KPIs for the non-financial institution might focus on renewable energy generation, the financial institution's KPIs might focus on reducing its carbon footprint[15]. However, these transactions are far less common.

Classification of KPIs

KPIs can be adapted to the specific requirements of the counterparties and the sectors in which they operate. To date, the KPIs commonly seen in the SLD market can be classified into the following categories:

- Reducing behavior that negatively impacts the environment. This includes KPIs that are linked to decreasing greenhouse gas emissions, lowering the quantity of waste sent to landfills, cutting water consumption or reducing other forms of pollution.

- Encouraging behavior that is beneficial for the environment. This includes KPIs that are linked to improving energy efficiency, boosting renewable energy use, production or generation, increasing recycling versus other forms of waste disposal or contributing to biodiversity[16].

- Linking counterparty performance to requirements under international agreements, such as the Paris Agreement or the UN Sustainable Development Goals[17].

- Tracking a counterparty's general ESG performance by reference to a rating issued by a specific third party or a supranational, regional or local rating system[18].

As this is an area that is developing rapidly, it is also likely that KPIs will be linked to new areas in the future. These might include:

- KPIs linked to supply chain performance to encourage counterparties to develop and improve performance from an environmental perspective. Such KPIs will need to be carefully drafted, as counterparties do not always have direct control over the entirety of their supply chain.

[15] For example, the sustainability-linked cross-currency swap entered into between JP Morgan Chase and Enel, which hedged the sterling/euro exchange rate and interest rate risk. The parties each pay interest to each other every six months under the cross-currency swap. The interest costs can rise for either party when environmentally friendly targets are not met and maintained

[16] See, for example, https://www.sc.com/en/media/press-release/weve-executed-our-first-esg-linked-derivative/, describing a transaction that involves combining conventional derivatives risk management with sustainability-linked KPIs that are linked to reducing greenhouse emissions – from owned or controlled sources – and to sustainable sourcing in the base metals business

[17] For example, the world's first SDG-linked cross-currency swap between Enel S.p.A. and Société Générale issued in September 2019 was executed in connection with Enel's General-Purpose SDG-linked bond. The goal of the derivatives transaction was to hedge against the exchange rate and interest rate risk created by the different denomination of the bond repayments (US dollars) and the source of repayments (euros). See https://wholesale.banking.societegenerale.com/en/insights/clients-successes/clients-successes-details/news/enel-electrifies-sustainability-market-with-inaugural-green-linked-bond-and-swap/

[18] In these situations, counterparties should clarify which aspect of the rating they are using. In addition, counterparties should note they have less control over an external third-party's rating and there is a corresponding risk that they may not meet the corresponding KPIs

- KPIs linked to market standards. Further standardization is likely as the number of SLDs increases, and these market standards can be used as a further means of benchmarking a counterparty's performance.

- KPIs linked to future international agreements. These may be general (for example, further international agreements building on the Paris Agreement) or relate to specific sectors (such as oil and gas, aviation, mining or shipping) as international consensus in this area continues to develop.

KPI GUIDELINES

Five Overarching Principles

To ensure the KPIs chosen are credible, counterparties should ensure they are specific, measurable, verifiable, transparent and suitable. This guidance explores and analyzes each of these criteria.

1. Specific

KPI(s) should be clearly and precisely defined to avoid disputes arising between counterparties. There are a number of aspects to this.

- **ESG targets should be clearly set out in the documentation.** Targets should ideally be described by reference to percentages or specific amounts (eg, a given percentage reduction in emissions over a pre-determined period, prevention of a certain volume of polluted water from flooding communities or entering local waterways over a pre-determined period, or achievement of a set ratio of renewable consolidated installed capacity to total installed capacity at an electricity generation facility).

  The target should make clear whether it involves an absolute or intensity-based change in the relevant metric(s), or a combination of both. In describing KPIs, it is advisable to avoid general concepts of reasonableness or materiality, unless these concepts are given specific scope and parameters.

- **The scope of a KPI should be clear to minimize the possibility of the counterparties reaching different interpretations.** For example, counterparties should specify whether a KPI refers only to the counterparty or other members of its group as well, and whether targets relate to a specific business line or its entire business. Entities with nationwide or international operations should also consider the geographic scope of the target, ideally covering all regions where relevant data is available, comparable and reliable.

- **The timeline should be clearly identified.** Counterparties should identify the period of time the target will cover, including a baseline year against which progress is measured (ideally, the most recent year for which reliable data is available).

- **The reference point or source for a KPI should be clearly established and ideally publicly available to enable verification** (for example, via an annual or management report). Ambiguity should be minimized by providing sufficient information in the documentation for the applicable reference point or source to be established with certainty. Counterparties should ensure they have a clear understanding of this reference point or source, and this is reflected clearly in the documentation.

- **The KPI methodology calculation should be included in the documentation.** Where calculations are required to establish whether a KPI has been met, the methodology should be included in full in the documentation and, where relevant, expressed as an equation or formula rather than a description of how it operates.

For example, emissions-based targets should:

- Be calculated in line with a generally accepted methodology, such as the Greenhouse Gas Protocol, if feasible; and

- Make clear whether they can be achieved in whole or in part using offsets and, if so, how much of the target reduction can be achieved using them, as well as any criteria to be applied in identifying acceptable offsets.

- **Fallbacks should be included** (where relevant) to allow for situations in which the KPI cannot be calculated in a satisfactory manner in accordance with the stated methodology.

  The counterparties may wish to allow for unforeseen events that could materially impact the calculation of the KPI and specify the applicable consequences should these events occur.

- **The consequence of achieving or failing to meet an ESG target should be clearly stated.** An intrinsic aspect of an SLD is that its economic characteristics will vary in line with whether one or both of the counterparties achieve the KPI(s) or not. As such, the economic impact of achieving or failing to achieve the KPI(s) should be clearly set out in the underlying documentation.

2. Measurable

KPI(s) should be quantifiable, objective and within the counterparty's control to achieve. The goal is to ensure there is no ambiguity in establishing whether or not a KPI has been met in order to reduce the scope for disputes.

An easy way of ensuring a KPI is measurable is to benchmark it against a global, regional, local or industry standard. A common example of this is the UN Sustainable Development Goals. Counterparties may also be able to benchmark a KPI by reference to applicable scientific measures.

However, this may not always be possible within the scope of the counterparties' objectives. In these cases, a counterparty may wish to choose a KPI that can be benchmarked against its own performance – for example, setting targets in areas that have been previously reported in that entity's annual report, sustainability report or other documentation over a number of years.

As the market develops, it may also become possible to benchmark counterparties effectively against their peers.

Ensuring KPIs are credible and effective is essential to address the risk of greenwashing (claims relating to sustainability performance or impact that are inaccurate, misleading or inflated) and encouraging the further development of this market[19].

[19] For a bilateral OTC contract, greenwashing is only relevant if the contract is disclosed to the public, reported to regulators or similarly represented in a way that gives a misleading appearance of sustainability impact. Moreover, advancing the credibility of KPIs may lead to increased liquidity in the SLD market and, likewise, enhanced market information, potentially resolving accounting concerns. See *Accounting Analysis for ESG-related Transactions and the Impact on Derivatives*, ISDA, www.isda.org/2021/09/07/accounting-analysis-for-esg-related-transactions-and-the-impact-on-derivatives

3. Verifiable

Whether or not the counterparty has met the relevant KPI(s) within the applicable time periods must be verified either by one of the counterparties or an independent third party.

As previously noted, the reference point or source for a KPI should ideally be publicly available in order to enable verification. When drafting the KPI, the parties should consider the availability and transparency of the information necessary for verification, including by a third party if relevant.

An independent third-party verifier: If appropriate, parties may specify an independent third party to verify whether or not the counterparty has met the relevant KPI[20]. Having an independent third party minimizes the risk of moral hazard and the potential for conflicts of interest to arise given the economic consequences of meeting or failing to meet a KPI. It may also minimize potential disputes.

In addition, nominating an independent third party may help to address greenwashing risks, which can be caused by an inappropriate choice of KPIs or inaccurate information being provided during the verification process. Greenwashing undermines trust and threatens the credibility of the product and, if sufficiently widespread, the entire industry.

The involvement of a third party will be intrinsic where the KPI is linked to a counterparty's general ESG rating. This is because the counterparty will be deemed to have met the KPI if it is granted a specific rating by the ESG rating agency. In other cases, the third party will need to be specifically chosen and appointed by the counterparties. This third party may be (without limitation) an auditor, environmental consultant or expert in the particular subject matter of the KPI.

When appointing a third party, the counterparties should consider the independence of that party, as well as its subject matter expertise and relevant qualifications. The counterparties should also document procedures for replacing a third-party verifier and appointing a new provider.

Counterparty verifier: Given the possible scope of KPIs, it may not always be feasible or practical for a third party to be appointed and one of the counterparties may instead be responsible for verification. In these situations, the relevant counterparty should develop robust procedures for verification and document these in a format that is available to the other counterparty upon request. The relevant counterparty should take seniority and subject matter expertise into account when appointing the individual responsible for verification within that organization. This will reduce reputational risk and minimize the appearance of a conflict of interest associated with self-certification.

In either case, the counterparties should consider and establish (where appropriate) a dispute resolution mechanism to address breaches and situations in which the counterparties cannot agree on whether a KPI has been met.

[20] Third-party verification is generally advisable to minimize the risk of moral hazard and mitigate greenwashing concerns. However, verification by internal audit functions may be preferable, particularly for smaller counterparties or transactions, for reasons of cost and logistics where KPIs are benchmarked against a counterparty's own performance. In this regard, counterparties will need to remain cognizant of regulatory prohibitions on intentionally or recklessly misleading statements in connection with derivatives transactions – for example, under CFTC Rule 180.1

4. Transparent

The counterparties should establish a process for information to be made available to relevant parties following execution of an SLD.

The parties will need to decide:

- What information should be made available over the life of the transaction;
- Which parties should receive this information; and
- The frequency at which this information should be disclosed and the process for dealing with market-sensitive information if required.

Incorporating provisions allowing relevant information (for example, compliance or failure to comply with the KPIs) to be disclosed publicly is one way in which counterparties can increase the impact of the SLD.

Conversely, it is equally important to consider the impact of disclosure requirements and the consequences of receiving information relating to KPI compliance. Such information, particularly if it is material to one of the parties or a third party and is non-public, may raise regulatory considerations – both from a compliance and documentation perspective. For example, if compliance with a KPI or failure to meet the relevant targets may eventually become material to a party's share price, and the party required to comply discloses its non-compliance to the counterparty, then the counterparty may be subject to restrictions on further disclosure and trading activity relating to that party (ie, under applicable insider trading or market abuse regimes). Materiality in this context is a significant regulatory focus[21].

5. Suitable

To avoid greenwashing concerns, it is advisable for the KPIs to be appropriate for the relevant counterparty and derivatives structure. Although the chosen KPIs should support sustainability objectives in a meaningful and positive way, what this means in practice will differ between counterparties.

Factors that may influence what this means for a particular counterparty will include its size, its geographical location, the sector in which it operates and its existing ESG commitments.

The observation period for satisfaction of the KPI and, implicitly, the term of the SLD (which may be shorter than other ESG-linked financial transactions) also merits consideration. For example, if the reference period for compliance is short, then the effectiveness of the SLD in enhancing sustainability may not be as obvious. Equally, it may be difficult to achieve meaningful transition in a short period. To avoid greenwashing, counterparties should ensure they choose KPIs that are appropriate and meaningful for their business, taking these factors into account.

[21] See, for example, Allison Herren Lee, Commissioner, Securities and Exchange Commission, Remarks: *Living in a Material World: Myths and Misconceptions about 'Materiality'*, www.sec.gov/news/speech/lee-living-material-world-052421 (May 24, 2021)

Counterparties should choose KPIs that:

- Are material and strategically significant to the relevant counterparty's business[22];
- Are consistent with the relevant counterparty's ESG strategy;
- Contain outcomes that are within the relevant counterparty's control;
- Are sufficiently ambitious and do not simply represent business as usual[23]; and
- Address meaningful sustainability issues for that counterparty[24].

[22] As previously noted, counterparties should consider the geographic and business scope of their target(s), ideally covering as many regions and relevant business lines as possible. Targets should, where possible, include all scope one and two emissions, as well as scope three emissions where appropriate. US Environmental Protection Agency, *Target Setting*, EPA Center for Corporate Climate Leadership (January 26, 2021), www.epa.gov/climateleadership/target-setting; TCFD Report at 27. Scope one emissions are direct emissions from a company's owned or controlled sources. Scope two emissions are indirect emissions from the generation of purchased energy. Scope three emissions are all indirect emissions (not included in scope two) that occur in a company's value chain (ie, all upstream and downstream activities associated with the company's operations). The Science Based Targets initiative (SBTi) recommends setting a separate scope three emissions reduction target if scope three emissions are 40% or more of total scope one, two and three emissions. SBTi Criteria at 10. It also states that companies that sell or distribute fossil fuel products should set absolute or intensity-based scope three targets for the use of sold products, regardless of the proportion of their total emissions attributable to these products. SBTi, *Quick Start Guide for Electric Utilities* (June 2020)

[23] As an example of an ambitious target, the US Environmental Protection Agency points to SBTi criteria, which specify absolute emissions reductions of 2.5% per year for targets that cover scope one and two emissions and 1.23% per year for targets that cover scope one, two and three emissions

[24] See, for example, TCFD Report, Annex at 51 (recommending that companies use "metrics and targets that are tailored to their particular climate-related risks and opportunities")

REGULATORY AND LEGAL IMPLICATIONS

Market participants should ensure they consider the regulatory implications of using sustainability-linked KPIs that affect the cashflows of derivatives transactions. An initial focus should be the proper characterization of the transactions in the relevant jurisdiction(s) and the compliance and regulatory obligations that may entail.

Market participants should also consider the applicability of any regulatory and related operational requirements and (where applicable) ensure they comply with them. Any corresponding risk management considerations should also be taken into account.

Examples of potential regulatory obligations include valuation requirements, dispute resolution and reporting requirements, risk management obligations associated with derivatives transactions, requirements for the identification and control of confidential and/or material non-public information, conflict of interest and inducement considerations and regulatory regimes that apply to particular types of market participant[25].

Equally, if the other counterparty is a regulated financial institution (eg, a registered swap dealer in the US or a credit institution/investment firm in the EU or the UK), it should ensure it has satisfied any applicable regulatory disclosure requirements, including with respect to bespoke or relatively novel features of the ESG component of the transaction that may not be fully covered by standard risk disclosures. The counterparties may wish to agree, as part of the due diligence process, what information should be made available and the process for dealing with market-sensitive information if required.

There may also be implications from a tax[26] and accounting perspective, as well as a potential impact on the enforceability of netting or collateral enforcement rights. Counterparties should consider whether SLDs fall within the list of transactions covered by the applicable ISDA netting and enforceability opinions. In this context, there are a number of jurisdiction-specific issues that will need to be considered (for example, whether a KPI-linked agreement in the form of a standalone agreement would impact the application of safe harbors and whether the KPI-linked payments might constitute a penalty).

[25] In addition to derivatives-specific regulations, financial institutions may be subject to general requirements on their safety and soundness

[26] SLDs may raise novel tax questions as a result of the unique terms of the transactions (including the KPI triggers) and the structuring between the counterparties and third parties. Equally, KPI-related cashflows may pose challenges, particularly for the non-financial institution to the SLD. The tax regimes of a number of jurisdictions include provisions that treat payments made under financial instruments that are linked to the performance of the payer's business as non-deductible distributions of profit for tax purposes. Often, these or similar provisions are drafted broadly, and concerns have been raised that they could apply to sustainability-linked financial instruments. Market participants should take appropriate tax advice

DRAFTING AND STRUCTURING OF SLDs

There is currently no industry standard wording given the diversity of transactions and benefits arising from flexibility. There are, however, various principles and best practices to consider when entering into SLDs to ensure the drafting is as clear, precise and unambiguous as possible.

There are various issues that relate to timing aspects of the transaction:

- Market participants should consider alignment of the intended duration of the SLD and the intended measurement and publication of the KPIs. As previously noted, too short a duration may increase the risk of the link between the sustainability feature and the achievement of the KPI being questioned.

- When a counterparty meets a KPI after the relevant calculation date has passed or between two calculation dates, the counterparties should consider whether there will be an impact on the transaction. If this is the case, then the parties should also determine whether this will occur immediately or upon the next calculation date.

Certain structuring and corresponding drafting issues also need to be considered.

- Some of these issues arise in the context of margin. In particular, market participants should:

    - Agree and reflect in the documentation whether the cashflows linked to the KPI should be taken into account for the purposes of any margin calls;

    - Ensure any relevant models (eg, the ISDA Standard Initial Margin Model and internal risk models) can account for the risks associated with the KPI; and

    - Consider whether to include specific provisions to agree how to determine the probability of the relevant counterparty achieving the KPI for valuation purposes and any corresponding dispute mechanisms.

- Market participants should consider whether there is any impact on close out and netting if payment following the failure to meet a KPI is owed to:

    - A charity or third party, as this could raise issues relating to mutuality; or

    - The counterparty, as this could raise issues of recharacterization of the payment as a penalty.

  In each case, participants need to determine whether there are drafting or structuring solutions that can mitigate these risks.

- When there is a close out prior to the KPI(s) being met, market participants should decide whether the close-out amount will be determined on the assumption that the KPI(s) has been met or not.

- Parties should cater for the impact on the SLD cashflows of:

    (a) Meeting or failing to meet a KPI;

    (b) Disputes over whether or not a KPI has been met;

    (c) A failure to verify a KPI[27]; and

    (d) Changes to the verification process.

Market participants should ensure the corresponding provisions are clear and unambiguous to avoid the introduction of legal and enforceability risk into what are otherwise vanilla and well-established derivatives transaction types.

- Market participants should consider whether specific provisions are required for early termination[28], recognizing that such provisions may differ substantially depending on the specific facts of the transaction[29].

- Parties should decide on the applicable process for KPI verification[30].

- Market participants should determine whether to include a mechanism to cancel any benefits provided to a specific counterparty under the SLD if that counterparty is publicly linked to negative ESG behavior and, if so, what would constitute negative ESG behavior.

- Parties should decide whether they wish to include any ESG-specific representations or warranties.

- Market participants should determine whether to include language allowing or requiring one or both counterparties to disclose the existence of the SLD, as well as their compliance or failure to comply with the KPIs. To the extent disclosure is permitted, parties should consider whether disclosure is allowed only for regulatory reporting purposes or whether it is allowed for other purposes, recognizing that disclosure of the SLD may increase its impact[31].

[27] For example, because the third-party verification agent fails to perform or is no longer acting as such

[28] In this context, consider legal opinion coverage. See the Regulatory and Legal Implications section

[29] For example, where a counterparty enters into an SLD that contains a mechanism to increase the payments made where a KPI is not met and that counterparty has used the SLD to publicize its ESG commitments, the counterparties may agree that the counterparty in question should not be able to unwind the transaction without taking into account the KPI set up. Equally, where there are provisions for a payment increase or decrease, the counterparties will need to consider situations in which the KPI is met (or otherwise) in the first year and the trade is subsequently unwound in the second year

[30] See part three of the KPI Guidelines section for a more detailed discussion. In addition, market participants should decide whether a form of certification for the purposes of verification should be appended to the underlying documentation, depending on the agreed process for KPI verification

[31] See part four of the KPI Guidelines section for a more detailed discussion of the considerations on disclosure

CONCLUSION

Given the nascent state of the market for SLDs and the need to tailor KPIs to specific counterparties' circumstances and sustainability goals, this paper is intended to provide general guidelines rather than uniformly applicable recommendations. Appropriate factors to consider in structuring and documenting an SLD may vary by transaction and may evolve with the market over time.

DISCLAIMER: This paper is intended to assist market participants in better understanding the role of SLDs in sustainable finance. It does not constitute legal advice and does not attempt to opine on the impact such transactions have on the market.

ISDA has published a variety of other papers on ESG-related topics, including

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