gfma
GLOBAL FINANCIAL MARKETS ASSOCIATION

Global Foreign Exchange Division

ESG & FX

September 14, 2021

The Global Financial Markets Association's (GFMA) Global Foreign Exchange Division (GFXD) was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA).

The GFXD is a financial markets trade association focused on the wholesale foreign exchange (FX) industry. Its members comprise 23 global FX market participants,[1] collectively representing over 75% of the FX inter-dealer market[2]. Both the GFXD and its members are committed to ensuring a robust, open and fair FX marketplace.

Background

Given the current pervasiveness of discussion around the impact of ESG on the financial markets, the GFXD has explored where and how ESG themes are or may be implicated in FX, and what challenges, opportunities and headwinds this brings with it. This paper identifies and discusses several areas where ESG factors come into play for FX, and includes a specific call to action in respect of FX industry-agreed principles of good practice in the context of ESG.

ESG refers to three categories of factors– Environmental, Social and Governance– considered when assessing the sustainability, and societal and ethical impact of, typically, an industry or company.

- **Environmental impact**: E.g., climate risks, natural resource scarcity, pollution, waste.
- **Social goals**: E.g., labour, product liability, diversity, human rights, geopolitics.
- **Governance quality**: E.g., board effectiveness, leadership, executive pay, audits, internal controls, shareholder rights.

Institutional investors are, more and more, using ESG benchmarks and criteria in assessing the long-term value of companies and screening potential investments.[3] ESG criteria are also considered by companies in their processes for mitigating ESG-related risks facing the company itself, such as those posed to them by climate change, poor sustainability, or by engaging or relying on parties who have

[1] Bank of America, Bank of New York Mellon, Barclays, BNP Paribas, Citi, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, Mizuho, Morgan Stanley, MUFG, NatWest, Nomura, Northern Trust, RBC, Standard Chartered, State Street, UBS, and Wells Fargo.

[2] According to the 2021 Euromoney survey.

[3] https://www.ussif.org/files/Trends%20Report%202020%20Executive%20Summary.pdf

weak ethics or governance standards. ESG performance and assessment also form part of global and local efforts around the world to promote and drive a transition to sustainable economies.

ESG Impacts on FX

As illustrated in the **Annex** to this paper, the GFXD have identified several areas where ESG factors could have a direct or indirect impact on the FX industry:

- Policy, laws, regulation and industry best practices.
- Corporate and business-line ESG goals and performance.
- Embedding ESG factors into currency strategy and FX products offerings.

These are discussed in more detail below.

1. Policy, Laws, Regulation and Industry Best Practices

The FX Global Code[4]

The FX Global Code (Code) is a set of principles of good practice for the wholesale FX market, developed by the industry to provide a common set of guidelines to promote the integrity and effective functioning of the global wholesale FX market.

The Code is promoted and maintained by the Global FX Committee (GFXC)[5], a forum which brings together central banks and private sector participants to promote a robust, liquid, open, and appropriately transparent FX market. FX market participants can demonstrate their recognition of and commitment to adopting the good practices set forth in the Code by signing a standardised "Statement of Commitment" to the Code.

Whilst much of the ESG focus for asset classes beyond FX has been on Environmental elements, given its intended purpose there is a strong case to be made for linking the Social and Governance aspects of ESG to the Code. First and foremost, in the GFXD's view, Code adherence is an obvious mechanism by which wholesale FX market participants can demonstrate good governance and control practices in their FX activities.

A July 2021 report published by the GFXC[6] also makes the connection, where it cites support by a number of FX buy-side firms for a linkage between the Code and ESG, with a suggestion that Code adherence could play a role in boosting a firm's market reputation given the growing focus on responsible investing, particularly in the asset management world.

There is also a case to be made for Code adherence furthering the UN Sustainable Development Goals (SDGs) given their focus on fair and regulated financial markets. The SDGs include targets to "Improve the regulation and monitoring of global financial markets and institutions and strengthen the

[4] https://www.globalfxc.org/fx_global_code.htm

[5] https://www.globalfxc.org/

[6] "Global Foreign Exchange Committee Report: The Effective Means of Buyside Engagement" available at: https://www.globalfxc.org/docs/effective_buyside_engagement.pdf

implementation of such regulations" and "Develop effective, accountable and transparent institutions at all levels".[7] Furthermore, Code adherence may be considered in the context of the UN-supported Principles for Responsible Investment (PRIs), which many investment managers and asset owners around the world have signed, committing to, amongst other things, ". . . incorporate ESG issues into [their] own ownership policies and practices".[8]

In light of the above, the GFXD makes a call to action for wholesale FX market participants who have not yet adhered to the Code to do so, on the basis that Code adherence can evidence a showing of support for ESG goals as well as be an indicator of action towards developing good ESG credentials.

GFXD CALL TO ACTION: As part of a commitment to ESG, wholesale FX market participants should adhere to the FX Global Code and, in turn, encourage other wholesale FX market participants with whom they interact to do likewise.

For these parties, adherence to the Code should, in the GFXD's view, represent a minimum standard for demonstrating social responsibility and good governance in the context of ESG.[9]

Adoption of the Code —whilst more widespread now than at its launch in 2018, with around 1,100 signatories globally— continues to be inconsistent across segments of market participants. Sell-side adoption, for instance, is significantly higher than buy-side adoption.[10]

The responsibility for safeguarding the well-being and effective functioning of the wholesale FX market is one that is common to all market participants across the wholesale FX ecosystem. That responsibility is not the sole preserve of the sell-side and, as such, driving broad adoption of the Code is in the interests of the entire industry, as it relates to safeguarding the robust, fair, and effective operation of the global FX market.

In addition to wholesale FX market participants themselves, in particular buy-side firms and companies not yet adhering to the Code, asset owners and shareholders are also encouraged to see adherence to the Code as an integral part of any FX market participant's commitment to social responsibility and good governance— be they a bank, asset manager, corporate end-user, infrastructure provider, venue, or any other wholesale FX market participant.[11]

[7] See https://www.saepiox.com/post/the-handshake; see, also, https://sdgs.un.org/goals (Targets 10.5 and 16.6).

[8] https://www.unpri.org/pri/about-the-pri. These include commitments to ". . . promote acceptance and implementation of the Principles within the investment industry", "Participate in the development of . . . standard setting", and "Ask for information from companies regarding adoption of/adherence to relevant norms, standards, codes of conduct or international initiatives".

[9] In addition to any other ESG expectations or obligations, such as ESG-related disclosures that may be required of public companies, etc.

[10] According to the July 2021 GFXC report, adoption of the Code has lagged for buy-side firms, constituting only around 10% of Code signatories. Adoption is most widespread amongst banks and other sell-side firms, representing around 70% of signatories. See https://www.globalfxc.org/docs/effective_buyside_engagement.pdf

[11] It is worth noting that almost 4,000 investment managers and asset owners globally have signed and thereby publicly demonstrated their commitment to the PRIs. See https://www.unpri.org/signatories/signatory-resources/signatory-directory

GLOBAL FINANCIAL MARKETS ASSOCIATION

Beyond the FX Global Code, there are several other areas where policy, laws and regulation could drive ESG change which may implicate FX:

ESG taxonomies, disclosures and metrics

In light of the current heightened focus on issues around climate change, social impact, and corporate responsibility, it is anticipated that policymakers and regulatory bodies around the world will continue to move towards making environmental/climate and, potentially, other ESG-related, disclosure obligations mandatory for regulated entities.

Whilst in most G20 countries companies with public debt or equity are required to disclose material risks, including climate change-related risks, and some firms do produce ESG scores or credit ratings,[12] there is currently no standard global taxonomy or framework for ESG disclosures.

Efforts are being made, however, in this area by bodies such as the US Securities Exchange Commission (SEC)[13], the ESG Subcommittee of the SEC Asset Management Advisory Committee,[14] and the US Commodity Futures Trading Commission (CFTC) Climate Risk Unit.[15] Also in the US, the Federal Reserve Board has established a Financial Stability Climate Committee to work on identifying and finding ways to mitigate climate risks to the financial system, such as consistent, comparable and reliable mandatory disclosures.[16]

In the EU, the Sustainable Finance Disclosure Regulation (SFDR) brings in disclosure obligations with the aim of providing more transparency on sustainability within the financial markets in a standardised way to prevent "greenwashing" and ensure comparability. The "EU Taxonomy" aims to introduce a harmonised classification system for sustainable investments, providing a consistent understanding of "ESG".[17] The European Commission has proposed a Corporate Sustainability Reporting Directive (CSRD) to enhance sustainability reporting[18] and the EU Platform on Sustainable Finance has consulted on potential extensions of the taxonomy beyond environmental activities, to cover social

[12] For example, MSCI, Sustainalytics and S&P. MSCI evaluates thousands of data points across 35 key ESG factors.

[13] See https://www.sec.gov/news/public-statement/lee-climate-change-disclosures?utm_medium=email&utm_source=govdelivery; see, also, https://www.sec.gov/news/speech/gensler-pri-2021-07-28?utm_medium=email&utm_source=govdelivery

[14] https://www.sec.gov/files/potential-recommendations-of-the-esg-subcommittee-12012020.pdf

[15] https://www.cftc.gov/PressRoom/PressReleases/8368-21?utm_source=govdelivery. The Climate Risk Unit is intended to accelerate early CFTC engagement in support of industry-led and market-driven processes in the climate and broader ESG space, which is deemed critical to ensuring that new products and markets fairly facilitate hedging, price discovery, market transparency, and capital allocation.

[16] https://www.federalreserve.gov/newsevents/speech/brainard20210323a.htm

[17] The EU Taxonomy sets out four overarching conditions that an economic activity has to meet in order to qualify as environmentally sustainable. It entered into force on July 12, 2020. A Delegated Act supplementing the EU Taxonomy requires financial and non-financial companies to provide information to investors about the environmental performance of their assets and economic activities.

[18] https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en

objectives and activities.[19] In the UK, the FCA has consulted on climate-related disclosures[20], with green finance a key part of the UK vision.

The FSB has been tasked by the G20 to play a leadership role on data gaps and to identify recommendations to support the use of comprehensive, comparable, and auditable climate-related disclosure standards.[21] The IFRS Foundation is working to establish the International Sustainability Standards Board to develop international sustainability reporting standards.[22] The International Organisation of Securities Commissions (IOSCO) has consulted on formal regulation of ESG ratings and data.[23]

Beyond these examples, action is also being driven bottom-up by client demand. Specifically with respect to climate change, in the last decade investor demand for, and corporate disclosure of information about, climate change risks, impacts, and opportunities has grown dramatically.

In order to try to better align the development of the various taxonomies above, as well as others, GFMA and The Boston Consulting Group (BCG) have issued "Global Guiding Principles for Developing Climate Finance Taxonomies"[24]. These principles may be relevant for the FX community, since they recommend that all existing and new taxonomies should be assessed against these global principles for climate finance taxonomies as well as the conclusions factored into shaping future enhancements and development of new taxonomies. The five principles are by design high level and not prescriptive for applications that are based on regional or nationally defined contributions, climate targets and policies, and sector-specific transition pathways.

The regulatory focus and emphasis on climate change issues in particular, but also ESG more broadly, is likely to continue in 2021 and beyond. Depending on the scope and application of a particular policy, law, regulation or best practice, ESG taxonomies, disclosure or reporting mandates, and metrics, likely could have at least an indirect impact on FX. For example, ESG disclosures at a financial institution's corporate level could impact how all business lines and operations within that institution, including the firm's FX business, are viewed and assessed by investors, trade counterparties and clients.

Though likely there will be some regulatory and/or jurisdictional differences in approach, rather than one single global unified framework, the GFXD supports the efforts being devoted to ESG taxonomies, disclosures and metrics and the goal of establishing more consistent ESG measures to provide better transparency for evaluation of an entity or product's performance against those

[19] https://ec.europa.eu/info/publications/210712-sustainable-finance-platform-draft-reports_en

[20] https://www.fca.org.uk/news/press-releases/fca-consults-further-climate-related-disclosure-rules

[21] https://www.fsb-tcfd.org/. Specific to climate change disclosures, the FSB set up a Task Force on Climate-related Financial Disclosures (TCFD) in 2015 to develop a set of recommendations for a standard approach towards making financial disclosures. The task force produced its final report in June 2017. This framework will form the basis for the disclosure regulation being introduced by G20 countries.

[22] https://www.ifrs.org/news-and-events/news/2021/03/trustees-announce-strategic-direction-based-on-feedback-to-sustainability-reporting-consultation/

[23] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD681.pdf

[24] https://www.gfma.org/wp-content/uploads/2021/06/global-principles-for-climate-taxonomy.pdf

measures.[25] This could be key in the context of FX product innovation and review, to ensure clarity as to new products' alignment with ESG criteria and avoid the risk of greenwashing or mis-selling, which can lead to litigation risk (also see the discussion on ESG factors or targets embedded into FX products below).

Further development of standardized taxonomies, disclosures and metrics for ESG ratings could also potentially help lay the foundation for a greater ability to factor ESG-related risks into, say, prudential regulatory requirements, decisions around the deployment of capital, and counterparty assessments. Discussions between FX liquidity providers and their counterparties and clients about ESG performance will likely become more commonplace going forward.

2. Corporate and Business-Line ESG Goals and Performance

Financial institutions, in all likelihood, adopt positions on ESG at the corporate level, with ESG performance expectations, targets and actions implemented similarly across their business areas firm-wide. For example, some financial institutions have made public statements about corporate carbon net-zero emissions or footprint commitments, and diversity goals for their Board and executive leadership positions.

Company-wide ESG goals could have an indirect effect on the subject firm's FX business, with FX included within the broader corporate ESG pledges, objectives and practices of its "head office". A direct impact on FX is also possible, for example if there are certain ESG criteria the FX business has targeted for itself to meet.

The GFXD, as a membership group of banks active in FX, is supportive of the banking sector's commitments to sustainability and good governance. In light of the evolving thinking around what are deemed ESG "good practices", however, the GFXD notes that firms will likely determine their own specific criteria in this regard.

ESG considerations in assessing counterparties, clients, service providers and vendors

Investment funds have for some time been incorporating ESG factors into their investment decision-making and this is expected to continue over the coming decade with further development of regulatory incentives for investors to "green" their portfolios and activities, and pressure from asset owners to provide "ESG-compliant" products and services.

GFMA and BCG have already taken a leading role in defining potential relationships between the banking sector and their clients in "Climate Finance Markets and the Real Economy", by recommending that the banking and capital markets sector accelerate the development and scaling of a broad range of products and instruments in both public and private markets to meet the financing, investing, risk management, liquidity, and funding requirements of a range of market participants actively starting to transition. The range of products and instruments should include syndicated and

[25] The principles developed by the GFMA and BCG provide a global, actionable set of principles that are recommended to be considered by officials and the private sector when developing regional and sector-specific Climate Finance taxonomies.

bilateral loans, bonds, equity, structured products, derivatives, project finance, and securities financing.[26]

Beyond investment choices and holdings, in the trading and markets arena it is expected that ESG review will form part of the selection process for financial products liquidity providers and trading counterparties,[27] as well as for the selection of ancillary service providers. This could be directly relevant to FX in terms of FX end-users seeking out ESG "good-performers" to trade with (and vice versa, with liquidity providers assessing their counterparties and clients with FX needs). FX market infrastructure providers and vendors may also be expected to evidence favourable ESG practices and performance to those using their services.

In light of this, in terms of knock-on impacts it is worth noting that a financial institution or FX business will likely be assessed not only on its own ESG commitments and adherence but also on the ESG practices of its client/customer base, as well as, potentially, that of market infrastructures and vendors with which the financial institution or FX business has relationships.

Again, whilst the GFXD is supportive of banks' focus on and commitments towards ESG, in light of the evolving thinking around ESG evaluation criteria and practices, firms will likely determine their own individual approaches to ESG assessments of this sort.

3. Embedding ESG Factors into Currency Strategy and FX Products Offerings

ESG informing currency strategy and as a driver of currency performance

ESG factors could have a direct impact on FX in the context of a firm's own commercial strategy. A well-devised approach to active currency management and investing using ESG factors, analysis and rankings could prove to be a source of value, including to provide forward-looking insights into a currency's future direction. A framework could, for example, assess whether investors take into account a country's sustainability behaviour by quantifying co-movements between portfolios and ESG rankings through the construction of indices to reflect country-level performance in each individual ESG factor.[28]

Country-level ESG data could also be integrated as a factor guiding allocation.[29] Incorporated into a qualitative FX strategy process, ESG analysis could be used as an input into thinking around the long-term outlook for a currency's performance; this may be particularly relevant for emerging markets currency strategy.[30]

From an environmental perspective, a methodology could, say, allocate currency pairs according to a country's vulnerability to climate change.[31] Also, although ecological factors can be challenging to link

[26] https://www.sifma.org/wp-content/uploads/2020/12/Climate-Finance-Markets-and-the-Real-Economy.pdf

[27] See, e.g., https://nordic-am.com/how-can-esg-be-applied-to-currency-investing/

[28] https://info.bnymellon.com/rs/651-GHF-471/images/Market%20Update%20September%2009%202020.pdf

[29] See https://nordic-am.com/how-can-esg-be-applied-to-currency-investing/

[30] https://am.jpmorgan.com/de/en/asset-management/institutional/insights/portfolio-insights/currency/currencies-through-an-esg-lens/

[31] https://www.statestreet.com/content/dam/statestreet/documents/Articles/climate-change-vulnerability-and-currency-return-20210519-final2.pdf

to FX markets, it is well established that currency movements are exposed to commodity price developments. Environmental rankings could therefore be used to help firms identify how currencies are exposed to commodity price developments. Social factors may drive moves in the FX markets, for example GDP, indicators of prospects for future wealth in a country, and political influence over economic policy. Governance factors could be used to assess risk premia for currencies.[32]

FX facilitating climate risk mitigation, FX used to hedge exposure from "green projects"

The capital deployment and intermediation needed to facilitate greater financing of climate or other pro-ESG action may, particularly in emerging markets, be constrained by currency risks (amongst other risks). FX derivatives can be used to ensure these risks are efficiently managed.[33]

Ongoing development and offering of FX hedging solutions in emerging markets could directly assist in climate risk mitigation by supporting the development of the climate transition finance market.[34] FX may be able to help bridge the gap between the "natural" currency of providers of ESG-focused investment funding/capital and the currency in areas which face urgent societal and climate change adaptation challenges (typically emerging markets). An example may be derivatives used to hedge FX exposure from the financing of an emerging market wind turbine project.

ESG factors or targets embedded into FX instruments - a shared commitment by FX product providers and clients to positive climate and sustainability goals

The FX business can also potentially play a role in delivering on its own ESG objectives, as well as supporting clients to achieve their sustainability goals, through developing and executing "sustainability-linked" or "ESG-linked" FX derivatives. It has been suggested that derivatives can deliver ESG value in four key ways: access to market trends such as indices or derivatives baskets of underlyings; hedging by market sectors such as energy; bringing ESG impact to portfolios; and incentivising corporates to demonstrate their ESG skills.[35] These may become even more prevalent as standardized taxonomies are further developed and propagated. With an increasing demand for ESG-linked products, what will be important is to ensure products are marketed as such accurately, to avoid "greenwashing" and risk of litigation.

In FX, a variety of sustainability-linked derivatives have been entered into by firms which include an ESG component to conventional hedging instruments, including FX forwards.[36] An example of a "sustainability-linked FX forward" is where the purchaser client commits to paying a premium to the bank should the client not meet certain ESG targets, with the bank committing to invest that premium, if received, in environmentally-friendly projects. Precedent also exists for transactions that link currency options to sustainability goals. Another example invokes an agreed "sustainability payment" from the bank to the client in recognition of the client delivering against certain sustainability key performance

[32] https://am.jpmorgan.com/de/en/asset-management/institutional/insights/portfolio-insights/currency/currencies-through-an-esg-lens/

[33] https://www.isda.org/2021/05/11/video-what-role-will-derivatives-play-in-tackling-global-climate-change/

[34] https://www.sifma.org/wp-content/uploads/2020/12/Climate-Finance-Markets-and-the-Real-Economy.pdf

[35] See https://www.globalinvestorgroup.com/articles/3696441/esg-zoo-must-be-standardised-panelist

[36] See https://www.isda.org/2021/01/11/overview-of-esg-related-derivatives-products-and-transactions/?_zs=00x8H1&_zl=q0i76; see, also, https://www.bloomberg.com/news/articles/2021-08-16/jpmorgan-plots-derivatives-path-into-new-era-of-esg-finance

indicators, which is linked to the volume of their FX hedging amount. Given financial firms' strong interest in helping clients embed ESG into their investments and activities, including FX, no doubt firms will increasingly design and develop more FX financial products that are linked to sustainability targets.

Conclusion

With the extensive influence being exerted by policymakers and regulators, as well as the broad interest and take-up by companies and investors around the world in favour of incorporating ESG factors into investment activity (including "responsible investment"), the interplay between ESG and financial markets looks to be a topic that will be prevalent for some years to come.

The GFXD is keen to play a role in the global efforts being made to promote and drive good ESG performance and ensure the sustainability and resiliency of the world's financial markets. This paper identifies several areas where ESG factors could have a direct or indirect impact on FX and voices the GFXD's support for global efforts to standardize relevant taxonomies, disclosures and metrics, which it is believed will help set the underpinnings for driving good ESG practices in the global FX market.

Importantly, the paper also issues a call to action to wholesale FX market participants, in particular from the buy-side and FX end-user community where take up has been more sparse, to formally adhere to the FX Global Code to demonstrate social responsibility and good governance in the context of ESG.

Understanding where there are ESG touchpoints for FX, and how they will or could have bearing on the FX business, is important in order to understand and appreciate the landscape within which FX operates, as well as prepare for and mitigate any challenges and take advantage of any opportunities presented for the FX business and for the industry as a whole.

Annex