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## Consultation Response

### ESAs Call for Evidence on Greenwashing

10 January 2023

#### Introduction

The International Swaps and Derivatives Associations (ISDA) welcomes the opportunity to respond to the Joint ESAs Call for Evidence on Better Understanding Greenwashing (the “Call for Evidence”). The Call for Evidence (CfE) is a welcome opportunity to strengthen our collective understanding of the key features, drivers and risks associated with greenwashing. The findings collected by the European Supervisory Authorities can inform a review of the measures in the EU sustainable finance framework aimed at fighting greenwashing practices and enhancing trust in sustainable finance markets. We are pleased to share our recommendations to support and inform the continuous efforts put forward by authorities to strengthen the integrity and effectiveness of EU sustainable finance markets.

ISDA has been a keen contributor to the ongoing discussion regarding the calibration of the regulatory framework for derivatives from a sustainability perspective. We are therefore pleased to provide input into the ESAs’ important work on addressing greenwashing risks. Actual or perceived misrepresentation of sustainability features may have a detrimental impact on investor and consumer perceptions of sustainable finance products and we strongly support the authorities’ goal to maintain trust in the market. This is crucial to support the further development of sustainable finance and in turn the vital objective that it is seeking to achieve.

ISDA has only responded to relevant questions of the CfE from a derivative-related standpoint. Additionally, we would like to note our endorsement of the responses submitted by the Association for Financial Markets in Europe (AFME) and the Association française des marchés financiers (AMAFI) to this CfE on the fundamental issue of greenwashing.

#### ESG data

Availability of reliable and comparable ESG data, as well as regulatory ESG classification methodologies, are key challenges in addressing greenwashing accusations and ultimately the risk of clients losing confidence in ESG financial instruments. This is paramount for regulations that already demand ESG disclosures at product level even in the absence of official public data and clear methodological approaches, such as MIFID ESG and SFDR.

MIFID II ESG<sup>1</sup>, already applicable, requires that all financial instruments be classified into three ESG regulatory categories, i.e. (i) environmental taxonomy sustainable investments, (ii) SFDR sustainable investments, and (iii) PAIs. SFDR also requires disclosure on these categories.

Nevertheless, official taxonomy data will start to be published only partially in Q1-Q2 2023 (for non-financial corporates and climate-related objectives), and a year later for the rest of entities

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<sup>1</sup> [EUR-Lex - 32021R1253 - EN - EUR-Lex \(europa.eu\)](#)

and objectives. Moreover, PAI data will become fully available only in 2026 as per CSRD, and PAIs are also an input in the definition of SFDR sustainable investments (for the DNSH part).

In the meantime, while official public data is lacking, credit institutions are nonetheless required to communicate the proportions of financial instruments aligned with the above-mentioned taxonomy and SFDR definitions, but based on “equivalent information” (taxonomy) or estimates

(SFDR, PAIs) from external providers. This data is not unique across providers, and may also be different from official data that will be published later. Hence, the ESG information communicated to clients under these regulations could be confusing for clients, all the more so when ESG classifications will be adjusted to reflect official data. This exposes financial institutions to a risk of undue accusations of greenwashing, stemming from regulatory misalignment, and in turn disincentivise them to offer innovative ESG products

Indeed, regulation does not allow financial institutions to delay regulatory ESG disclosures until official data becomes available. The only alternative to using equivalent information/estimates is to disclose that products have 0% ESG alignments, which might not be accurate either.

### **ESG classification methodologies**

In addition to missing official data, some classification methodologies are either completely lacking (e.g. for derivatives) or vague (e.g. SFDR sustainable investments definition).

The three above-mentioned regulatory ESG classifications are compulsory for all financial instruments within MIFID II ESG, including derivatives, in the same way as for securities (i.e. bonds, stocks). Nonetheless, policy makers only provide ESG classification methodologies for securities, leaving out derivatives, and explaining that more time is necessary to reach a conclusion on derivatives, thus transferring regulatory responsibility and risks to financial institutions for these instruments.

In particular, derivatives are treated inconsistently within SFDR at product/fund level: while allowing funds to use derivatives for their ESG characteristics or objectives, SFDR imposes that derivatives be fully penalised within the fund-level taxonomy-alignment ratio, i.e. they are excluded from the numerator, but included in the denominator – this is equivalent to considering them eligible instruments for taxonomy classification, but 0% aligned, in contradiction with the previous regulatory standpoints. The same asymmetric framework applies at entity level for all financial institutions when measuring their Taxonomy alignment (“GAR” for banks “Green investment ratio”/“GIR” for asset owners – Article 8 Delegated Act of the Taxonomy Regulation). These inconsistencies regarding ESG derivatives need to be addressed rapidly, as they are highly confusing and unduly favour accusations of misrepresentation despite financial institutions’ best efforts to comply with regulatory obligations (please refer to proposals of classification approaches in the ISDA response to the ESMA MIFID Product Governance consultation, Q.2 and Q.3).<sup>2</sup> Moreover, this asymmetric framework would have detrimental/negative consequences on the EU derivatives market, among others:

- Financial institutions will not benefit from the same level of market risk protections / tailoring when investing in taxonomy aligned activities compared to other investments and will likely reduce their investments in taxonomy aligned activities.

<sup>2</sup> Please refer to ISDA’s response to the review of ESMA’s guidelines on the MiFID II product governance rules: [https://assets.isda.org/media/96dd7ed5/2ea3b2a1-pdf/?\\_zs=5CRsN1&\\_zl=Vuor6](https://assets.isda.org/media/96dd7ed5/2ea3b2a1-pdf/?_zs=5CRsN1&_zl=Vuor6)

- Investors may restrict their derivatives activities to cash equity/bond for the sake of achieving better Taxonomy alignment ratios;
- It ignores the role of derivatives to foster investments by providing companies with a reduction in their cost of capital and market risk tailored to their risk appetite and profile, and/or by providing access to wider markets and investment opportunities;

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- It ignores the role that derivatives play for retail investors helping them participate in the equity market via capital protected products. Retail appetite to Taxonomy aligned products may reduce as a consequence;
  - It ignores the fact that banks selling to investors derivative instruments – e.g. bonds or shares issued by companies with taxonomy aligned activities – will invest directly or indirectly in these bonds or shares to hedge their position, hence contributing to the financing itself of these activities;

In addition, the SFDR definition of “sustainable investments” is vague and must be determined in detail internally by financial institutions, both under MIFID ESG and SFDR disclosure obligations. Hence, SFDR classifications will likely differ from one institution to another, including between manufacturers and distributors of financial instruments. It is important that regulators clarify that responsibility for the misrepresentation of sustainability related features lies with the entity that determines those features and communicates them down-stream.

### **Regulatory intricacy**

Beyond classification methodologies for certain instruments and missing data, the complexity of regulatory ESG classification is a challenge in itself, with three compulsory categories of ESG instruments, and associated quantitative minimum proportions of sustainable investments to be expressed by clients (for MIFID suitability assessment purposes).

In addition, there are also SDFR classifications at fund level (Art. 8 and Art. 9), different from MIFID ESG ones.

A client needs to have a good knowledge of those complex regulations just to express their ESG preferences, which is difficult to achieve and hence prone to misunderstandings and ultimately undue greenwashing allegations against financial providers which attempt to meet their stated ESG preferences. It is therefore paramount that regulators publish training and standardised communication materials on regulatory ESG classification for all financial instruments, in order to avoid greenwashing perception by clients and market participants in general, and discourage the development of sustainable financial products. Further, the market may benefit from the regulators clarifying the protections and controls related to misrepresentation that are already in place more broadly, and which cover sustainability features of investment products. This could address undue greenwashing perception without introducing additional complex regulation.

## **Derivative-related observations**

*“ESG derivatives including those with an ESG underlying and with an ESG performance target, other derivatives”* are mentioned in Q A.12.4 of the present CfE as a potential asset class/type of financial product involved in greenwashing.

This statement creates especially high legal uncertainty, as there is currently no regulatory basis on which to assess the sustainability of derivatives. As mentioned above, current EU legislation on sustainable finance does not have a consistent approach towards derivatives. Financial institutions and investors face inconsistencies and uncertainties between, on the one hand (i) ESG regulatory classification obligations in MiFID II and SFDR but missing methodological instructions on how to tackle derivatives, and on the other hand, (ii) penalizing treatment within Taxonomy-alignment ratios (at fund level and entity level).

Overall, this regulatory framework provided for an inconsistent treatment of derivatives and an unclear representation of derivatives’ roles in sustainability, exposing them to unwarranted claims of greenwashing. This is especially problematic for regulations that are already in application, such as MiFID II ESG and SFDR, which also cover the use of derivatives without clear instructions on how to deal with them, either as part of a fund or when sold directly to clients. In this latter case, the issue is of particular importance for equity and credit derivatives, which in ISDA’s view can contribute to sustainability but whose sustainability assessments are currently being assessed in the context of the sustainability of the underlyings, proportionately to the exposure the derivative offers to the underlyings.

In light of the above, there is a pressing need for regulatory clarity on the treatment of derivatives from an EU sustainability perspective. It is thus paramount that specific ESG classification guidelines be issued for derivatives and structured products in order to allow financial institutions to implement their ESG obligations without undue regulatory risks.

The application of the greenwashing concept to derivatives should be based on stable regulatory provisions, otherwise it could expose firms selling these products to a significant risk of litigation and reputation, thus jeopardizing the use of these products by investors and corporates and ultimately the development of these markets.

ISDA’s members’ activities in derivatives are of paramount importance for their ability to answer their clients’ needs both in terms of financing and investing. ISDA has been working over the past year on the contributory role of derivatives to sustainable finance and had the opportunity to provide comments on this matter to the EU’s Platform on Sustainable Finance (PSF) in relation to its work on how to account for them, in particular those with equity and corporate bonds as underlyings, in the Taxonomy disclosure KPIs for financial undertakings. ISDA therefore stands ready to continue their engagement with policy makers to contribute to framing derivatives’ contribution to sustainability and help test and calibrate the relevant options currently under examination.

## **The contributory role of derivatives in sustainable finance**

Derivatives perform a critical role in economic activity by facilitating the raising and allocation of capital for green finance, helping businesses and investors better manage the risks to which they are exposed, and allowing market participants to more effectively align their exposures with risk tolerance and risk management requirements. The derivatives market also plays a major role in enhancing transparency through providing information on their underlying commodities, securities or assets. This can ultimately contribute 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.

The financial sector is a key enabler of economic activity and plays a critical role in facilitating and accelerating the transition to a low carbon economy, and the transition to a sustainable economy will take a significant amount of long-term funding. ESG investments and the associated derivative instruments that help mitigate the risk of those investments and contribute to their financing will be critical in the transition to a green economy, enabling companies to meet their sustainability goals effectively and efficiently.

It is important to note that derivatives on equity and corporate bonds contribute to defining a company's cost of capital by mitigating its business risks. Hence, they contribute to its financing/refinancing costs similarly to when a critical mass of activist investors divest from certain types of companies/sectors that would result in these assets/sectors facing a higher cost of capital. These types of derivatives provide a clear signal / indication to the market which sector is likely to have higher or lower cost of funding.

The exponential growth of ESG markets over the past few years shows the need for forward prices for these assets and their related indices. Derivatives markets are a key component of mature secondary markets, and the recent growth in demand for listed and over-the-counter (OTC) ESG derivatives illustrates that these products are a core component of sustainable investment strategies, especially since the availability of liquid and transparent derivatives can fundamentally reduce funding and financing costs for share and bond issuers in the primary markets.

As markets for ESG investments develop and trillions need to be raised to finance the transition to a sustainable economy, the derivatives market will be critically important in facilitating the financing of green investments, including in their role as hedging tools to manage the associated risks. To this end, derivatives can play a very important role in achieving the goals outlined by the EU's Green Deal, and financial market participants should be able to use them freely.

The role of derivatives in sustainable finance is explored in greater detail in a July 2020 paper published by the Centre for European Policy Studies ("CEPS") and the European Capital Markets Institute ("ECMI").<sup>3</sup>

The financial sector is responding to the challenges in sustainable finance with a diverse range of product structures and transaction types in the derivatives market. 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. In January 2021, ISDA published a research report that gives a valuable overview of such ESG-related derivatives products and transactions.<sup>45</sup>

<sup>3</sup> [Derivatives-in-Sustainable-Finance.pdf \(isda.org\)](https://www.isda.org/derivatives-in-sustainable-finance.pdf)

<sup>4</sup> [Overview-ofESG-related-Derivatives-Products-and-Transactions.pdf \(isda.org\)](https://www.isda.org/overview-of-esg-related-derivatives-products-and-transactions.pdf)

<sup>5</sup> As plenty of academia suggests, there are currently three channels by which cash securities and derivatives contribute to positive outcomes for the real world: a) Voting rights/engagement; b) Sharing business risk/economic exposure and c) Bringing cash:- A study by Eugene F. Fama and Kenneth R. French 'Disagreement, Tastes, and Asset Prices', [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=502605](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=502605) - Paul Brest & Kelly Born: 'Unpacking the Impact in Impact Investing, [https://ssir.org/articles/entry/unpacking\\_the\\_impact\\_in\\_impact\\_investing#](https://ssir.org/articles/entry/unpacking_the_impact_in_impact_investing#) and industry initiatives, including

## Sustainability-linked Derivatives (SLDs)

Sustainability-linked products – whose liquidity, price transparency and attractiveness to investors can be further enhanced through the use of derivative instruments – can attract much-needed investment in the transition to a net zero economy. Such investments have long-term objectives and require a long-term orientation. One particular area of growth is sustainabilitylinked derivatives (SLDs), which have gained increasing prominence in the EU, UK and US, and are mentioned in footnote 14 of the CfE. In this context, please note ISDA's publication of a white paper outlining key performance indicators (KPIs) guidelines for SLDs.<sup>6</sup>

Although SLDs are highly bespoke transactions typically entered in by sophisticated investors, it is important that the ESG-related KPIs are transparent and well-defined in order to ensure legal certainty and enhance the integrity of this new and emerging market. SLDs embed or create a sustainability-linked cashflow using KPIs that are designed to monitor compliance with

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environmental, social and governance (ESG) targets. KPIs are therefore critical to the effectiveness and integrity of the SLDs to which they relate. They need to be accurately defined in order to have legal certainty over how they operate and impact cashflows to be objectively verifiable. This will enhance the credibility of SLDs and the sustainability-linked market as a whole.

As SLDs are currently a niche and nascent market, the ISDA guidance seeks to establish a transparent, common framework of best practices that can be applied across KPIs and their related SLDs more widely in a way that is specific, verifiable and transparent. By establishing best practices and addressing key risks, the guidance seeks to address greenwashing concerns by encouraging adequate disclosure of how SLDs help attain sustainability objectives, therefore supporting the integrity of this developing market.

Moreover, although interest rate, currency, carbon and commodity trading derivatives have neutral underlyings to Taxonomy and SFDR definitions of sustainable investments, 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.

In April 2022, ISDA launched a survey to assess the current state of the SLD market<sup>7</sup>. Sixty-nine respondents indicated they engaged in SLD transactions and use existing ISDA documentation to do so. The survey report proposes a path forward for standard SLD documentation that aims to strike an appropriate balance between enhancing trading efficiency and maintaining the ability to tailor transactions to meet specific sustainability objectives.

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for example the Investor Contribution Strategies developed by the Impact Management Project:  
<https://impactfrontiers.org/norms/investor-contribution/>.

These channels are also described at section 4.10 of the FCA consultation for SDR:  
<https://www.fca.org.uk/publication/consultation/cp22-20.pdf>

<sup>6</sup> [Sustainability-linked-Derivatives-KPI-Guidelines-Sept-2021.pdf \(isda.org\)](#)

<sup>7</sup> [The-Way-Forward-for-Sustainability-linked-Derivatives.pdf \(isda.org\)](#)



As there is currently no single approach to documenting SLDs, having a range of standardized provisions will allow market participants the flexibility to document bespoke SLDs using standardized components, which will ultimately help counter greenwashing concerns by encouraging adequate and transparent documentation of SLDs transactions.

### **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 79 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: [www.isda.org](http://www.isda.org). Follow us on [Twitter](#), [LinkedIn](#), [Facebook](#) and [YouTube](#).

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