ISDA submission to the European Commission's consultation on the Certification of carbon removals

The establishment of a robust EU regulatory framework for the certification of carbon removals is an important part of global discussions around the governance and scaling of voluntary carbon markets. Financial market participants play a crucial role in offering liquidity, increasing transparency, providing certification assessment, and developing trading infrastructure and standardized contracts. To this end, ISDA supports the European Commission's intention to create a sound carbon removal certification framework next year.

Main risks and opportunities presented by voluntary carbon offsets

A robust voluntary carbon market plays an important role in delivering a reliable, market-based approach for investment opportunities that reduce greenhouse gas emissions and remove carbon from our atmosphere.

As a derivatives trade association, we have a strong interest in the development of a robust voluntary carbon offset market that will strengthen the functioning of the carbon credit derivatives markets and enable the continued development of liquidity in derivatives products so that market participants can appropriately manage their business risks. Facilitating trading in carbon credit derivatives that serve as hedge for climate mitigation projects will contribute to the development of deep and liquid voluntary carbon credit markets.

One of the main obstacles to advancing voluntary carbon trading is a lack of clarity about the legal nature of voluntary carbon credits (VCCs). Specifically, very few jurisdictions provide legal certainty about how credits can be created, bought, sold, and retired, thus making it unclear what type of security may be taken and enforced against VCCs and how that can be achieved, as well as how VCCs would be treated following an insolvency (including with regards to netting). Such determination may also have an impact on broader considerations, including the regulatory, tax and accounting treatment of VCCs. In short, understanding the legal treatment of VCCs is necessary to create robust voluntary carbon credit markets, which, in turn, will enable the development of a clear price signal for carbon and allow funds to be efficiently channeled towards emissions-reducing projects.

ISDA also supports the use of market-based mechanisms, including a price on carbon that supports long-term decision-making. As highlighted in the Principles for a U.S. Transition to a Sustainable Low-Carbon Economy, published by the US Climate Finance Working Group in February 2021, carbon pricing can also spur development of climate-related financial products, promote transparent pricing of climate-related financial risks, and inform and help scale key initiatives like voluntary carbon markets.[1]

Finally, in view of the EU's leading role globally in climate policy action, it is strategically positioned to support well-functioning voluntary carbon markets with a view to making Europe the world's first climate-neutral bloc by 2050.

Voluntary offset market regulation and standards

Voluntary carbon credit markets are global in nature. From ISDA's perspective, one of the main challenges to achieving Net Zero as outlined by the updated COP26 guidance for voluntary offsetting is the likelihood that multiple regional certification mechanisms will be developed under Article 6, creating inconsistences with international requirements. Thus, it is important that the EU as well as national standard setting bodies ensure that any approach taken regionally is consistent with global standardization efforts, such as those undertaken by the Integrity Council for Voluntary Carbon Markets (ICVCM).

In this regard, we support the ICVCM in its work to increase market confidence in the quality of voluntary carbon credits and address market participants' concern related to environmental and reputational risks associated with trading voluntary carbon credits. The ICVCM's focus on the governance around standards for voluntary carbon credit issuance, validation and verification is crucial to developing of a strong primary market in voluntary carbon credits, which will provide a solid foundation for carbon credit derivatives markets. Further success of both primary and derivatives markets will depend on the validity and legal status of carbon credits across jurisdictions.

Global legal standard setters (for example, UNCITRAL and UNIDROIT) have a good track record in working with other intergovernmental bodies and regulators in

[1] Principles for a U.S. Transition to a Sustainable Low-Carbon Economy, https://www.isda.org/a/qXITE/Financing-a-USTransition-to-a-Sustainable-Low-carbon-Economy.pdf

producing legislative guidance on a range of substantive law issues related to a wide variety of commercial transactions for states across all regions. This, in turn, will encourage industry organizations to issue positive legal opinions and associated contractual documentation to support the voluntary carbon market.

Separately, we note, in the established secondary markets, there are various levels of oversight depending on whether a voluntary carbon credit derivative is traded on a designated contract market or is executed bilaterally between eligible contract participants. Listed carbon derivatives traded on a designated contract market are subject to oversight (such as trade practice surveillance and enforcement actions) and bilateral carbon derivatives are subject to margin requirements and reporting regulations.

Establishing clarity around the legal nature of voluntary carbon credits is fundamental to the drafting of standardized documentation and supporting legal opinions for derivatives transactions. In order to make informed decisions on entering into and structuring derivatives transactions, market participants will require certainty as to the treatment of the underlying voluntary carbon credits, including for purposes of netting, insolvency, and taking security analysis in all relevant jurisdictions.

Standardized documentation is the cornerstone of safe and efficient derivatives markets. It allows market participants to transact with confidence, using clearly defined provisions for business-as-usual execution and settlement and setting out mechanisms to resolve different asset and market related risk scenarios. Documentation standards also help to minimize unintended basis risk in otherwise similar products and reduce counterparty credit risk (with corresponding reductions in regulatory capital) by providing the contractual ability to net exposures. In this way, standardized documentation promotes greater liquidity, better efficiency and reduced market and credit risk.

Since its inception, ISDA has worked with the derivatives industry to develop global standards and documentation for multiple asset classes. This includes emissions, and ISDA has published several template documents for use in the mandatory carbon market. In order to progress standard OTC derivatives documentation for secondary market trading in voluntary carbon credits, ISDA is currently working to identify the best approach for creating template documentation and to consider the provisions and elections market participants require.

The exchange-traded market has also contributed to the development of derivatives markets in these markets, by enabling firms to hedge using exchange contracts. ISDA, as a global derivatives organization, supports the development and trading in various types of carbon derivatives contracts, including standardized offset contracts listed on exchanges (e.g., the N-GEO and GEO futures contracts jointly developed by Xpansiv and CME Group in 2021 and other futures contracts expected to be listed by ICE this year).

Harnessing Financial Flows

Our members are continuing to develop innovative new products including green loans and mortgages, exchange-traded funds, climate risk insurance and risk financing instruments for low-carbon innovations, as well as mitigation strategies and tools such as carbon credit derivatives to manage or hedge climate exposure. By building out the climate-aligned investment universe, financial institutions and markets can help drive cutting-edge, world-changing solutions.

Most projects generating offsets are located in the Global South. Thus, in order for carbon credits to be viable underliers (or reference assets) in the secondary market, including the EU's carbon credit derivatives market, legal and regulatory frameworks in those jurisdictions need to be certain.

From ISDA's perspective, as noted above, a key first step to increasing private investment in offsets requires establishing clarity about the legal nature of voluntary carbon credits across jurisdictions.