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Progressing on Carbon Trading

Tags:

Basel III, Carbon Credits, Carbon Trading, Environmental Social and Governance (ESG), Fundamental Review of the Trading Book (FRTB), Risk and Capital

*ISDA Chief Executive Officer **Scott O'Malia** offers informal comments on important OTC derivatives issues in derivatiViews, reflecting ISDA's long-held commitment to making the market safer and more efficient.*

April 28, 2022

Without access to carbon credits, companies all over the world will only get so far in their efforts to reduce emissions – credits allow them to offset those emissions that may be otherwise impossible or difficult to eliminate. But new analysis published by ISDA last week confirms our earlier findings that the conservatism of Basel III capital requirements for carbon credits could impair the ability of banks to support the transition to a sustainable economy.

As it stands, the Fundamental Review of the Trading Book (FRTB) – the Basel III market risk rules that are due to be implemented in the coming years – would include a standardized approach to capital calculation that assigns a 60% risk weight to carbon trading. This is among the highest of all commodities. In July 2021, ISDA published a detailed analysis of historical data from the EU Emissions Trading System (ETS) that suggested the risk weight for carbon trading should actually be 37%.

While the EU ETS accounts for nearly 80% of global trading in carbon credits, we recognized the need to extend this analysis so policymakers in other jurisdictions have the relevant facts and data at hand when making decisions about capital requirements. This was the rationale for our latest paper, which replicates the analysis

for two North American markets – the Western Climate Initiative (WCI) and the Regional Greenhouse Gas Initiative (RGGI) – and the UK ETS. The paper is based on analysis of all available, relevant data from these markets.

The latest findings suggest historical volatility during periods of stress in North American markets is significantly lower than in the EU – 33% for the RGGI and 20% for the WCI, compared to the 56% observed volatility in the EU ETS. However, given the size and maturity of the EU ETS, we maintain our previous recommendation for the risk weight (which incorporates historical volatility in its calculation) to be set at 37%, in line with EU ETS findings.

The FRTB also imposes a capital charge for buying spot and selling forward, applying a correlation of 0.99 to these carry positions to account for the fluctuating costs of storing commodities, despite the fact there are no physical storage costs for carbon credits. Our latest analysis confirms our original recommendation that the correlation should be increased to 0.996.

The new paper comes at a critical time, as key jurisdictions are developing legislation that will transpose Basel III into law. The EU fired the starting gun in this process in October 2021 with publication of the EC's legislative proposal for the third Capital Requirements Regulation, and we welcome its suggestion that the risk weight for carbon trading should be reduced to 40%. We urge EU officials and politicians to support this proposal, and we believe it should be replicated in other jurisdictions to ensure an appropriate and consistent approach to this market.

Time and again during the evolution of Basel III, this kind of fact-based advocacy has proved critical in identifying and ironing out calibration issues. Reducing the risk weight and increasing the tenor correlation for carbon credits as recommended would lead to an overall reduction in capital requirements of as much as 60%. This will make an important difference in determining the extent to which banks can participate in carbon trading, which, in turn, will impact the speed and effectiveness of the green transition.