Sustainability Blog

By PwC Deutschland | 11.05.2022

The ESG transition and the rise of sustainability-linked products

The ESG transition poses unprecedented challenges for the financial industry. Business strategies and portfolios must be realigned to successfully combat climate change and meet growing social and government expectations.

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In this context new financial products are emerging that enable institutional investors to manage green cash flows, pursue market opportunities, and manage risk. This blogpost by our experts Klaus Böcker and Julia Zima introduces this intriguing subject and illustrates, using the example of sustainability-related derivatives, the role these products play and why they will be indispensable for a successful ESG transition.

The ESG transition and the rise of sustainability-linked products

In its recent assessment report, the Intergovernmental Panel on Climate Change (IPCC) stated that global warming is already affecting ecosystems around the world and the lives of billions of people. To limit global warming to 1.5 °C, greenhouse gas (GHG) emissions need to shrink by 43% by the end of this decade, which means that emissions need to fall immediately.

The necessary efforts to combat climate change, but also to protect biodiversity and prevent environmental pollution can only succeed if more economic attention is paid to the cost of environmentally damaging behavior and financial flows are made "greener" and more sustainable. This requires Environmental (E) goals, which together with other social (S) and government (G) criteria define the ESG transition.

The ESG transition requires the will of all parties, such as governments, companies, households, of course the financial sector, and furthermore it needs tailored financial products to manage necessary investments and mitigate associated risks.

Financial products to facilitate the ESG transition

In this context, ESG-related financial products have emerged and are constantly being further developed. Although a final classification of these products does not yet exist, they could be divided roughly into two categories. First, sustainability products and, second, sustainability-linked products (SLP). The most prominent example of the former is a green bond (or loan) whose proceeds must directly be used to finance “green” activities. But also derivatives, such as an exchange-traded future on an ESG stock index, would belong to this class.

In contrast, the relatively new SLPs, also called ESG-linked products are not confined to sustainable investments. This class includes certain debt instruments, such as sustainability-linked bonds, loans, and sustainability-linked derivatives (SLD), also referred to as ESG-linked derivatives. The defining feature of SLPs is that their cash-flows are linked to the ESG performance of a company. As the terms of the ESG-link are usually very company-specific and negotiated between the counterparties, they are typically traded over the counter.

Sustainability-linked derivatives

The debut of sustainability-linked derivatives is often traced back to 2019 when ING completed a receiver interest rate swap with SLM Solutions, a global provider of floating production systems. The swap contract included a spread that was linked to SLM's ESG performance, scored by Sustainalytics, and that would either decrease or increase depending on whether SLM meets or fails on its ESG targets.

The above example is a prototypical SLD. It shows how the pay-off profile directly depends on ESG targets defined by ESG KPIs. They could be the amount of GHG emissions, an ESG rating as in the case of ING, the volume of wastewater produced during a manufacturing process, but also the gender pay gap within a company. These KPIs are embedded in conventional derivatives parameters and determine for example an additional spread or add-on factor, which then move as a function of the ESG performance. SLDs can be symmetric, meaning the cash flows of both parties are connected to ESG factors, but are most often asymmetric, i.e. only one counterparty's ESG performance is involved.

SLDs can further boost the transition to a sustainable economy

With the SLD, the counterparty subject to the spread adjustment, which we refer to as the ESG-linked counterparty, has direct monetary incentives to meet the specified KPIs to obtain a benefit or at least not to be disadvantaged. The benefit or disadvantage can take very different forms and does not necessarily involve payments to the other counterparty. It could also be agreed that a certain amount of money will be donated if ESG targets are missed, which may then partially compensate for the failure. In addition to the direct P&L effect, indirect earnings effects might occur through the reputational risk channel.

Now let's turn to the non-ESG-linked counterparty (such as ING above) who is willing to offer the spread benefit and to the question, why it would enter into such a contract. Often such SLDs are combined with a loan to the ESG-linked counterparty. In this case, the non-ESG-linked counterparty has a vested interest to reduce the ESG-induced credit risk of the debtor. Therefore, the non-ESG-linked counterparty might be willing to pass on a few basis points to incentivize a good ESG performance and ambition of the client, which ultimately decreases ESG credit risk.

The above arguments show that when the stipulated ESG targets are met, both counterparties of an SLD transaction benefit from ESG-linked derivatives; on the one hand, cash-flow benefits and/or reputational gains and, on the other, a reduction in ESG risk. Hence, SLDs can help to boost the transition to a sustainable economy as more capital can be channeled towards sustainable investments and, furthermore, companies can use SLDs to (at least partially) hedge against ESG risks.

Being still at the outset, only few SLDs have yet been entered into. This might at first seem surprising having in mind the booming market for ESG products and the benefits they may provide. However, ESG-linked derivatives have some properties that make their wider use challenging and further clarification, research, and definitions are needed. One challenge is ESG quantification and, related to it, the pricing of such instruments. Fundamental pricing theorems teach us that unique pricing and thus standard hedging is only possible if certain conditions such as the tradability of the underlying and market completeness are met. In the case of ESG products and associated risk factors, this can by no means be just assumed. What's more, the measurement of ESG risks on single assets (e.g. loans) is still in its infancy and the question remains open to what extent ESG metrics are sound and consistent over time and comparable across different stakeholders. Other issues are the traceability and monitoring of a firm's ESG performance in terms of transparent KPIs, and organizations such as the International Sustainability Standards Board (ISSB), the International Swaps and Derivatives Association (ISDA) but also the EU Green Taxonomy may guide the way.

However, keeping in mind that long-term investments typically go hand in hand with risk mitigation, often via derivatives hedging, a significant market growth in SLDs can be expected once the challenges are overcome. As is true for the entire ESG transition, we are on a learning path.

We will be discussing the challenges, evolving practices and potential solutions related to sustainability (linked) products in further articles in this blog, so stay tuned.

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Keywords

Climate Change, Derivate, ESG, EU-Klimapolitik, Sustainable Finance (SF)

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