

FACT SHEET - NAB

EXPLAINER: ESG-linked derivatives

What is a derivative?

Banks like NAB help clients mitigate the risks associated with fluctuating interest rates, currencies and commodities prices by structuring and executing derivative transactions.

One of the most common derivatives is an interest rate swap, in which one party typically 'swaps' the variable rate is it paying on a loan to a fixed rate so that it has consistent liabilities.

The bank charges a fee, also called a credit spread, to cover the cost of holding capital and funding these positions through the life of the derivative transaction.

Typically, this is a flat charge that doesn't change.

What is an ESG-linked derivative?

The ESG-linked derivatives market is still developing. For this reason, there is no consistent terminology in this space.

An ESG-linked derivative is a risk management product that derives its value from both financial markets as well as a counterparty's ESG performance. They can be used to hedge interest rate, inflation or FX risk for NAB clients. These can be transacted when a client has entered into a sustainability-linked loan or bond or on a stand-alone basis.

In the case of an ESG-linked derivative that hedges interest rate risk, the credit spread charged by the arranger (in this case NAB) decreases by an agreed amount if the client meets pre-determined sustainability performance targets (SPTs), such as improvements in decarbonisation, energy efficiency, diversity of workforce or electrification of infrastructure.

If a client achieves its SPTs, the overall cost of the transaction to the client will be reduced.

An ESG-linked derivative that hedges FX or inflation risk can be tailored to specific preferences. NAB will work closely with clients to structure a mechanism that not only promoted achieving their SPTs but also reduces the overall cost of executing the hedge.

What type of sustainability performance targets can be attached to ESG derivatives?

Sustainability performance targets (SPTs) are highly dependent on a client's ESG strategy and can range from reducing greenhouse gas (GHG) emissions, to delivering greater diversity in the workforce, to building more affordable housing.

A growing number of organisations are looking to attach SPTs to improving the energy efficiency standards of their infrastructure, as an example.

How are the sustainability performance targets determined?

Sustainability performance targets are proposed by the client, set with the help of recognised independent third-party opinion providers and negotiated in conjunction with NAB's Sustainable Finance team in Australia.

For example, a KPI requiring a client to reduce their scope 1, 2 or 3 GHG emissions would be verified by a third party on an annual basis, with the audit certificate passed on to NAB to assess the KPI compliance and relevant discount.

Why were ESG-linked derivatives created?

For both corporates and investors, ESG considerations are becoming a key focal point of their operations. This is driving the need for organisations to adapt their strategic ambitions and business models to better align with investor and consumer demands.

There is an increasing acknowledgement that companies who focus on improving their ESG metrics are able to attract new sources of capital and potentially better pricing outcomes, driven by large inflows of capital into ESG-related investments.

What type of ESG-linked derivatives has NAB transacted so far?

NAB currently offers ESG-linked interest rate swaps, including cross currency swaps and inflation swaps.

What is the benefit to the customer?

Lower costs. Clients can save up to 20% on their credit spread if they achieve all the sustainability performance metrics.

What is the benefit to the community and the environment?

ESG-linked derivatives further incentivise organisations to set, meet and increase targets related to positive social and environmental impact.

This is a visual representation/example of one structure. Other structures may also exist.

