Sustainability-linked derivatives: some practical considerations

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Sustainability-linked derivatives have emerged as one of the key types of ESG derivatives that parties are increasingly looking to in order to assist them in meeting their sustainability targets. This article highlights some practical issues for market participants to consider when documenting sustainability-linked derivative transactions.

ESG-related derivatives products have a key role to play in helping companies meet their sustainability targets. Since 2019, there has been a particular focus on sustainability-linked derivatives (SLDs), which look set to play an important role in assisting companies to achieve their ESG goals. This article highlights key issues to consider when documenting SLDs.

For information on ESG derivatives more generally, please see our previous alerts:

- ESG derivatives: new tools unlocking capital in sustainable finance
- Derivatives as a tool for sustainable investment and impact financing

What are SLDs?

SLDs create an ESG-linked cashflow in the context of a conventional derivative, such as an interest rate swap or cross currency swap or forward. They do this by using Key Performance Indicators (KPIs) to monitor compliance with certain ESG targets. Although the product type is still in its relative infancy, a variety of SLDs have emerged in the last few years.

The same or different KPIs can apply to one or sometimes both counterparties and meeting a KPI could result in an increase or decrease in payments, payment of a rebate or fee, a margin or spread amount or payment to an agreed charity. SLDs are highly customisable as counterparties are free to agree particular KPIs or sustainable performance targets (SPTs) to meet their individual ESG requirements and can negotiate the consequences of meeting the KPIs or SPTs. Accordingly, they are currently illiquid products tailored to specific circumstances.

To date, SLDs have been structured as bilateral bespoke instruments so there is little public information available on their terms or format and no clear standard approach taken to documentation. Additionally, there is no common format on how KPIs should be developed. As a result, there have been some concerns that the KPIs are inconsistent and hard to verify and that the lack of widely accepted standards opens the door to greenwashing.

In an effort to encourage standardisation and greater confidence in SLDs, ISDA has recently published a paper that provides overarching guidelines on how KPIs could be developed and drafted. The ISDA paper, which seeks to create a common framework to ensure that KPIs are specific, measurable, verifiable, transparent and suitable, hopes to encourage widespread adherence to the guidelines with the result that best practices as well as greater consistency and transparency will be established across the market.
What types of SLDs have been issued to date?

By way of illustration, a couple of recent contrasting SLD transactions include:

- In August 2019, [ING entered into a SLD with SMB Offshore](#) (a global supplier of floating production solutions to the offshore energy industry) which was designed to hedge the interest rate risk of SMB’s USD 1 billion 5 year floating rate revolving credit facility. A positive or negative spread is added to the fixed rate paid by SBM based on SBM’s ESG performance which is scored by Sustainalytics.

- [Enel’s sustainability-linked cross-currency swap with JP Morgan](#) which hedges against the sterling/euro exchange rate and interest rate risk in connection with its £500 million sustainability-linked bond issuance in 2020. Enel and JP Morgan pay interest every 6 months on the cross-currency swap which increases if either side does not keep to its environmentally friendly targets. For more information on notable SLD transactions to date, please see our previous alert and also this previous [ISDA paper](#).

SLDs: practical documentation considerations

When documenting SLDs, there are many issues to consider. Set out below is a high-level checklist:

- **Regulatory requirements** - as for any derivative product, counterparties should ensure that they comply with applicable regulatory requirements, including in relation to reporting, risk mitigation, disclosure and conflicts of interest. There is still some uncertainty as to the extent to which SLDs are subject to ESG-related reporting and disclosure requirements and the extent to which they fall within the EU Sustainable Finance Disclosure Regulation (SFDR) and EU Taxonomy Regulation. Further guidance will be needed as the uptake of SLDs increases.

- **Drafting KPIs** - KPIs need to be clearly defined in the documentation and should specify certain objectives. The exact scope of the KPIs, the KPI methodology and source to be used all need to be identified.

- **Determination** - the documentation for the SLD will also need to set out a methodology for determination of compliance with KPIs. The reference period for the determination should be clear and the timing of the measurement and publication of the KPIs consistent with the term of the SLD as a whole.

- **Determination agent and verification** - a common approach for transactions documented using ISDA standards is for one of the parties to the agreement to act as the calculation agent. Thought will need to be given as to how appropriate this is for determination of whether a party has met its KPIs, including whether it should be the same party as the calculation agent for the base product. The parties may also wish to consider appointing an independent third party with relevant expertise to act as the determination agent although this will involve additional cost. A third party could also be used for verification of a determination or disputes.

- **Fallbacks** - the parties should consider including robust fallbacks that set out how the KPI will be determined in the event of unforeseen circumstances, similar to fallbacks
for benchmarks, for example where a source is not available temporarily or permanently.

- **Failure to meet a KPI** - there should also be adequate provisions dealing with the failure to meet a KPI and effective dispute resolution clauses, which set out how to deal with breaches and disagreements over whether a KPI has been met.

- **Disputes** – thought will need to be given to disputes in relation to the KPIs and whether the existing dispute mechanics for the trade can be leveraged of if something more bespoke is required. It may be appropriate to engage a third party for resolution.

- **Disclosure requirements** - the parties should carefully consider how and when information should be made available during the life of the transaction, ensuring compliance with relevant market abuse regimes in the event that any material information is disclosed.

- **Is this a penalty?** - careful drafting is required to ensure that any payment owed to a counterparty in the event of a failure to meet a KPI is not recharacterized as a penalty.

- **Margin requirements** - the transaction must comply with relevant margin requirements and the cashflows linked to the KPIs should be taken into account for the purposes of any margin calls.

- **Other issues** - consideration should be given to whether any additional early termination provisions or ESG-specific reps or warranties may be required.

**What’s next?**

In order for liquidity in the SLD market to develop, there is further work to do around standardisation and also to understand how compliance can be monitored on an on-going basis. It will be beneficial to the market if regulators work together to ensure that standards are consistently applied on a global basis and ISDA has a role to play in fostering this cooperation.

**Where can I find more information?**

Derivatives are an important component of the market’s continued, and accelerating, transition to sustainable finance. We can provide practical guidance on market standards for investing in ESG-related products, as well as, documentation and implementation of the new ESG-related disclosures. Please contact us for more information on how we can help.

*This note is for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. Please contact your normal contact at Hogan Lovells if you require assistance or advice in connection with any of the above.*

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