ICSWG

Investment Consultants Sustainability Working Group

ICSWG guide on how to consider emissions reporting for derivatives

September 2024

This guide sets out Investment Consultants Sustainability Working Group (ICSWG) endorsement of existing guidance for reporting emissions on derivative instruments. The Group is a collaboration between UK investment consulting firms which aims to drive better sustainable investment practices across the industry for its key stakeholders, working with asset owners, asset managers and regulators.

The ICSWG endorses the Institutional Investors Group on Climate Change (IIGCC) Derivatives and Hedge Fund Guidance which encourages greater transparency in reporting with a focus on real world emissions reduction. However, clients have the flexibility in reporting their preferred metric e.g. emissions from physical holdings only (financed emissions); or include emissions from synthetic holdings (associated emissions); or net emissions provided this is accompanied by appropriate disclosures and commentary.

This guide has been prepared by the ICSWG for reference by asset owners. The ICSWG is a collaboration between 19 firms formed in 2020 taking action to support and accelerate sustainable investment initiatives in the UK. The ICSWG members are:

Aon	Cambridge Associates	Hymans Robertson	Momentum	SEI
Apex Group	Capita	ISIO	Redington	WTW
Barnett Waddingham	Cardano	LCP	River and Mercantile	XPS Investment
bfinance	Gallagher	Mercer	Schroders	

As part of the proposals for reporting emissions on sovereign bonds, the ICSWG agreed that it would be beneficial if reporting included emissions in respect of gilt derivatives but that this was reported separately from emissions in respect of physical sovereign bond holdings. Investors' exposure to derivative instruments extends beyond gilt derivatives and the ICSWG has set up a separate working group to provide a guide in this area.

The focus of this working group has been to consider whether the ICSWG could endorse existing guidance or whether it would be beneficial to develop its own methodology for reporting emissions on derivative instruments. The ICSWG considered the following available guidance:

- IIGCC Derivatives and Hedge Funds Guidance[1]
- MSCI ESG Climate Reporting with Derivatives[2]
- Standards Board for Alternative Investments (SBAI) Principles for GHG-Emission Accounting in Alternative Strategies[3]

The guidance above pertains primarily to derivatives on corporates entities and does not cover interest rate and inflation swaps or derivatives on commodities. Given the data available, we have also focused on derivatives on corporate entities.

Principles of agreement

Alongside the review of the materials referred to above, we also attended a round table debate hosted by MSCI which included representatives from regulators, investment managers, IIGCC, SBAI and investment consulting firms.

From our review of the guidance and from the roundtable discussion, there are clear areas of overlap but also several key differences. We have coalesced around several key principles that are largely common across the available guidance but best represented in the IIGCC guidance and naming convention.

We note that the purpose of the IIGCC guidance differs in its aim to the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD), in that the focus of the IIGCC paper is on real world emissions reduction as opposed to risk management. However, we have chosen to focus on the IIGCC guidance as we believe this is consistent with the aims of ICSWG, and have noted flexibility in our guide relating to a focus on risk exposure in item 3 below.

The IIGCC guidance starts with the guiding principle that the focus of emissions reporting should be to encourage real world emissions reduction rather than portfolio emissions reduction and this principle is reflected in the recommended approach within their guidance.
The key principles that we have agreed, and which are encompassed in the IIGCC guidance are as follows:

1. **Reporting emissions on derivative exposures is valuable and should be included**.
   Whilst exposure from derivative instruments does not necessarily fall within “financed emissions” there are undoubtedly “associated emissions” and exposure to climate related risks associated with the underlying exposure. Not reporting on derivatives could result in significant misrepresentation – e.g. if derivatives were not reported on, holding cash and equity Total return swaps in a portfolio would have no reported emissions versus investing the cash in a passive equity index fund which would have to report emissions.

1. Derivatives and Hedge Funds Guidance (iigcc.org); 2. ESG and Climate Reporting with Derivatives - MSCI; 3. Principles for GHG-Emission Accounting in Alternative Strategies (sbai.org)

2. **Report separately on physical and synthetic exposures**
   Whilst there should be little/no difference in the exposure to risk and price movement between physical or synthetic instruments, there is a clear distinction in terms of investor rights (such as voting or covenant enforcement) and the ability to engage with issuers where physical shares/bonds are held. The influence of direct engagement activities does not extend to holders of derivative instruments as strongly. This distinction is important to establish the different actions investors could take to affect real world emissions reduction.

3. **Report long exposures and short exposures separately**
   From a risk management perspective, equivalent sized long and short positions in respect of the same underlying issuer should result in zero net exposure. Netting emissions data from long and short positions may be appropriate from a risk perspective but a lot of information is lost. There is no visibility as to whether the underlying issuers have improving or worsening emissions over time if a net position is shown. We would endorse the common guidance to report on both long and short legs separately. *However, the only addition from the IIGCC guidance that we would put forward is that in some cases it may be appropriate for advisors and clients to also report a net figure with appropriate disclosures. We would emphasise that a net figure is to be used only as a financial risk measure and not as an indication of real-world emissions or net zero alignment.*

4. **Use delta adjusted notionals (no guidance currently on time value)**
   To scale and attribute emissions to derivative exposures, the notional exposure should be used and adjusted by the delta of the derivative. This is a widely accepted approach to reporting the exposure to spot prices for derivative instruments. There is no guidance currently on allowing for time value within options so this would effectively be ignored for now.

5. **Use a dashboard approach for reporting on climate metrics**
   Using a dashboard approach to report on other relevant metrics to help investors understand climate risks, beyond simply a focus on carbon emissions. This could include for example “new capital provision” for any primary market issuance over the period or portfolio alignment metrics for both long and short exposures.

The key areas of disagreement in the three guidance documents analysed and from the roundtable discussion relate primarily to:

- ***Netting of long and short positions.*** We recommend greater transparency and reporting long and short positions separately, although in some cases it may be appropriate for advisors and clients to also report a net figure with appropriate disclosures.
- ***Applying different approaches to reporting for different client objectives.*** Again, we favour transparency and reporting in line with the principles above. However, a dashboard style output could be useful for clients, allowing for differing methodologies to be considered depending on the purpose of the reporting.

Objective	ICSWG preferred approach to reporting
Emissions reporting with a focus on emission reduction	We recommend reporting emissions associated with physical and synthetic holdings separately, along with reporting long and short positions separately. This avoids information loss and allows the user to understand their exposure to financed emissions and associated emissions.

Emissions reporting with a focus on risk exposure	Reporting of total emissions of physical and synthetic holdings, and long and short derivative positions. We note that reporting a net figure may also be appropriate. However, we suggest that accompanying disclosure is still included when reporting a net figure. This would help to avoid information loss and to avoid misrepresenting a net figure as the real-world emissions associated with the portfolio, which may be misleading.

We note that DWP guidance for emissions reporting on derivatives, where data is available, for climate reporting by occupational pension schemes[4] also focuses on separating the "real" and "synthetic" exposures as well as long and short positions, in line with our recommendation above. In line with DWP guidance, we also propose that emissions associated with derivatives are measured with a "look through" to the underlying holdings where possible.

We suggest ongoing engagement by consultants and asset owners with investment managers (particularly hedge fund managers) to understand the main data concerns and to overcome any potential barriers. We are supportive of a pragmatic approach in the interim to overcome any potential data gaps e.g. the use of proxies or noting where data cannot currently be provided.

4. Governance and reporting of climate change risk: guidance for trustees of occupational schemes (publishing.service.gov.uk)