



Act Now: The Need for Public-Private Sector Collaboration on Climate Risk and Carbon Markets

Speech by Scott O'Malia, Chief Executive Officer, ISDA

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Good morning and thank you for inviting me to address this plenary meeting of the International Organization of Securities Commissions (IOSCO) Sustainable Finance Task Force. Global policymakers and financial market participants have a critical role to play in the transition to a sustainable economy, so I'm delighted to participate in this important forum.

Meeting the objectives of the Paris Agreement by 2050 will require trillions of dollars of investment in sustainable infrastructure and technology. This is an unprecedented global challenge and there is no time to waste. Governments simply cannot fund the transition on their own – they need to leverage global capital markets to raise the financing that is needed.

Fortunately, the objectives of the official and private sectors are largely aligned. Just as governments have committed to the goals of the Kyoto Protocol and Paris Agreement, thousands of corporates have now adopted net-zero strategies that have the potential to bring those commitments within reach.

But shared objectives are not sufficient to meet this challenge. We need continuous collaboration and dialogue between the official and private sectors to move the needle on climate change. It must be a partnership. This is particularly important in two areas.

First, the development of data-driven, risk-appropriate scenario analysis for climate risk. Over the past two years, ISDA has developed and tested a conceptual framework for climate risk scenario analysis in the trading book. By enabling financial institutions to prepare for the effect of future climate shocks on traded assets, this framework breaks new ground. Regulators and market participants must now work together to make sure the potential impact is properly understood and appropriately managed.

Second, the setting of robust and consistent standards for the voluntary carbon market. If strong guardrails are in place to prevent greenwashing, the carbon market could serve as an important financing channel that allows companies to offset those emissions they can't eliminate now. But the market must be transparent, standardized and auditable, based on consistent definitions and high standards. This can only be achieved if the public and private sectors work together.

If we are successful in bringing about constructive and sustained collaboration in these two areas, I'm confident we can improve the management of climate risk globally and increase investment in technological and nature-based carbon solutions. I'll explore both topics in these remarks and I'll set out five vital steps that must be taken to develop liquid, effective and transparent voluntary carbon markets.

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Climate risk

I'll start by bringing you up to date with our work on climate risk.

Effective risk management requires firms to assess the potential impact of a variety of risks that might affect their businesses, both in the short and long term. There's no doubt this now includes climate risk. Severe weather events are occurring with increasing frequency, and they can have far-reaching consequences. Up until now, however, there has been relatively limited understanding of the potential impact on traded assets.

Climate shocks fall broadly into two categories: a physical event, such as a flood or an earthquake; or a transition event, such as a change in climate policy or the introduction of a carbon tax. In either scenario, there would be knock-on implications for financial markets, which could be severe depending on the scale of the shock or repricing.

Good progress has been made in developing scenarios to model the effect of climate shocks on long-term assets. The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) has played a key role here, as have the European Central Bank, the Bank of England and the Federal Reserve. The scenarios they have developed typically take a long-term view, modelling the expected impact of climate shocks over a period of years or decades.

But climate scenario analysis for shorter-dated traded assets has been hampered by the lack of standardized methodology and scarcity of data. In response, ISDA has worked with a group of more than 30 banks to develop a conceptual framework for the trading book, as well as defining key issues to support the design and implementation of scenarios.

We published the framework in the middle of last year, establishing a solid foundation for a robust and consistent approach to trading book scenarios¹. The framework maps the specific stages of scenario design and implementation, from defining the objective and climate narrative to deriving data and generating market risk shocks.

In the next phase of the project, we set about designing and modelling three specific scenarios². These comprised a physical risk scenario involving a sudden increase in temperature, a transition risk scenario in which carbon taxes increase sharply, and a combined scenario in which both physical shocks and transition repricing take place at the same time.

These scenarios demonstrate how the trading book impact of climate events can be modelled, with severe but plausible situations. Our analysis projected the 12-month effect on a set of macroeconomic indicators, and we then modelled the expected market risk impact across equities, credit, interest rates, commodities and foreign exchange.

This is entirely new territory that has given market participants a glimpse of how climate shocks and repricing could affect their traded assets, with time horizons running from one year to a single day. In developing these scenarios, ISDA engaged closely with the public sector, particularly the NGFS, which is working to expand its own set of climate scenarios.

We've now embarked on the next phase of this work, which involves the expansion of the scenarios to include more regions and sectors. We're working with a group of banks on this, but we can't do it on our own. As the project evolves, we will need the support and collaboration of the official sector so we can raise the bar on climate risk management across jurisdictions.

Carbon markets

I'll now turn to the carbon markets.

As I noted at the outset, there is remarkable alignment between the public and private sectors on the need to find robust solutions to remove and offset carbon emissions. The ambition on both sides is unmistakable, and we can see it in a series of important developments:

¹ A Conceptual Framework for Climate Scenario Analysis in the Trading Book, ISDA, July 12, 2023, www.isda.org/2023/07/12/a-conceptual-framework-for-climate-scenario-analysis-in-the-trading-book

² Climate Scenario Analysis in the Trading Book – Phase II, ISDA, February 12, 2024, www.isda.org/2024/02/12/climate-scenario-analysis-in-the-trading-book-phase-ii/

1. First, the Kyoto Protocol and the Paris Agreement have established a global framework to reduce carbon emissions to net zero by 2050.
2. Second, the public-sector aspiration has been matched by the commitments of thousands of corporates around the world to reduce their emissions.
3. Third, regulated emissions trading systems are well-established in many countries and regions, including the EU, the UK and China. In parallel, there has been a concerted push to scale up the voluntary carbon market, which provides a valuable channel for investment in nature-based and technological solutions that will be critical in shifting to sustainable processes.
4. And finally, the EU's Carbon Border Adjustment Mechanism (CBAM) will introduce a levy for carbon emitted during the production of certain goods imported into the region. When it comes into effect in 2026, the CBAM will be transformative and will reshape the EU's trade and climate policies, so we need to be ready for this.

With gathering momentum to scale up carbon markets globally, I believe the die has been cast and we are now set on an irreversible path towards a more sustainable future. Derivatives markets have an important role to play in supporting this transition. By enabling market participants to manage their risk in a cost-effective way and providing a price reference for buyers and sellers, they are critical to the development of vibrant, liquid markets.

But we can't afford to rest on our laurels. The development of derivatives markets over the past 30 years has shown that alignment and standardization of terms, practices and rules are the foundation for vibrant, liquid markets.

The good news is we have seen some progress on raising standards and a strong push to make sure carbon credits are consistently defined and managed. ISDA has been very supportive of these efforts, particularly the work of the Integrity Council for the Voluntary Carbon Market (ICVCM). We also appreciate IOSCO's commitment to developing good practices for the regulation of voluntary carbon markets, as well as its recognition of the critical role financial market participants have to play.

But more needs to be done. I'll now outline five key areas where urgent action is needed to enable the voluntary carbon market to reach its full potential.

1. First, we must have a globally consistent definition of a ton of carbon that is adopted by all market participants. That definition must align UN Article 6 credits with voluntary market standards. This goes hand-in-hand with an independent, science-based system to verify and audit the soundness and integrity of voluntary carbon credits (VCCs).
2. Second, we need a sound legal framework to create greater certainty and confidence. This includes standard documentation and consistent definitions of products.
3. Third, we need clarity on the accounting treatment for VCCs.
4. Fourth, we need to develop a liquid forward market, which will provide valuable price signals as the market evolves. This will be built on standardized, common units of larger carbon projects that are fungible and benefit from market pricing.
5. Finally, we need to continue to engage with the official sector, advocating for a globally consistent regulatory framework for this market. This must be considered in the context of implementation of the EU's CBAM.

1. Definitions

I'll start by explaining why consistent definitions are so important.

There has been a concerted push in both the public and private sectors to more accurately define what constitutes genuine carbon removal and mitigation. Without broad agreement on this, it is impossible to make progress. A globally consistent, widely adopted definition of a ton of carbon will be the foundation on which we can build and grow an effective voluntary carbon market. That means having consistency in the definition used in Article 6 of the Paris Agreement, which sets out how countries can cooperate to reach their climate targets, and alignment with the ICVCM, the Carbon Offsetting and Reduction Scheme for International Aviation and other relevant agencies.

Linked to this is the need to build trust in carbon trading through effective and independent verification and identification systems. If there is uncertainty over the environmental value of the credits being bought and sold, or a lack of transparency over what a credit represents, prices and investment will remain well below their true potential. This undermines the basic premise of the market and could result in a missed opportunity on the road to net zero.

Greater transparency, integrity and standardization are non-negotiable ingredients for an effective carbon market. Verification of carbon credits must be based on scientific evidence – there can be no shortcuts if this market is to reach its true potential.

Some progress has certainly been made. The ICVCM has now established its core carbon principles that set a global benchmark for high-integrity carbon credits, with rigorous thresholds on disclosure and sustainable development. We have integrated these higher standards into the 2022 ISDA Verified Carbon Credit Transactions Definitions, enabling market participants to efficiently reference them in their trading documentation.

We've also seen the appearance of a new group of firms that provide science-based verification and ratings of carbon projects. By offering meticulous validation of carbon removal and mitigation, these firms will help to provide the transparency, integrity and confidence that is required.

We must make sure standards are properly applied to promote and maintain carbon credit integrity. We also need to establish a consistent global product identification system that enables credits to be tracked, audited and subdivided into common units. This will require both collaboration and persistence to develop a framework that can be rolled out on a global basis.

2. Legal framework

I'll now turn to the importance of a sound legal framework.

As for any intangible asset, the legal nature of a verified carbon credit determines how it can be created, bought, sold and retired. To sustain deep and liquid secondary markets, create clear price signals and allow funds to be efficiently channeled to emissions-reducing projects, it is critical to understand and define the legal treatment of VCCs. This also paves the way towards the drafting of standardized documentation and legal opinions for the VCC derivatives market.

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ISDA believes all VCC trades should be protected by a consistent legal framework that creates certainty over the exchange of collateral and obligations in a bankruptcy scenario. This includes sovereign-originated contracts such as Internationally Transferred Mitigation Outcomes (ITMOs) that represent a ton of greenhouse gases reduced or removed from the atmosphere. By establishing consistent legal foundations that cover all contracts, we will build greater market depth.

Earlier this year, the first bilateral Article 6.2 ITMO transfer took place between Thailand and Switzerland³, and many other countries have negotiated similar transfers. Suriname, for example, recently announced its intention to be the first country to sell ITMO credits in the private market, consistent with UN guidelines⁴. And last week, Singapore's state-backed GenZero announced a deal to generate Article 6 credits in Rwanda⁵.

ISDA has explored the key legal issues relating to VCCs in key jurisdictions and we set out steps to create greater legal certainty in a series of whitepapers^{6,7}. We've also asked two intergovernmental institutions focused specifically on commercial law standards – the International Institute for the Unification of Private Law and the United Nations Commission on International Trade Law – to provide guidance on the appropriate standards to ensure bankruptcy treatment and the exchange of security are properly defined, and the rights of holders are protected. This guidance will enhance the legal certainty of these transactions for all types of counterparties, giving individual countries a common baseline when drafting rules for these markets.

As we've seen in other asset classes, investors will be drawn to those jurisdictions that have done the groundwork to create legal certainty for the trading of carbon credits. This will enable them to be loaned and used as collateral, contributing to a virtuous circle of greater trading and liquidity.

Standard trading documentation setting out the legal rights and obligations of counterparties is also critical. ISDA's VCC definitions, which we published in late 2022, have created a single contractual framework for the trading of these contracts⁸. The definitions can be used for any carbon standard or registry, allowing firms to trade VCCs more easily and on a global basis. They're published in digital format on ISDA's MyLibrary platform, which means we can seamlessly update the documentation for all users as the market evolves and new transactions emerge.

³ Switzerland, Thailand conclude first Article 6.2 deal in landmark move for carbon markets, S&P Global, January 8, 2024, www.spglobal.com/commodityinsights/en/market-insights/latest-news/energy-transition/010824-switzerland-thailand-conclude-first-article-6-2-deal-in-landmark-move-for-carbon-markets

⁴ ITMO Ltd and BancTrust Investment Bank Limited Announce the Offering of the World's First Sovereign Carbon Credits from the Republic of Suriname under Article 6 of the Paris Agreement, PR Newswire, August 23, 2024, www.prnewswire.co.uk/news-releases/itmo-ltd-and-banctrust-investment-bank-limited-announce-the-offering-of-the-worlds-first-sovereign-carbon-credits-from-the-republic-of-suriname-under-article-6-of-the-paris-agreement-302229214.html

⁵ Singapore's GenZero to work with Rwanda on carbon offset projects, Reuters, September 19, 2024, www.reuters.com/business/environment/singapores-genzero-work-with-rwanda-carbon-offset-projects-2024-09-19

⁶ Legal Implications of Voluntary Carbon Markets, ISDA, December 1, 2021, www.isda.org/2021/12/01/legal-implications-of-voluntary-carbon-credits

⁷ The Legal Nature of Voluntary Carbon Credits: France, Japan and Singapore, ISDA, November 22, 2022, www.isda.org/2022/11/22/the-legal-nature-of-voluntary-carbon-credits-france-japan-and-singapore/

⁸ ISDA Launches Standard Definitions for the Voluntary Carbon Market, ISDA, December 13, 2022, www.isda.org/2022/12/13/isda-launches-standard-definitions-for-the-voluntary-carbon-market/

3. Accounting treatment

Just as we need a robust legal framework, a strong accounting framework is also vital. This will give market participants greater confidence that the transactions they enter into are appropriately reported in line with the relevant standards. However, there are currently no specific provisions relating to carbon credits under either US Generally Accepted Accounting Principles (US GAAP) or International Financial Reporting Standards (IFRS).

We understand the Financial Accounting Standards Board will issue an exposure draft in the near future, which we look forward to reviewing. In the meantime, a recent ISDA whitepaper explores the key accounting issues and advocates for continued convergence of specific accounting standards to enable comparability and avoid fragmentation under US GAAP and IFRS⁹.

4. Secondary market

While there is a clear need to evolve the primary market, which is still characterized by bespoke transactions and relatively poor liquidity, we should not forget the importance of the secondary market. Having a liquid forward market would represent a positive step that would send valuable price signals to buy- and sell-side firms, enabling them to gauge supply and demand and manage their risk.

Transforming a bespoke, project-based market into a more standardized set of fungible carbon units that can be used to create portfolios for sale in the secondary market must be a priority. Only with a vibrant and liquid secondary market will we secure long-term investment in carbon removal technologies and nature-based solutions. The development of forward pricing curves will bring greater pricing transparency and improved risk management.

5. Regulatory engagement

Before finishing, I'll say a few words on the ongoing need for education and engagement.

Sustainable finance has been a key focus for ISDA since 2020. We've explored the legal, regulatory and accounting implications of VCCs; we've developed key performance indicators and guidance for sustainability-linked derivatives; and we've broken new ground in developing climate scenario analysis tools for trading book assets. We've published more than a dozen whitepapers on these topics and held conferences and meetings with policymakers around the world. As carbon markets evolve, ISDA will continue to work with members, policymakers and other stakeholders to provide the education, expertise and guidance that is needed.

It is vital that the official sector focuses its efforts urgently and appropriately. There is no need to reinvent the wheel. Before developing a new regulatory framework, policymakers should be mindful of existing rules for trading in the secondary market, which are sufficiently robust and fit for purpose.

Last week, the US Commodity Futures Trading Commission published final guidance for the listing of voluntary carbon derivatives contracts on regulated futures exchanges¹⁰. This new framework underscores the commission's fraud and manipulation authority over commodities and clarifies that it has the authority to require futures exchanges to conduct a more diligent review of certain commodities, such as VCCs.

⁹ Accounting for Carbon Credits, ISDA, October 19, 2023, www.isda.org/2023/10/19/accounting-for-carbon-credits

¹⁰ CFTC Approves Final Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts, September 20, 2024, www.cftc.gov/PressRoom/PressReleases/8969-24

Another important regulatory driver that will impact carbon markets will be the implementation of the CBAM. This will be an absolute game changer. It might be an EU policy, but it has global ramifications, so we need to get ahead of this change and make sure we are ready to deal with it. By requiring importers of certain carbon-intensive goods to pay a levy for the carbon they have emitted, the CBAM will put carbon pricing right at the center of trade policy.

As the director-general of the World Trade Organization pointed out in a recent press interview, we now need a global carbon pricing mechanism to avert trade friction and transition to the CBAM without disruption.

Conclusion

I'll finish by once again thanking IOSCO for inviting ISDA to participate in this meeting.

IOSCO is uniquely positioned to deliver the much-needed collaboration between the public and private sectors that I have talked about in my remarks. We need thought leadership and education on appropriate legal frameworks that address bankruptcy and security transfer issues, as well as the application of appropriate common identifiers. IOSCO also has a role to play in supporting efforts to improve market transparency and liquidity formation.

This is not the first product to face these challenges. ISDA and IOSCO have decades of combined experience in bringing greater standardization and transparency to the derivatives, bond and credit markets. It is critical that we now focus our efforts on the carbon market. ISDA is committed to working with you and other agencies to address the challenges and opportunities that lie ahead.

We are at a unique moment, and we must work together to align the legal and eligibility standards for carbon credits. Science will help to validate the standards. Rating agencies and registries will track the projects. Markets will improve transparency and pricing, driving the investment that is needed in innovative technologies and nature-based solutions. We would urge policymakers to consider ISDA's five recommendations to create a vibrant, efficient voluntary carbon market – and to work with us to implement them. Now is the time for action.

Thank you.