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Capital Markets and Climate Change: Odd Bedfellows?

By Adam Lapidus and Philip A. Schuster*

In this article, the authors argue that asset managers, institutional investors, financial regulators, and capital markets lawyers should play a leading role in developing proposals to mitigate climate risks.

It is natural to wonder why financial markets should be at the center of climate risk mitigation. Why would financial markets and financial regulators be in the position to lead this effort? Why not the Environmental Protection Agency, or Congress, or better yet an institution whose primary focus is combating climate change? Matt Levine suggests an argument, in his ongoing "Everything is Securities Fraud" series: "You don't need to address specific problems through the democratic process; you can address them through the capital markets, and just use securities regulation to make sure that those markets are fully informed."[1]

But even if there is skepticism that, say, asset managers, institutional investors, financial regulators, and capital markets lawyers should play a leading role in developing proposals to mitigate climate risks, we can at least have confidence that they will be effective in focusing attention and resources on climate concerns. Asset managers and institutional investors in particular are capable of shifting their resources to climate issues, notwithstanding that they are constrained by investment mandates and client expectations regarding financial performance.

ESG FACTORS

Whatever the rationale for their heavy involvement, capital markets are giving climate risks and other ESG factors considerable attention.[2] ESG (short for "environmental, social, and corporate governance") is an umbrella term that

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[1] *See* Levine, Matt. Bloomberg, October 25, 2018. https://www.bloomberg.com/opinion/articles/2018-10-25/exxon-is-in-trouble-over-climate-change (discussing New York's unsuccessful suit against Exxon Mobil Corp., *People of the State of New York v. Exxon Mobil Corp.* ("Exxon"), alleging that Exxon made misleading material misstatements or omissions in its practices or procedures for accounting for climate risk).

[2] *See, e.g.*, "Larry Fink CEO Letter." BlackRock, January 26, 2021. https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (emphasizing that "We know that climate risk is investment risk.").

is generally used to refer to a values-based approach to investing. The objective of ESG investing is to reward (or provide incentives for) companies that make business decisions considered to be desirable on "E," "S," and/or "G" criteria, and not (or at least not solely) on the basis of short-term profitability.

Conversely, ESG investing disfavors the allocation of capital to companies or industries considered to be deficient on ESG conduct. Investing on the basis of ESG objectives, from transparency to social justice, is now mainstream. In this article, we focus primarily on the environmental pillar of ESG, and more specifically on investments targeted at preventing catastrophic climate change.

Capital market participants have devised a number of products designed to direct market resources towards climate friendly uses. The first and arguably most widely used of these is the green bond, which has evolved from a niche product issued primarily by international financial institutions to a routine component of offerings by sovereigns, municipals, and corporates alike. It is estimated that over US$1 trillion in principal amount of green bonds have been issued since the product's debut in 2007, with over a quarter of those funds raised in 2020 alone.[3]

The types of products available to borrowers and investors has increased in the last few years as the ESG trend spread to other sectors of the market. Besides green bonds, borrowers and investors can choose from sustainability bonds, sustainability-linked bonds and social bonds, as well as comparable products in the form of loans.

Sovereign issuers have found sustainable financing attractive as well. For example, in 2020 the Republic of Ecuador issued the world's first Sovereign Social Bond, raising US$400 million to provide access to decent and affordable housing for medium- or low-income families.[4]

Trading exchanges are focused on the ESG trend as well. For example, CME Group, the largest financial derivatives exchange, listed the E-mini S&P 500 ESG Index futures in 2019. The ESG Index comprises only those S&P 500 companies who meet CME Group's ESG eligibility standards.[5] This contract

[3] "$1 Trillion Mark Reached in Global Cumulative Green Issuance: Climate Bonds Data Intelligence Reports: Latest Figures." Climate Bonds Initiative, December 15, 2020. https://www.climatebonds.net/2020/12/1trillion-mark-reached-global-cumulative-green-issuance-climate-bonds-data-intelligence.

[4] "Hogan Lovells Advises the Republic of Ecuador in a US$400 Million Financing," February 5, 2020. https://www.hoganlovells.com/en/news/hogan-lovells-advises-the-republic-of-ecuador-in-a-us$300-million-financing.

[5] "FAQ: E-Mini S& P 500 ESG Futures - CME Group." Accessed February 24, 2021.

enables investors to express their ESG preferences and provides them an accessible performance benchmark versus the full S&P 500.

More recently, in the fourth quarter of 2020, CME Group introduced a futures contract on the Nasdaq Veles California Water Index, designed to hedge fresh water price risk in California.[6] Although of limited geographic use, this California contract is an interesting test case for the efficacy of derivatives markets to develop new products addressing climate and sustainability concerns. CME Group will also launch a global voluntary carbon emissions offset contract on March 1, 2021.[7] The Intercontinental Exchange, a competitor to CME Group, also offers ESG index contracts, as well as an ESG data service, renewable energy certificate futures, and carbon offset futures.

A through line in the development of these products, and the product harmonization and standardization that evolve from these products, is that futures markets are critical to generating the requisite scale to be useful for market participants (and to achieving their ESG goals). As the Futures Industry Association ("FIA") stated: "Shared standards are also a key factor in price discovery—and ultimately, in creating market-driven solutions that will properly account for the costs of climate change in everything from power markets to agricultural commodities."[8]

ESG PRODUCTS

Bespoke derivatives contracts, traded in over the counter ("OTC") markets, provide less liquid but more bespoke mechanisms for ESG risk management. Since 2003, the International Swaps and Derivatives association ("ISDA") has published template documentation confirmations and related defined terms for weather derivatives. ISDA has more recently published templates for carbon emissions trading. ISDA describes customization of OTC products as a feature rather than a limitation. Recognizing that OTC contracts have less liquidity than futures, because they are privately negotiated and do not trade on

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https://www.cmegroup.com/trading/equity-index/us-index/e-mini-sp-500-esg-futures-frequently-asked-questions.html.

[6] "CME Group to Launch First-Ever Water Futures Based on Nasdaq Veles California Water Index." CME Group, September 17, 2020. https://www.cmegroup.com/media-room/press-releases/2020/9/17/cme_group_to_launchfirst-everwaterfuturesbasedonnasdaqvelescalif.html.

[7] "CME Group to Launch a Global Emissions Offset (GEO) Futures Contract on March 1." CME Group, January 26, 2021. https://www.cmegroup.com/media-room/press-releases/2021/1/26/cme_group_to_launchaglobalemissionsoffsetgeofuturescontractonmar.html.

[8] "How Derivatives Markets Are Helping the World Fight Climate Change." FIA, September 2020. https://www.fia.org/sites/default/files/2020-09/FIA_WP_Sustainable_Finance.pdf ("FIA Paper"), at p. 10.

exchanges, ISDA points to OTC transactions' comparative strength of affording "greater flexibility as contracts can be customized more precisely" to match the parties' specific risks.[9]

ISDA documentation can support a varied range of ESG transactions. For example, over the past few years there have been several interest rate and foreign exchange derivatives with ESG metrics affecting pricing, such as reducing amounts payable upon the satisfaction of an agreed sustainability performance target.

In addition, parties can use credit default swaps to hedge not only counterparty credit risk but also risks stemming from fluctuations in market value of ESG-linked debt. In the context of renewable energy, a wind or solar project can use a financial hedge, often referred to as a synthetic power purchase agreement, to smooth the project's cash flows and provide a stable revenue stream to project sponsors. ISDA documentation is highly customizable and can help companies manage risk not perfectly captured by the standardized products referred to above.

Given the broad interest in ESG product development, FIA, ISDA, and other industry trade groups are rallying their members to the cause. FIA[10] and ISDA[11] have recently published policy papers giving prominence to ESG products and their role in addressing climate risks and promoting sustainability.

In May 2020, the Loan Syndications and Trading Association published sustainability-linked loan principles, encouraging "lenders to incentivize the sustainability performance of the borrower."[12] A private-sector led initiative, the Taskforce on Scaling Voluntary Carbon Markets, is focused on expanding the size of the market for carbon credits as a crucial complement to carbon emissions reductions. The Taskforce's goal is to help engineer a "whole-economy transition" to net zero emissions by no later than 2050.[13]

THE SKEPTICS

Skepticism is warranted. The United Nations, itself an advocate for sustainable investment and ESG principles, has expressed concern over certain

[9] "Overview of ESG-Related Derivatives Products and Transactions." ISDA, January 2021. https://www.isda.org/a/qRpTE/Overview-of-ESG-related-Derivatives-Products-and-Transactions.pdf ("ISDA ESG Paper"), at p. 9.

[10] FIA Paper.

[11] ISDA ESG Paper.

[12] "Sustainability Linked Loan Principles (SLLP)." LSTA, May 5, 2020. https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/.

[13] "Consultation Document." Taskforce on Scaling Voluntary Carbon Markets, November 2020 https://www.iif.com/Portals/1/Files/TSVCM_Consultation_Document.pdf.

of these financial products. In response to CME's California Water Index contract mentioned above, the U.N. communicated reservations that the literal commodification of water threatens, rather than reduces risks related to, a precious resource that "belongs to everyone."[14]

This skepticism is foreseeable but more difficult to reassuringly address. The FAQ published by the Taskforce on Scaling Voluntary Carbon Markets answers "categorically not" to the question of whether expanding voluntary carbon markets could enable "greenwashing" by promoting carbon but not reducing carbon emissions, before going on to concede that absolute emissions reductions—the vital complement to carbon trading markets—is only "a goal, not our current reality."[15]

Greenwashing is a persistent concern. For example, the ESG Subcommittee of the Asset Management Advisory Committee ("ESG AMAC") convened by the Securities Exchange Commission (the "SEC") has focused on issuer disclosure and investment product disclosure, as well as how to assess and measure the performance of ESG strategies. Like the Taskforce on Scaling Voluntary Carbon Markets, ESG AMAC specifically flags the potential for greenwashing—"investment products bearing the name ESG but not actually engaging in meaningful ESG investment"—as an important item to monitor.[16] But how?

Currently there are no securities rules in the United States targeted specifically at addressing greenwashing with respect to particular products or industry sectors. Instead, the SEC has issued broadly applicable guidance encouraging disclosure of climate risks where such information is "material" under federal securities laws.[17] Some of the commissioners have stressed the need for the SEC to go further and develop a standardized and comparable

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[14] Durisin, Megan. Bloomberg, December 11, 2020. https://www.bloomberg.com/news/articles/2020-12-11/un-warns-new-water-futures-may-spark-bubble-for-vital-resource.

[15] "Taskforce on Scaling Voluntary Carbon Markets: FAQs." Taskforce on Scaling Voluntary Carbon Markets, January 27, 2021. https://www.iif.com/Portals/1/Files/TSVCM_FAQ.pdf, at FAQ 2.

[16] *See* "Potential Recommendations of ESG Subcommittee." SEC Asset Management Advisory Committee, December 1, 2020. https://www.sec.gov/files/potential-recommendations-of-the-esg-subcommittee-12012020.pdf.

[17] Commission Guidance Regarding Disclosure Related to Climate Change [Release Nos. 33-9106; 34-61469; FR-82].

disclosure regime for climate-related risks, including greenhouse gas emissions.[18] This continues to be an area of focus for Congress and regulators.[19]

Similarly, the Commodity Futures Trading Commission (the "CFTC") has increasingly trained its attention on climate risks. In 2019, the CFTC's Market Risk Advisory Committee ("MRAC"), which has an advisory role within the CFTC on a broad range of issues, began to focus on risks to derivatives markets arising from climate change. MRAC's work culminated in its 2020 report "Managing Climate Risk in the U.S. Financial System."[20]

MRAC's comprehensive report discusses many features of climate risk and makes certain recommendations related to market structure, but one striking feature of the report is the description of political inertia as the primary obstacle to addressing climate change issues.[21]

Even the government recognizes the need for financial markets to lead, and the MRAC report considers ways that the government can catalyze private-sector involvement.[22]

THE REGULATORS' ROLE

Regulators, in their function as a producer of economic data, also have a role. For example, the Federal Reserve Bank of Chicago (the "FRB") has called for the recognition of new risk categories. Novel risk categories—physical risk, transition risk, and liability risk—each related to fallout from climate change, could complement companies' existing financial risk metrics to form a comprehensive risk management framework, in addition to typical risk metrics such as market risk, credit risk, liquidity risk, and operational risk.[23]

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[18] "Speech of Commissioner Lee." SEC, November 5, 2020. https://www.sec.gov/news/speech/lee-playing-long-game-110520.

[19] *See, e.g.,* Warren, Elizabeth. "All Info—S.2075—116th Congress (2019-2020): Climate Risk Disclosure Act of 2019." Congress.gov, November 17, 2020. https://www.congress.gov/bill/116th-congress/senate-bill/2075/all-info.

[20] "Release Number 8234-20." CFTC, September 9, 2020. https://www.cftc.gov/PressRoom/PressReleases/8234-20.

[21] "Managing Climate Risk in the U.S. Financial System: Report of the Climate-Related Market Risk Subcommittee, Market Risk Advisory Committee of the U.S. Commodity Futures Trading Commission," September 2020. https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf. *See* foreword, "The Heart of the Matter."

[22] *Id.*, at Recommendation 8.2.

[23] Alvarez, Nahiomy et al. "A New Framework for Assessing Climate Change Risk in

Analogous to the recent trend of reconsidering the purpose of a corporation—from pursuing shareholder value to generating value for "all stakeholders"[24]—the looming threat of climate damage opens the possibility of companies adopting a broader risk management framework. But, as the FRB acknowledges, this broader risk management framework is not yet well developed.

There is a noteworthy regulation with respect to the ESG trend that is relevant to individual investors who allocate assets through their retirement plans. In October 2020, the Department of Labor ("DOL") announced a final rule ("Financial Factors In Selecting Plan Investments")[25] intended to limit the ability of fiduciaries of private-sector retirement and other employee benefit plans to make investment decisions based on non-pecuniary considerations "in light of recent trends involving environmental, social and governance (ESG) investing."[26]

In this rulemaking, the DOL has taken a position that potentially limits the role of capital allocation as a means to address ESG risks (or, at a minimum, limits the role of Americans' retirement savings in this effort). However, the DOL's rule is not effective until April 30, 2022 and, critically, the rule announcement preceded the U.S. presidential election. On March 10, 2021, the DOL announced a nonenforcement policy in this regard.[27]

CONCLUSION

Enthusiasm surrounding ESG investing is in the early stages. It presents interesting opportunities for issuers seeking to implement solutions to the climate crisis, investors seeking to align their investment strategy with their values, and nations seeking to meet their emissions targets under the Paris Climate Agreement. Which brings us back to our original question: Why should financial markets be at the center of climate risk mitigation?

Financial Markets." Federal Reserve Bank of Chicago, November 2020. https://www.chicagofed.org/publications/chicago-fed-letter/2020/448.

[24] "Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans.' " Business Roundtable, August 19, 2019. https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

[25] "Financial Factors in Selecting Plan Investments," 85 Fed. Reg. 72846 (Nov. 13, 2020).

[26] "U.S. Department of Labor Announces Final Rule to Protect Americans' Retirement Investments." U.S. Department of Labor, October 30, 2020. https://www.dol.gov/newsroom/releases/ebsa/ebsa20201030.

[27] "U.S. Department of Labor Statement Regarding Enforcement of its Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans." U.S. Department of Labor, March 10, 2021. https://www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/laws/erisa/statement-on-enforcement-of-final-rules-on-esg-investments-and-proxy-voting.pdf.

Admittedly, the capital markets on its own cannot mitigate climate change or stop the oceans from rising. But any solution, whether large or small, to these problems will come at a financial cost. The implementation of such solutions on a scale needed to curb climate change will require a major shift in the allocation of resources. The capital markets provide an avenue for this shift to be effected swiftly and efficiently. It is estimated that the global economy needs to invest $1.6 to $3.8 trillion every year until 2050 to achieve the Paris Climate Agreement's goal of limiting global warming to 1.5° Celsius.[28]

It is hard to imagine that these sums can be reached, and these authors suggest it is impossible, without the capital markets playing center stage.

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[28] Buchner, Barbara, et al. "Global Landscape of Climate Finance 2019." Climate Policy Initiative, November 7, 2019. https://www.climatepolicyinitiative.org/publication/global-landscape-of-climate-finance-2019.