ISDA Safe, Efficient Markets

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Submitted Electronically

Christopher Kirkpatrick
Secretary
U.S. Commodity Futures Trading Commission
1155 21st Street NW
Washington, D.C. 20581

Re: Request for Information on Climate-Related Financial Risk

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] appreciates the opportunity to submit comments on the *Request for Information on Climate-Related Financial Risk* ("**RFI**") published by the U.S. Commodity Futures Trading Commission ("**CFTC**" or "**Commission**") on June 8, 2022 in the Federal Register.[2] ISDA applauds the Commission's proactive approach to seeking industry's views on the impact of climate-related financial risk on derivatives markets. In this regard, we also strongly support the creation of the Commission's Climate Risk Unit with the mission of assessing the interaction between climate-related risks and derivatives, including how derivatives can be used to mitigate such risks.

Environmental, social and governance (**"ESG"**) issues are rightfully high on the global regulatory agenda. Market participant, social and investor attention on ESG is driving important discussions in global financial markets. The derivatives markets help the global economy manage risk and are therefore poised to play a key role in supporting the transition to a low carbon economy. Derivatives enable more capital to be channeled towards sustainable investments, help market participants hedge risk related to ESG factors, facilitate transparency, price discovery and market efficiency, and contribute to long-term investment planning in furtherance of a more sustainable future.[3]

As a preliminary matter, it is important to recognize the key challenges faced by financial markets in addressing climate-related financial risks, which include: (i) access to data, such as historical climate data, company emission data, physical address data, and (ii) uncertainty

[1] 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: www.isda.org.
[2] 87 Fed. Reg. 34856, *available at* https://www.govinfo.gov/content/pkg/FR-2022-06-08/pdf/2022-12302.pdf.
[3] ISDA published a paper that discusses the role of derivatives in ESG markets and provides an overview of ESG-related derivatives product: https://www.isda.org/a/qRpTE/Overview-of-ESG-related-Derivatives-Products-and-Transactions.pdf

regarding future climate-related events and their associated financial and physical risk impacts. Existing data and tools to measure and quantify climate-related financial risk (in particular, longer-term transition and physical risks) are only just emerging. In order to be useful and reliable, such data will need to undergo extensive analysis, refinement, and adaptation over time. Although data capabilities are improving, significant gaps in data sourcing, capture, standardization, and aggregation currently affect the accuracy of projections and risk assessment. As noted by the Basel Committee on Bank Supervision ("**BCBS**") in April of 2021, beyond the data challenges, methodologies need "to be further developed to adequately address the uncertainty inherent to joining up the modelling of climate and financial variables, as well as analy[z]ing unusually long-dated risks."[4] Further, as also acknowledged by the BCBS, there is a growing disparity between the increasing availability of transition risk data as compared to less available physical risk data. Consequently, firms' ability to understand and analyze physical risks is even more difficult.

The lack of reliable data is not due to a lack of willingness to produce or share data, but rather is both a scientific and mapping issue. As we are still beginning to understand the impact of climate change, it remains unclear what information should constitute climate-risk data, and how it can be effectively measured and systematically mapped against and translated into financial risk or other risks to the financial sector. Thus, it is critical that the private and public sector work together to better identify and understand climate-related risk data and the related features of measurement and mapping. Additionally, it is important to recognize that how we approach climate-related financial risk will be an iterative process that will continue to evolve in tandem with better quality and more granular data.

Our comments below reflect our members' collective experience trading in derivatives, with the understanding that reliable climate-related financial risk data is not yet widely available. Both the public and private sectors are in early stages of understanding the nature of climate-related risks and how to measure and map their impact on financial markets. Against this backdrop, we address the following key areas of the RFI and provide recommendations to the Commission:

- **Scenario Analysis & Stress Testing:** We do not believe that the Commission, at this time, should consider imposing distinct scenario analysis and stress testing requirements for climate-related financial risk that is specific to a firm's swap dealing activity. Given the nature of derivative transactions, which are often short-dated, there is a time horizon mismatch with scenario analysis and stress testing that typically assess longer term impact of climate risks.
- **Disclosure:** The Commission should take a holistic view of its approach to disclosures to ensure that any rule making is efficient and not duplicative, in whole or in part, with requirements or standards under consideration by other domestic and international regulators. Further, the Commission's existing swap dealer rules provide a framework to ensure that appropriate counterparty disclosures are made.

[4] Basel Committee on Banking Supervision: Climate-related financial risks – measurement methodologies, 43 (April 2021), https://www.bis.org/bcbs/publ/d518.pdf.

- **Risk Management:** Guidance from the CFTC should complement its existing swap dealer risk management framework and align with any guidance established by prudential authorities. We welcome the recognition that climate-related financial risks are drivers of existing risks and banks are at a developmental stage in embedding these into their existing risk management frameworks, thus we encourage supervisors to take a phased approach towards introducing climate risk-related expectations. This will allow for methodologies to mature, for greater standardization to be developed, data availability to increase and for consistency across jurisdictions to grow.
- **Product Innovation:** The Commission should provide a forum, via the Climate Risk Unit, for exploring and discussing the manner in which sustainability-linked derivatives ("**SLDs**") may aid in the transition to a lower carbon economy and the regulatory and operational requirements related to trading these contracts.
- **Voluntary Carbon Markets:** The Commission should continue to take a leadership role in supporting and enhancing the integrity of voluntary carbon markets ("**VCMs**").
- **Regulatory Coordination & Engagement:** As climate-related financial risks are global in nature, the CFTC should continue to coordinate on a regional and international basis when establishing principles or guidance that address climate risk, SLDs and other derivatives that are ESG-related.

Scenario Analysis and Stress Testing

As a general matter, we support the development of a principles-based approach to scenario analysis and stress testing, leveraging common standards including those promulgated by Network for Greening the Financial System ("**NGFS**"), Representative Concentration Pathways ("**RCPs**"), and International Energy Agency ("**IEA**"). Such initiatives work best when there is joint industry and regulatory collaboration.[5] Both the private and public sector should strive to reach a consensus on available scientific and economic forecasts and a range of climate scenarios, so that firms can then tailor their approaches to scenario analysis and stress testing as appropriate in relevant business models and risk profiles.

While publicly available climate scenarios provide important insight into a range of plausible outcomes, they do not provide firms with the appropriate sectoral granularity in order to *directly* translate scenario output into readily consumable inputs for risk modeling. The value of climate scenario analysis will continue to develop as the science-based or macroeconomic outputs are mapped to financial risk and then translated into granular financial impacts, which can then be applied across a diverse set of sectors and jurisdictions.

Consistent with recent statements of FRB and OCC, we acknowledge that climate scenario analysis is nascent and will require further exploration before final guidance is issued. A principles-based approach will allow for further development of climate-based solutions across the industry, and coordination with other regulatory authorities is important.

[5] For example, the establishment of the Climate Financial Risk Forum in the UK.

Having said so, with regards to a firm's swap dealing activity in particular, it would be premature to indicate that running scenario analysis or conducting stress testing for climate-related financial risk that is specific to derivatives activity is necessary or would otherwise be beneficial from a climate-risk management perspective.

In the case of swap dealers that are prudentially regulated, where risks are material, they are appropriately assessed and monitored. Moreover, the Basel Committee on Banking Supervision, as well as the FDIC and OCC, have recently proposed guidelines for such practices, aiming to introduce some level of consistency on how such exercises are conducted across firms. Given that climate-related financial risk is macro in nature and runs across various business lines, it is premature to suggest that scenario analysis or stress testing that is specific to derivatives dealing would advance existing efforts to measure the impact of climate-related financial risk at the entity-level. Instead, imposing such requirements may run the risk of duplicating existing efforts or adding unnecessary regulatory complexity without adding any benefit to regulatory oversight.

For swap dealers that are not prudentially regulated, we believe that the existing risk management framework under Title VII provides sufficient safeguards to ensure that climate-related financial risk is addressed. Until there are more apparent benefits to conducting scenario analysis and stress testing of climate-related financial risk to the derivatives business, the Commission should rely on its existing Title VII regulations, such as risk management requirements, to address climate-related financial risks.

For these reasons, we believe that it would be too premature for the Commission to adopt specific regulations to address climate-related financial risks in scenario analysis and stress testing exercises.

Disclosure

While we recognize the importance of a coherent climate risk disclosure regime, there are other domestic and international regulatory bodies, as well as joint public and private sector initiatives[6] that are actively working to establish appropriately calibrated standards for climate-related financial disclosures. Instead of duplicating efforts and potentially inadvertently creating complex conflict of laws issues, we encourage you to continue to work with them in furtherance of a harmonized approach.

In respect of existing swap dealer rules, we believe that the Commission's risk management and client disclosure rules currently provide an adequate framework for climate-related risks and safeguard the Commission's ability to obtain information relating to the swap dealers' risk exposures, including climate-related risks.[7]

Risk management rules require that swap dealers, among other things:

[6] For example, the International Sustainability Standards Board was established at COP26 to develop a comprehensive global baseline of sustainability disclosures for capital markets.
[7] 17 CFR §23.600.

- establish, document, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the dealer's swaps activities (the **"Risk Management Program"**);
- identify applicable risks and set appropriate risk tolerance limits related thereto; and
- create periodic risk exposure reports that describe the dealer's applicable risk exposures and any recommended changes to the Risk Management Program.[8]

In respect of disclosures aimed specifically at swap dealer counterparties, the Commission's current regulatory framework sufficiently requires swap dealers to provide their counterparties (all of which are sophisticated eligible contract participants) with material information designed to allow the counterparty to assess the material risks of the particular swap in question. These disclosures, which may include information regarding material, climate-related financial risks, put the counterparty on notice of the potential risks associated with the transaction, furthering the Commission's customer protection goals.

Together the risk management and external business conduct rules establish an appropriate foundation for swap dealers' disclosures to the Commission and to counterparties. As the market participants and regulators collaboratively develop and refine methodologies to measure, map and quantify climate risks, risk management programs and disclosures will similarly evolve. Imposing additional disclosures, at this time, would be premature and perhaps unconstructive in light of the ongoing work of domestic and global standard setters.

Risk Management

To-date, our members' risk management practices, in the context of climate-related financial risk, have centered around the identification and evaluation of potential climate-related financial risks under different scenarios, specifically focusing on assessing materiality for different risks over varying time horizons. Firms are largely taking individualized approaches to incorporating climate-risk into their specific risk assessment models and risk management programs as proportional to their business size and mix. In our view, the Commission's regulations related to risk management programs provide a sufficient framework in which registrants can consider and include/embed applicable climate-related risks.[9]

We believe the Commission's existing rules described above, as well as the proposed climate-risk principles recently released by the FDIC and OCC,[10] provide an appropriately calibrated foundation to understanding and incorporating climate-related risks into a swap dealer's existing risk management programs. Taking a more prescriptive approach to climate-risk management, at this time, would be premature given the existing limitations of historical and observable climate-risk data. Once we have data that is reliable, mapped to financial risks, consistent and more granular, the industry and the Commission can begin to develop common standards and

[8] 17 CFR §23.600.
[9] 17 CFR §23.600(b).
[10] These proposals are available at: https://www.fdic.gov/news/press-releases/2022/pr22027.html; https://www.occ.gov/news-issuances/bulletins/2021/bulletin-2021-62.html.

guidelines relating to the inclusion of material climate-related risks into swap dealers' risk management frameworks.

Nevertheless, should the CFTC produce specific guidelines addressing climate-related financial risk management, we ask that the Commission ensure that its guidelines fall within the scope of its existing risk management rules and align with any guidance established by U.S. prudential regulators.[11]

Voluntary Carbon Markets

We believe that the Commission should take a leading role in enhancing the integrity of voluntary carbon markets (**"VCMs"**), as well as promoting the use of sustainability-linked derivatives, each of which are discussed in more detail below. The VCMs, are in essence, a market-driven solution to climate change. Our members strongly support the further development of VCMs, both in the US and globally.[12] We recognize the urgency to reduce, remove or avoid greenhouse gases, and while we understand that participation in VCMs should be secondary to firms reducing their own emissions, we nevertheless believe in the potential for VCMs to play an important role in the global fight against climate change.

Before seeking to expand its jurisdiction, it is important for the Commission to evaluate its existing regulatory authority over VCMs. Understanding the scope of the current regulatory reach will help eliminate the perception that these markets are unregulated and lacking standards, with no ability to prevent greenwashing.

The CFTC's consistent confirmation that voluntary carbon credits ("**VCCs**") are commodities supports efforts to enhance the integrity of VCMs. Given that VCCs are commodities, the Commission has the authority to police fraud and manipulation in VCC spot markets. In order for these markets to flourish, there can be no room for greenwashing, double-counting of credits or any other types of fraud and manipulation, and thus, we are supportive of the Commission's intent to use its enforcement authority to address these issues.

Moreover, the Commission is well-aware that its exclusive jurisdiction over futures contracts extends to all commodity futures contracts, including VCC futures. The CFTC and Self-

[11] Both the FDIC and OCC, in proposing climate-related risk principles, stated their intention to provide principles and guidance surrounding new and emerging climate-related financial risks that align with the existing risk management regulatory framework.

[12] As with any intangible asset, it is important to establish the legal nature of VCCs that will, in turn, determines how a VCC can be created, bought, sold and retired. It affects what type of security interest may be taken and enforced in relation to VCCs and how that can be achieved, as well as how VCCs would be treated following an insolvency or close-out exercise. Understanding the legal treatment of VCCs is important for developing deep and liquid secondary markets, which, in turn, will enable the development of a clear price signal for carbon and allow funds to be efficiently channeled to emissions-reducing projects. While the U.S. itself has a strong legal foundation for VCMs, other jurisdictions are less clear. In order to optimize the enormous potential that a global VCM can offer, we need to work collaborative towards creating a strong legal foundation for VCCs across jurisdictions and we believe that the CFTC, as the primary regulator for commodities in the US, has an important leadership role to play in this effort.

Regulatory Organizations could use the same oversight tools that they have traditionally used in physical commodity futures markets to ensure the integrity of VCC futures markets, including through conducting additional due diligence on carbon registries since they are used as delivery points for VCC futures contracts. Such an approach would enhance the integrity of VCMs, likely resulting in increased liquidity and boosting market confidence in VCCs.[13]

Finally, while not as prevalent in the market as VCC futures, the CFTC would also have authority over carbon swaps between eligible contract participants, potentially subjecting these transactions to the CFTC's reporting and recordkeeping regulations, as well as non-cleared margin requirements.[14]

Product Innovation

Derivatives linked to sustainability objectives ("**SLDs**") are positioned to play a key role in the transition to a more sustainable economy and in enhancing the flow of private capital to meet ESG objectives. Although still a relatively niche marketplace with its first transaction executed in 2019, the number of SLD transactions is growing, reinforcing the role that derivatives play in advancement of environmental objectives in the financial markets.

SLDs add an ESG pricing component to conventional hedging instruments, such as IRS, cross-currency swaps or forwards. These transactions are used to incentivize ESG performance and/or to facilitate support for sustainable projects. They are highly customizable and use various key performance indicators to determine sustainability goals. ISDA has done some analysis of the SLD structure and provided a roadmap for drafting SLD contracts.[15] We have also analyzed the possible regulatory treatment of these contracts in major jurisdictions, including the United States.[16]

Increasing awareness and understanding regarding how these novel products trade and fit within legal and regulatory frameworks may ultimately promote more trading in SLDs. In this regard, we would welcome engagement on the part of the CFTC that raises awareness of these products; for example, through offering a forum for discussion, including CFTC roundtables, where both the public and private sector can share views and determine a path forward for trading SLDs.

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[13] *See* ISDA Paper: Voluntary Carbon Markets: Analysis of Regulatory Oversight in the US, *available at* https://www.isda.org/2022/06/02/voluntary-carbon-markets-analysis-of-regulatory-oversight-in-the-us/

[14] Carbon swaps are OTC contracts that involve the exchange (or a series of exchanges) of allowances, offsets or cashflows at a given time (or for a set period). Offset-allowance swaps allow companies that have not yet reached their quota of allowed offsets to sell their allowances and buy offsets, therefore taking advantage of the price difference, as opposed to companies that may have more offsets than allowances and are already over their quota. Swaps are usually settled by payment rather than physical delivery. If the contract is intended for physical delivery, it may qualify for the CFTC's forward contract exclusion from the definition of a "swap". For more information, *see* ISDA, Voluntary Carbon Markets: Analysis of Regulatory Oversight in the US, *available at* https://www.isda.org/a/93WgE/Voluntary-Carbon-Markets-Analysis-of-Regulatory-Oversight-in-the-US.pdf.

[15] https://www.isda.org/2021/09/07/sustainability-linked-derivatives-kpi-guidelines/.

[16] https://www.isda.org/2021/12/01/regulatory-considerations-for-sustainability-linked-derivatives/; *see also* https://www.isda.org/a/qRpTE/Overview-of-ESG-related-Derivatives-Products-and-Transactions.pdf.

Digital Assets

The usage of Blockchain/DLT and digital assets in climate-related finance is in its early stages of development. With respect to digital assets, the connection between these instruments and climate related financial risk is too attenuated at this point, and thus, we believe it is too premature for us to comment on the potential interaction between digital assets and climate-related risk. However, the underlying DLT technology of digital assets has potential to accelerate ESG efforts for CFTC registrants and other market participants.

Blockchain technology, at its core, is immutable, traceable, has a single source of truth and is transparent—and these features lend themselves to supporting the development of the climate-related market. Blockchain technology allows deeper access to underlying data and confirmation of that data's provenance, allowing investors to potentially have access to real-time raw data, which could minimize greenwashing. The use of DLT could also streamline disclosures and guard against double counting across markets when considering offsets and permits.

Regulatory Coordination & Engagement

Globally, there is clear attention from regulators and the private sector to address climate-related risk. As noted, derivatives markets are global in nature and within the U.S. are subject to multiple regulator mandates. As a result, domestic and international regulatory coordination and engagement is critical to ensure that climate-related financial risks are addressed in a manner that is appropriately calibrated and functional for entities with both global and domestic operations. Separately, we understand that the Basel Committee on Banking Supervision is reviewing the current capital framework in respect of climate-related financial risks and would strongly encourage global regulators to wait for the final findings of this work and related recommendations before adjusting local capital frameworks. Any uncoordinated adjustment domestically could result in capital allocation distortions for international banks, while at the same time, potentially fragmenting markets and financial resilience in relation to climate-related financial risk.

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We appreciate the opportunity to submit our comments in response to the RFI on Climate-Related Financial Risk. We commend the CFTC for its consideration of these important issues. Our members are strongly committed to maintaining the safety and efficiency of the U.S. financial markets and recognize that the financial sector has a big role to play in the management of climate-related financial risks. We hope that the CFTC will consider our suggestions, as they reflect the extensive knowledge and experience of financial market professionals within our membership.

Please feel free to contact me or Nicolette Cone, Associate General Counsel (202-569-5782), should you have any questions or would like to discuss.

Bella Rozenberg
Head of Regulatory and Legal Practice Group
(646)-515-0567
ISDA