Securities Regulation Daily Wrap Up, INDUSTRY NEWS—FIA policy paper identifies climate-related risks and the derivatives industry's role in the global battle, (Sept. 2, 2020)

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By Brad Rosen, J.D.

The Futures Industry Association's paper addresses how financial market players are currently involved in fighting climate change while highlighting potential partnerships with the public sector to help build a more sustainable economy in the future.

The FIA has published a policy paper focusing on climate-related risks for financial markets and the global economy. The paper, titled *How derivatives markets are helping the world fight climate change* provides a detailed explanation of the various climate related-risks facing the markets. The paper also outlines how derivatives markets can play a role in building a more sustainable future.

FIA leadership weighs in. As noted in the association's release, Walt Lukken, FIA's president and CEO stated, "FIA and its members know that climate change poses a serious risk to the global economy. To help manage these risks, the regulated derivatives markets have already developed innovative products and trading platforms to help the world transition to a low-carbon future." Moreover, Lukken also noted that, "FIA encourages policymakers to leverage the power of markets and private innovation in building a more sustainable global financial system and economy."

Climate risks. The paper notes that climate-related risks will require more research and discussion in order to create an effective response and manage an orderly transition for the global economy. Specifically noted are the following risks that could impact the derivatives industry:

- **Physical risk.** Changes brought about by climate change could include severe flooding or droughts, as well as long-term shifts in growing seasons or precipitation patterns. These present direct, real-world risks, and those to follow, will alter commodity derivatives markets. This applies particularly apply for agricultural commodities that have long been exposed to weather-related risks, and for energy market infrastructure or the transportation of any commodity that is vulnerable to disruption from hurricanes and other extreme weather.
- **Transition risk.** The global transition away from reliance on fossil fuels or legacy commodities that are produced unsustainably presents a host of challenges, including in the commercial physical markets Market participants will need time to unwind their existing positions and bring new contracts into their trading and clearing systems. Transition periods managed ineffectively could result in a lack of real price discovery and increased price volatility for end users and throughout the real economy.
- **Liability risk.** Derivatives markets and their participants may face a set of liability risks resulting from the listing of sustainability-related derivative contracts, including fraud and misrepresentation. Markets will naturally rely on certifications from producers, processors, manufacturers, and sponsors of benchmarks. As such, the consequences of intentional or unintentional violations of those certification obligations may have residual liability for various market participants.
- **Reputational risk.** Various market players have some measure of reputational risk in the market. Financial firms will seek integrity in their investment strategy, exchanges will seek integrity in their contract offerings, and commodity trading houses will seek integrity of their sustainability commitments

and production systems. Regulators may also seek validation prior to approving markets, products, or commodities related to climate change and sustainability.

- **Operational risk.** Climate risk has a direct impact on businesses and, specifically, on the operational risks of derivatives markets. As the global pandemic of 2020 illustrates, disruptions to how our markets function can come in unexpected ways. Partnerships between the global cleared derivatives industry and its regulators are broadly useful to measure, track, and respond to operational risk, but these frameworks will be particularly meaningful in any discussions of climate risk and related actions.

Partnership and opportunity. The paper notes that FIA is eager to work in partnership with regulators, lawmakers, and other policymakers and identifies three key areas of partnership and opportunity:

- **Innovation.** Innovations in derivatives markets, such as carbon trading platforms, help market participants discover prices for commodities that are vital to addressing climate change concerns. Exchanges, working in partnership with market participants, are quickly identifying new products that assist in sustainability efforts.
- Derivatives markets are naturally innovative and have already influenced sustainable finance strategies around the globe through their support of new products and trading venues.
- **Standardization.** Derivatives exchanges have a long history of developing and enforcing standards for commodity contracts. In recent years, some exchanges have begun building sustainability standards into their operations. These derivatives exchanges have unique knowledge of the underlying marketplace and have built trust with market participants through a history of communication and transparency. Regulators can play an important role by supporting this industry-led process, and acknowledging the existing standards that underpin our markets.
- **Harmonization.** Derivatives markets are global, yet face fragmented regulatory landscapes across jurisdictions and, sometimes, even within a single country. To meet the substantial work that lies ahead, it is crucial for any sustainability-related laws to acknowledge existing industry-led solutions and the disparate regulatory and legal burdens currently in place in order to avoid complexity and confusion. Regulators, global standard-setters, and lawmakers can play an important role by encouraging consistency in policy actions across jurisdictions.

Looking to the future. The paper notes that FIA intends to help market participants effectively manage climate-related risks as their business models might face periods of significant disruption and will work in partnership with policymakers to design regulatory frameworks that support continued innovation and the development of market-based solutions. In doing so, FIA indicated that it welcomes the opportunity to help forge a sustainable global financial system that reflects high social and environmental standards.

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