

SUSTAINABLE FINANCE STRATEGY: ENABLING DERIVATIVES TO CONTRIBUTE TO TRANSITION EFFORTS

The mitigation of climate change is one of the major challenges our planet is facing. Through the European Green Deal, the Union aims at setting an example through the definition of ambitious goals such as reversing biodiversity loss, strengthening resilience to climate change as well as becoming the first climate-neutral continent by 2050¹.

The financial sector has a central role to play to support that transition. Following up from its 2018 Action Plan on financing sustainable growth², the European Commission adopted last July its renewed Sustainable Finance Strategy (the Strategy)³. It emphasizes a financing need of € 350 billion per year to meet the 2030 emissions-reduction target in energy systems alone and € 130 billion for other environmental goals.

In this context, the EU sustainable finance framework⁴ and the Capital Markets Union⁵ are instrumental tools to enable the public and private sectors not only to raise the capital but also to channel investments into sustainable economic activities.

Amongst the four areas identified in the Strategy features the necessity “to finance the transition from the real economy towards sustainability”. Considering what has been achieved so far, one can notice that legislative reforms have focused on the development of direct financing instruments both from the supply side (labelled products for e.g. EU Green Bonds and green products with SFDR) and the demand side (consideration of client’ sustainability objectives with MiFID II, UCITS/AIFMD and IDD).

While these regulatory efforts appear logical in light of these instruments’ capacity to substantially contribute to the financing of sustainable activities, it is worth stressing that derivatives have not so far benefited from such attention even though they play an important role in the economy: they constitute an essential tool for economic agents to hedge their risks and facilitate financing and the development of businesses. AMAFI considers that these key functions of derivatives in hedging risks and facilitating financing are especially important to develop sustainable activities and are a key component of the financial sector’s contribution to the EU Green Deal. A pragmatic and appropriate regulatory approach with respect to derivatives is thus a necessary step to consider.

AMAFI welcomes the EC’s renewed Strategy on Sustainable Finance and in this paper would like to highlight (i) the significant role played by derivatives in the economy and hence (ii) the necessity to adopt a balanced regulatory approach for derivative instruments in upcoming reforms of the sustainable finance regulatory framework.

¹ https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal/delivering-european-green-deal_en

² <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN>.

³ https://eur-lex.europa.eu/resource.html?uri=cellar:9f5e7e95-df06-11eb-895a-01aa75ed71a1.0019.02/DOC_1&format=PDF

⁴ We refer to the Multiannual Financial Framework 2021-2027 and the Next-Generation-EU through which the Union aims to spend € 650 billion on projects to tackle climate crisis and € 100 billion in projects supporting biodiversity.

⁵ https://eur-lex.europa.eu/resource.html?uri=cellar:61042990-fe46-11ea-b44f-01aa75ed71a1.0001.02/DOC_1&format=PDF.

I. The significant role of derivatives in the economy

Derivatives have two main benefits for economic agents: they allow them to hedge their risks and, in doing so, they also facilitate their financing needs.

a. An efficient risk-hedging and ...

Their historic⁶ role in risk management is useful to industrial and commercial companies as well as investors by allowing them to minimize the consequences of unfavourable changes in interest rates, exchange rates, prices or even volatility. Companies and investors seek to hedge the risks associated with their activities and investment strategies, mainly the risk of fluctuations in commodity prices, currency risk, interest rate risk and volatility risk.

Derivatives are one of the most cost-effective and flexible ways to cover these risks. They are available in the form of standardized products on organized derivative markets or are developed on a case-by-case basis by financial institutions to provide bespoke coverage of the specific risks to which their clients are exposed, especially when the latter are companies.

In this regard, derivatives help companies and clients in their projects and investments, including longer term ones, by allowing the management of some of the uncertainties associated with such time horizon⁷.

Moreover, the ability of an investor to cover the risks of their portfolio directly contributes to their appetite to buy securities in the primary or secondary market, that is to say to participate in the financing of the issuer concerned. As such, derivatives help provide liquidity in the market of the securities concerned and play a key part in allowing investments, including on the longer term. In other words, derivatives also play a role in raising capital. They facilitate the risk-taking of investors who commit capital to the project or the activity of an issuer because they allow them to limit this risk.

b. ... facilitating instrument for fund raising ...

Derivatives also allow issuers to find the best balance between bearing a financial risk and meeting investors' appetite, when they decide the financial terms of their debt issuance.

For example, an issuer who decides to raise funds by issuing fixed-rate bonds to meet the interest of investors, but whose income is dependent on the level of interest rates, is exposed to the risk that its income will fall in the future in the event of a drop in rates while its cost of borrowing will remain the same.

HEDGING OF THE WHEAT PRICE BY A FARMING CO-OP

A farming co-op wants to lock in the price at which it can sell part of its total production of milling wheat in the coming year. It finds a financial institution willing to act as counterparty to a trade that will allow (but not oblige) it, during that year, to sell a daily quantity of milling wheat for delivery December of that year, at a fixed price per tonne.

In practice, this means that every day during the year:

1) If the market price of the December milling wheat contract is below the fixed price, the co-op can exercise its right to sell with the financial institution, which will then pay the difference between the set price and the market price.

In addition, the co-op will physically sell its December wheat at the market price. The result of these transactions is that the co-op sells its December milling wheat at the fixed price.

2) If the market price of the December milling wheat contract is above the fixed price, the co-op will sell its December wheat at market price.

Through this mechanism, the co-op is certain it will be able to sell its milling wheat for December delivery at a price that will be equal or above the fixed price.

⁶ Commodity derivatives markets are the oldest known markets, dating back to Antiquity.

⁷ For the role of derivatives in encouraging long-termism, see § 3.4 of "Derivatives in sustainable finance", CEPS and ECMI, 15 July 2020, https://www.ceps.eu/ceps-publications/derivatives-in-sustainable-finance?mc_cid=07e495f4fc&mc_eid=2db85089e8.

HEDGING AN INTEREST RATE RISK LINKED TO A BOND ISSUE OF A COMPANY OR A STATE

An issuer, such as a state or a company (also a local authority or a national or supranational institution) decides to meet a financing need by raising funds on the bond market through an issue of EUR 1 billion, with a maturity of 7 years, at a fixed rate. It should be noted that these last two conditions form a market standard to which investors are accustomed, and therefore constitute an important element in the success of the issue.

To cover its risk, the issuer decides to exchange its 7-year fixed rate for a 3-month "renewable" rate over this 7-year period. A financial institution acts as a counterparty to a "7 years / 3 months" swap. Under the terms of this swap, the issuer will receive from the financial institution, or pay to it, the difference between the 3-month variable rate (set based on the Euribor benchmark, which measures the interbank lending rate) and the fixed rate.

As a result of this swap, the financial institution is exposed to the risk that the 7-year rate drops. To cover this risk, the financial institution looks for more liquid instruments that will allow him to switch to a fixed rate. This double constraint (sufficient liquidity and exposure to a fixed rate) will guide its own choice of hedging.

By using a derivative product, this issuer is able to exchange its fixed rate for a variable rate to avoid this risk (see box).

Derivatives, through their hedging capacity, then facilitate access of debt issuers to the markets by securing the conditions of their fundraising. They allow issuers to better control their financing costs and therefore their capital cost on which depends their capacity to engage in new developments and projects.

Derivatives therefore contribute to the proper functioning of the economy notably by facilitating fundraising both for project promoters and investors and by enabling the management of the risks associated with the projects and activities of companies and

investors. These two functions are especially important both for the massive financing necessary to achieve the transition to a sustainable economy and the rising need of economic agents to cover their ESG risks. Derivatives are thus due to play an even greater role in the years to come.

c. ... that necessitates expert dealers

Derivatives used by issuers and investors to hedge and finance their strategies often contain bespoke features. Their structuration, trading and management require the intervention of professional dealers able and willing to take risks and to manage them⁸. By doing so, they ensure that hedging costs are economically interesting for the client compared to the costs of bearing the risk, that the product features meet its specific needs, and that the client will be able to get out of the derivative before its maturity if it wishes so⁹.

Dealers then have, in turn, to manage the risks induced by the contracts they entered in with their clients. This is the reason why derivatives involve hedging operations on the part of the financial institutions offering them: to manage costs and provide liquidity, they need to cover as exactly as possible the risks they take and to adapt to changing market conditions. This results in multiple operations, for a value well above the one of the original operation concluded with the client¹⁰.

CLIENT-SPECIFIC DERIVATIVES AND ACTIVE HEDGING MANAGEMENT

Concluding with a client a derivative meeting its specific hedging needs implies that the financial institution will actively manage the resulting risk position. This consists in making daily trades to adjust risk by buying or selling underlying instruments.

The transformation of the risk also involves entering into transactions of a shorter duration than the original operation done with the client. These transactions are generally rolled hence the exposure may be maintained over the original long-term operation.

Such dynamic hedging management is absolutely critical to maintain the ability of a financial institution to offer its clients the protection sought. This allows clients to offload unwanted risks and their associated costs whatever the market conditions.

On this ground, it is clear that the treatment by sustainable finance regulation of the derivatives that financial institutions conclude to answer their clients' needs and to hedge their related positions will be critical to ensure that expert dealers remain willing to provide liquidity and offer these products, and ultimately that derivatives can play their role in supporting the decarbonation of the economy.

⁸ As an illustration of the central role of dealers, they make up for nearly 40% of the global outstanding notional amounts of Forex OTC derivatives as of 31 December 2020 (source: <https://stats.bis.org/statx/srs/table/d5.1?f=pdf>).

⁹ The risks to which the client is exposed may evolve over time because of changing circumstances inherent to the client or to the economic outlook. It is therefore important for the client to be able to get out of a derivative contract if needed and to potentially replace it by a new one more adapted to the changed conditions.

¹⁰ In the example in b. of a company swapping a fixed rate for a variable one, the total value of the hedging operations carried out by the financial institution can be 6 times higher than the notional of the derivative concluded with the client.

II. Treatment of derivatives in sustainable finance regulatory reforms: a call for neutrality and further analysis

Based on the above, the economic legitimacy of derivatives designed for the benefit of clients' projects and activities are indisputable. Their function in the economy at large should hence also materialise in facilitating the transition towards a sustainable economy.

It is therefore critical that sustainable finance regulation be designed to enable derivatives to play their role in the development of "green" activities and more generally in the transition of industries towards decarbonation. Action 4 of the Strategy calling for the financial sector to accelerate its contribution to transition efforts, underlines that all economic actors should be encouraged to contribute to the success of the Green Deal for Europe. In this context, it is important not to ignore or consider as harmful as a matter of principle a core component of the financial markets constituted by derivatives¹¹ and instead to embrace all the solutions the sector can offer.

a. Concerns on the regulatory treatment of derivatives

However, certain aspects of the regulation raise concerns about the treatment of derivatives.

For example, derivatives are out of the scope of the SFDR Regulation, which implies that these products cannot by nature claim to be Article 8 products (which promote environmental, social and governance characteristics) or Article 9 products (whose intrinsic objective is sustainable investment).

Another example is the Taxonomy Regulation¹² which currently requires financial institutions to publish a green asset ratio calculated by excluding derivatives from the numerator, i.e. green assets, while including them in the total assets value of the denominator. This would mean that derivatives cannot by nature participate in the emergence or development of sustainable activities and that the institutions offering them could not, even in theory, achieve a green asset ratio of 100%. We understand that this approach may not be definitive, and that further analysis may take place. Such analysis would be welcome as it would also inform the method for calculating the trading portfolio ratio of which derivatives can form a significant component.

With respect to labels associated to investment products, it can also be noted that the use of derivatives is often subject to questions and concerns leading to differing approaches in the EU. For example, the proposal for an EU Ecolabel seems to exclude synthetic replication for ESG funds, as such exposure is proposed to be only temporary and linked to significant subscriptions.

It is therefore AMAFI's view that an upfront analysis of the contribution of derivatives to sustainability is needed to ensure this category of products, either used solely or in the frame of investment products, be not per se a cause for exclusion from the category of sustainable assets.

b. Defining the conditions for derivatives to contribute to sustainable development

For AMAFI, sustainable finance regulation should adopt a neutral approach to derivatives as long as a thorough analysis has not been completed. While not all derivatives are intended to contribute to sustainability, there are conditions under which they do contribute based on their very purpose mentioned above. These conditions may relate to the following elements, or a combination of them:

- The underlying of the product: for example, a derivative with an underlying eligible to the European Taxonomy (such as a share, bond or commodity) could qualify as contributing to sustainability under certain conditions;

¹¹ With approximately USD 582 trillion in notional amount of outstanding OTC derivatives as of June 2021 (<https://stats.bis.org/statx/toc/CBS.html>), the global derivatives market is more than four times larger than the global equity and bonds markets combined.

¹² Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

- The counterparty of the derivative: for example, a parallel could be drawn with the treatment of general purpose lending/funding in the Regulation on prudential requirements for credit institutions and investment firms (CRR)¹³, whereby it is not the “use of proceeds” that must be considered to assess the green part of the loan but the proportion of the counterparty’s turnover¹⁴ derived from economic activities that qualify as environmentally sustainable with the meaning of Taxonomy¹⁵;
- The purpose of the product: for example, a derivative aiming at hedging the risk of a sustainable project could qualify as contributing to sustainability;
- The financial characteristics of the product: new ESG derivatives are emerging, whose terms and functioning are linked to ESG criteria¹⁶. These types of derivatives play a role in incentivising financial participants to meet their ESG targets. Derivatives whose characteristics enable investment into sustainable activities (such as asset swaps) should also be considered.

Going forward AMAFI thus intends to continue discussions with its members to make concrete proposals in this direction. In its view, it is of paramount importance that the EU sustainable finance regulation allow the use of derivatives as a financial technique useful to the development of a sustainable economy. This will ensure that the full potential of financial markets to contribute to the transition is harnessed.



About AMAFI

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI’s members operate for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives, including commodities. Nearly one-third of members are subsidiaries or branches of non-French institutions.

¹³ Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013.

¹⁴ Information published by the counterparty according to the Article 8 of the Taxonomy Regulation.

¹⁵ EBA Consultation Paper Draft Implementing Standards on prudential disclosures on ESG risks in accordance with Article 449a CRR, 1 March 2021.

¹⁶ For example, a counterparty may have to pay a premium on an interest rate swap if it misses some pre-defined ESG targets or may benefit from an adjustment of the premium down if the relevant targets are met.