

ISDA Draft Response to ESMA Consultation on the Review of the Guidelines on MIFID II product governance requirements

Q2: Do you agree with the suggested approach on the identification of any sustainability-related objectives the product is compatible with? Do you believe that a different approach in the implementation of the new legislative requirements in the area of product governance should be taken? Please also state the reasons for your answer.

The industry welcomes ESMA's request for input on sustainability classification approaches, particularly regarding derivatives and structured products, which can be assessed against the sustainability preferences prescribed by MIFID (i.e. taxonomy and SFDR sustainable investments, and consideration of PAIs), yet without any regulatory guidelines or instructions.

Indeed, classification methodologies have only been proposed for standardised securities (bonds and equities) and portfolios of such securities, to allow financial institutions to implement the new MIFID ESG obligations in a consistent manner. However, no classification methodologies or industry-wide standards have been developed to date for derivatives and structured products that are able to consider sustainability aspects, even though they would be subject to the same MIFID ESG target market and suitability constraints.

The MiFID delegated acts on suitability and product governance are not intended to stop the distribution of non-sustainable products. However, as already acknowledged by the ESAs, derivatives and structured products can be beneficial for sustainability purposes and are part of the universe of ESG products. Derivatives are absolutely critical in the transition to a green economy, enabling companies to meet their sustainability goals effectively and efficiently.¹ While conventional derivatives can certainly be used to hedge green instruments such as green bonds, a new wave of sustainability-linked derivatives and exchange-traded ESG derivatives has developed in recent years, alongside emissions trading derivatives, renewable energy and renewable fuels derivatives, and catastrophe and weather derivatives.²

In the absence of specific methodological guidelines, the new MIFID ESG requirements impose undue legal and reputation risks on financial institutions (despite their best efforts to meet these regulatory obligations). They also implicitly discourage the development of ESG-related derivatives due to increased funding costs for environmentally sustainable investments in the real economy and a cooling effect on the future R&D in the ESG derivatives space. This is detrimental to greening financial markets, and ultimately the economy, as derivatives play several important roles in the good functioning of financial markets by:

- facilitating the raising and allocation of capital for sustainable projects and activities, both directly in the primary market, and indirectly through their contribution to the efficiency of the secondary market (e.g. via risk management both by issuers and investors, and enhanced market liquidity);
- helping businesses and investors better manage the risks to which they are exposed;
- allowing market participants to more effectively align their exposures with risk tolerance and risk management requirements;

¹ <u>https://www.isda.org/a/KOmTE/Derivatives-in-Sustainable-Finance.pdf</u>

² <u>Overview-ofESG-related-Derivatives-Products-and-Transactions.pdf (isda.org)</u>

- enhancing transparency through providing information on their underlying commodities, securities or assets;
- contributing to long-term sustainability objectives by bringing information about sustainability-related activities in the real economy into the financial markets, allowing investors to appropriately respond to economic actors' positive or negative contributions to the green transition (e.g. via hedging and tailored features to match firms' ESG strategies).

It is thus paramount that specific ESG classification guidelines are issued for derivatives and structured products in order to allow financial institutions to implement MIFID ESG obligations without undue regulatory risks.

It is important to note that the industry is just beginning to form consensus around how to design classification methodologies covering derivatives. In this light, we would like to put forward for consideration the suggested approaches below, which only reflect views from some members but do NOT constitute a homogenous ISDA position on this issue, which is still being developed. These suggestions aim to incorporate ESMA's proposed classification alternatives in the consultation document, namely based on (i) the underlying, (ii) the issuer, (iii) the use of proceeds, or (iv) combinations of these.

Derivatives

<u>Equity</u>: ESG Equity futures, options and forwards enable institutions to better hedge their ESG risks and more efficiently implement their ESG strategies. Using ESG futures and options allows investors an alternative way of investing other than directly in the underlying stocks.

<u>Credit</u>: Market participants can use CDS to manage the credit risk of a counterparty or credit where its financial results may suffer because of climate change impacts or where its viability might be threatened. In that respect, CDS can serve two different purposes: i) to hedge future potential losses that would be realized following the occurrence of a catastrophic event (that leads to bankruptcies/defaults); and ii) to hedge the risk of changes in the market value of ESG/sustainability-linked bonds/loans resulting from market expectations of future potential losses/damages and other market factors.

IR) and foreign exchange (FX) derivatives: contrary to the previously mentioned types of derivatives, IR and FX derivatives do not have ESG characteristics by definition (although they may form part of sustainable investments strategies) and would thus be out of scope of MIFID ESG products.

Derivatives are based by definition on one or several underlyings and hence the assessment of their sustainability could be assessed in the context of the sustainability of the underlying(s), proportionately to the exposure the derivative offers to the underlying(s).

According to MIFID, the above-mentioned sustainability is expressed as (a) the proportion of taxonomy alignment, (b) the proportion of sustainable investment as per SFDR, and/or (c) PAIs taken into consideration.

To illustrate this, for an asset swap whereby an investor receives the return of an asset A, the MIFID ESG classification is that of the issuer A, because the asset swap offers full exposure to equity A.

Another example is an option with an equity underlying A. Its proportions of taxonomy and SFDR sustainable investments could be computed by taking into consideration (i) the notional, (ii) the option's delta (i.e. the exposure to the underlying), and (iii) the proportions of taxonomy and SFDR sustainable investments of equity A, respectively. This classification approach also applies to put or call warrants.

In both examples, the *qualitative* classification in the PAIs category of MIFID mirrors that of the underlying, namely the issuer A.

Credit and equity derivatives should be eligible to qualify into the MIFID ESG categories according to the suggested approach illustrated above.

This approach would have the following benefits:

- ensure a level playing field between cash positions and derivatives position;
- avoid taxonomy inflation because both positive and negative delta exposures to the underlying will contribute.

Structured notes

Structured notes are similar to bonds, but their cash-flows include, in addition to (or in lieu of) a traditional interest payment, a component based on the performance of another financial instrument (equity, bond), or an equity/bond index. This component is usually obtained through derivatives. Accordingly, the ESG classification approaches of structured notes combine those of (i) bonds, described in existing regulatory texts (e.g. SFDR RTS, Taxonomy Art. 8 Delegated Act), and (ii) derivatives, commensurate with the exposure of the product to ESG underlying(s), where applicable.

More precisely, the ESG contribution of the <u>bond-like component</u> reflects that of (i) the issuer, typically the banks' Green Asset Ratio (when it will be available), except (ii) where the proceeds are assigned to specific projects. In this latter case, analogously to a green or social bond, the sustainability of the projects will be used.

In order to obtain the overall proportion of sustainability of the product, the <u>derivative</u> <u>component is subsequently added</u>, according to the approaches described above (see Derivatives section), proportionately to the exposure the product offers to sustainable underlyings. The sum of the two components cannot be higher than 100%. This 100% cap would apply both the taxonomy alignment, and the sustainable investment proportion of the structured note, as reported in the EET (European ESG Template) fields.

Equivalent input data

In order to be able to apply ESG classification methodologies to financial instruments (simple and structured securities, and derivatives), input data is obviously necessary, and particularly the taxonomy alignment and the PAIs of the issuer and/or underlying(s). In the absence of input data, MIFID ESG obligations would still enter into application before the availability of official input data. Indeed, official taxonomy input data will be fully available for large European firms in Q1 2024 and PAIs quantitative data in Q1 2026. In the meantime, financial institutions have

been instructed to use "equivalent data" for missing official data, obtained directly from counterparties or from external providers.

We welcome this alternative given that a variety of ESG data are supplied by several providers. Nonetheless, we urge ESMA to detail the definition of "equivalent data" from external providers at European level in order to avoid market fragmentation in Europe.

Q3: What are the financial instruments for which the concept of minimum proportion would not be practically applicable? Please also state the reasons for your answer.

Sustainability-linked derivatives (SLDs)

They embed or create an ESG component to a traditional derivative payoff, typically based on one or several key performance indicators (KPIs) that are designed to monitor compliance with ESG targets and provide a financial incentive to the counterparty to implement its sustainability strategy and improve their ESG performance.³ A range of sustainability-linked derivatives has been issued over the past several years, which add an ESG pricing component to conventional hedging instruments, such as IRS, cross-currency swaps or forwards. These transactions are highly customizable and use various key KPIs to determine sustainability goals.

An example of a SLD is an interest rate swap whereby a corporate counterparty pays a penalty (x bps), in addition to a vanilla IR payoff, if it does not attain a predefined level of an ESG KPI, e.g. GHG emissions reduction target. The penalty is not paid to the financial institution, but to an organisation/charity that works in a field linked with the underlying KPI.

Moreover, although interest rate, currency, carbon and commodity trading derivatives are not applicable to Taxonomy assessments, they can be a tool to help implement a sustainable strategy when they include ESG KPIs aligned with this strategy. For example, for IR and FX SLDs, the ESG features are exclusively based on the KPIs embedded in the payoff, which are usually specific targets of the counterparty's sustainability strategy. Hence, for MIFID ESG classification purposes, these SLDs would typically be products taking into consideration the PAIs corresponding to the embedded KPIs, the other two categories (taxonomy and SFDR minimum proportion alignment) not being applicable.

Actual vs. minimum proportion

We agree with footnote 13 in paragraph 26 of the Consultation paper which indicates "*The* concept of minimum proportion does not apply to financial instruments for which it is not practically possible to define such minimum proportion. These types of products could refer to the actual proportion instead of the minimum one". The minimum proportion concept could make sense in the case of actively managed funds where the fund manager could provide a form of commitment towards investors. However, for products like structured notes, there is no possibility to change the exposure or the payout formula during the life of the note to achieve a minimum exposure. The minimum proportion concept should be read as "actual proportion" available at the moment of the transaction. The same logic applies to debt securities, shares, and derivatives

³ <u>https://www.isda.org/a/xvTgE/Sustainability-linked-Derivatives-KPI-Guidelines-Sept-2021.pdf</u> https://www.isda.org/a/58ngE/Regulatory-Considerations-for-Sustainability-linked-Derivatives.pdf



Q4: Do you agree with the suggested guidance on complexity in relation to the target market assessment and the clustering approach? Please also state the reasons for your answer.

Joint response with AFME

We would like to note that the Association for Financial Markets in Europe (AFME) has also produced a response to this consultation, to which we generally agree with and support their position.

New paragraph 27 of the draft guidelines provides that "for certain more complex products, such as certain OTC derivatives or structured products, it is expected that a clustering approach will not be appropriate and that firms should define the target market at the level of the individual product".

For structured products

In this respect, Members note that substantive work has been done by manufacturers in the last years to build clusters of structured products having like-for-like characteristics which are assigned a similar target market. Such clustering work has been conducted taking into account the features of those products, for example, the level of complexity, risks, underlying, level of capital protection, duration etc. of the products and resulted in very granular categories which are working well and the functioning of which is constantly assessed in the context of the annual reviews of the financial instruments performed by the manufacturers.

Also, the benefit of rules-based target market definition is that it leads to granular enough outcomes in the form of a European MiFID template (i.e. a level playing field with funds), and provides comparability across products in a consistent way.

Furthermore, where a manufacturer decides to issue a new typology of structured product whose characteristics may, in abstract, fall into one of the already established clusters, manufacturers' internal committees determine whether products of the new typology can actually be assigned the target market of the cluster or will require an additional cluster to be defined..

In light of the above, Members ask that ESMA reconsiders the wording of the proposed new guideline above by erasing reference to structured products or limiting the circumstances where the clustering approach is not expected to be appropriate only in cases of **certain** structured products (in line with wording used for OTC derivatives).

For OTC derivatives

To determine the target markets for OTC derivatives, we considers that a distinction needs to be made between standardised OTC derivatives (which are fairly generic products) and "case-by-case" derivatives designed to meet the needs of a particular client.

For standardised OTC derivatives, i.e. those with common characteristics (type of underlying instrument, currency of derivative, par value, barrier, etc.), a clustering approach can be suitable. However, for "bespoke" OTC derivatives, which by their nature are unique products intended for a unique transaction, as set out by ESMA in its Guidelines, the target market

defined is considered as the client having ordered the product (§24 of ESMA Guidelines on product governance ESMA35-43-620 dated 2 June 2017).

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: <u>www.isda.org</u>. Follow us on <u>Twitter</u>, <u>LinkedIn</u>, <u>Facebook</u> and <u>YouTube</u>.