

Observations and categorisation relating to sustainability in the repo market

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Introduction

From repo transactions where the cash proceeds are used to fund green projects or assets, to sustainability-linked repo transactions to encourage borrowers to meet their pre-set sustainability KPIs, the repo market is starting to play a more active role in sustainable finance. Financial market participants are developing new sustainability-related products in the repo space, either to invest or finance, to facilitate the transition to a sustainable economy. In response to these new market developments, ICMA established a [Taskforce on Repo and Sustainability](#) at the beginning of 2022 with the aim of promoting dialogue around repo and sustainability, monitoring and assessing existing or upcoming market and regulatory initiatives, as well as developing relevant standards and best practices as the market continues to grow. The Taskforce is set up as a joint group, with notably representatives from both the [European Repo and Collateral Council](#) (ERCC) and the [Executive Committee of the Green, Social, Sustainability and Sustainability-Linked Bond Principles](#).

One strong message from the group has been the need to foster convergence on terminology in order to ensure transparent communication among market participants. As a first public output, the group decided to reflect on recent market developments and outline some observations and a high-level categorisation for sustainability-related repo transactions and products that have emerged. The paper is not meant as a validation by ICMA for any existing trades and it is purely a market reflection to provide further transparency and information on the different sustainability approaches that are used in the repo market, as well as their related challenges. Standardising commonly used terms could help to avoid misinterpretation in green and sustainable repo financing operations, as well as “greenwashing”. A clear understanding of current market practice will also be an important basis for developing any future guidance.

This paper looks at the intersections between repo and sustainable finance from two perspectives, based on the current practices in the market:

- 1. Wider sustainability considerations in the existing repo market**, e.g., collateral and counterparty considerations.
- 2. Specific sustainability-related repo products that have emerged**, e.g., use of proceeds repos and sustainability-linked repos.

The extent to which these transactions and products can contribute to firms’ overall sustainability objectives varies. The paper discusses their unique characteristics as well as some early market observations, which could be helpful considerations for future market practices.

The primary role of repo in sustainable finance and its limitations

Before considering the wider role of the repo market in sustainable finance, it is worth mentioning that the nature of a repo transaction is not changed by sustainability considerations. While specific sustainability-related repo products are appearing, repo is primarily a trading tool, not an investment. The primary role of a repo is to provide short-term secured funding, and these transactions in themselves are collateral agnostic. A repo, regardless of whether it is “green” or not, serves an important function in the financial market by channelling liquidity to market participants as well as facilitating collateral fluidity. According to the [ERCC’s consultation on the role of repo in green and sustainable finance](#) (hereinafter referred to as the “Survey”), respondents also mentioned other benefits in repo trading against sustainable collateral, such as facilitating market-making, reducing the cost of issuance and fostering price discovery for sustainable assets. Furthermore, there is evidence to suggest that short-selling, as one of the basic functions that repo supports, allows investors to take financial positions on companies that fall short of their social responsibility expectations.

Although repo provides important supporting functions in sustainable finance, there are some obvious limitations too. Taken in isolation, a repo with sustainable collateral does not generate additional financing for sustainable projects or activities, as the collateral has already been subscribed for, and the proceeds are channelled and accounted for accordingly. Therefore, a repo transaction should not be considered as providing green or sustainable financing solely based on the type of collateral it uses, as the accounting treatment should be the same as a conventional repo (with non-sustainable collateral). Currently, this seems to be the broader understanding of the industry, as there is no evidence to suggest that any market participants have double claimed¹ sustainable investments based on taking sustainable assets as repo collateral alone. We do not expect this view to change as the size of repo against green collateral grows.

Another important consideration besides additionality is how to reconcile short-term financing with the intrinsically long-term nature of sustainable investment and a firm’s overall sustainability objectives. Opportunities and risks related to climate change and social challenges are long-term in nature and it is difficult to see how a large portion of the repo market, with maturity of one month or less, could be relevant for these types of investment. In fact, most of the repo market today does not provide a direct contribution to sustainable finance. However, working within the constraints of the product, the market has come up with pragmatic ways to support sustainable finance in their repo business, such as the use of revolving financing facilities² or rollovers. There are also specific repo products that have been developed with sustainability characteristics, which will be discussed in the following sections.

¹ Based on the implicit assumption that the repo seller has automatically gained credit for financing the sustainable assets.

² I.e., to fund long/medium term sustainable investment funded with a mix of short- and long-term liabilities where repo is just one of a number of financing instruments.

High-level categorisations of repo transactions and products

Although the market is nascent, we have identified the emergence of four types of intersections between repo and sustainability. They can be split into two broader groups (as shown in the below diagram): 1. the wider sustainability considerations in the existing repo business through the differentiated treatment of collateral and counterparties and, 2. specific repo products providing sustainable financing, such as sustainable “use of proceeds” repo and “sustainability-linked” repo. The extent to which these transactions and products can contribute to firms’ overall sustainability objectives varies, and their characteristics and limitations will be discussed in the following sections, together with some observations on early market practices.

| Repo supporting sustainable financing | Repo providing sustainable financing |
|---|---|
| <p style="text-align: center;">Repo against sustainable collateral</p> <p>A repo transaction in which buyer and seller use sustainable asset(s) as collateral for the trade.</p> | <p style="text-align: center;">Sustainable Use of Proceeds (UoP) Repo</p> <p>A repo transaction where the cash is used exclusively to finance or re-finance, in full or in part, new and/or existing eligible sustainable projects or the borrower’s sustainable asset portfolio</p> |
| <p style="text-align: center;">Repo with sustainable counterparty</p> <p>A repo transaction that considers the sustainability credentials of the counterparties to the repo transaction, i.e., counterparties that meet certain sustainability criteria.</p> | <p style="text-align: center;">Sustainability-Linked (SL) Repo</p> <p>A repo transaction in which the financial and/or structural characteristics of the repo is linked to the seller’s performance with respect to a set of predefined Sustainability Key Performance Indicators (KPIs) or Sustainability Performance Targets (SPTs).</p> |

Repo supporting sustainable finance

Collateral considerations

As mentioned in the previous section, while taking sustainable collateral in a repo alone has a limited direct sustainability impact and does not represent an increase in the supply of sustainable financing, these repo transactions help channel financing and collateral through the sustainable ecosystem and therefore provide an indirect contribution to sustainability. Based on the Survey³, a majority of respondents also found repo with sustainable collateral to be the most straightforward concept to implement with fewer barriers to entry than, for example, a restriction based on the use of proceeds. However, as discussed earlier, there is a risk of using collateral as a green metric.

There are two groups of “sustainable collateral” that the market often refers to and it is important to differentiate them. Most sustainable collateral refers to bonds with clear sustainability credentials which meet recognised market standards such as the [Principles](#) supported by ICMA, or future regulatory requirements such as the [EU Green Bond Standard](#). On the other hand, “sustainability-screened” collateral that is screened based on ESG criteria, often at the issuer level, is also an approach considered by some firms, which may want to align their repo business with internal ESG guidelines they might have in the investment space. Such screening would reference ESG ratings or other relevant indicators from data providers or internal methodologies from company in-house metrics. However, there are currently no agreed market standards for such ESG ratings and therefore such ESG-screened collateral schedules have to be approved by each party in the transaction.

Current market observations

Low trading volume:

While collateral discrimination (such as sustainable assets inclusion or non-sustainable assets exclusion) may become popular in the long term, the vast majority of the repo market today is still using non-sustainable assets⁴. The low volume of trading against sustainable collateral⁵ relative to conventional assets could be owing to several factors. Firstly, there is no real necessity for dedicated green collateral transactions, due to the absence of any direct regulatory incentives or requirements⁶, although future regulatory proposals such as Green Asset Ratio (GAR) may change the picture as it may encourage more repo activities in green assets. Secondly, the typical buy-and-hold behaviour of green investors also further amplifies the demand and supply gap of green bonds. From a triparty perspective, according to the Survey, several respondents thought there is still room to further develop and expand triparty ESG collateral baskets, although a genuine General Collateral (GC) basket may be difficult to achieve in practice until there is sufficient issuance of the same type of sustainable bond by the same type of issuer with the same or similar credit rating⁷.

Contribution measurements:

As indicated in the earlier section, inaccurate sustainability claims against the sustainable collateral may lead to an allegation of “greenwashing”. A simple transfer of sustainable collateral cannot be counted as a sustainable investment by both parties. The party that finances the assets and retains the economic exposure to the assets (i.e., the seller) should logically be considered as the sustainable investor, although the situation might get more complicated when there is

3 Note that there were also other possible integrations of repo and sustainability which were mentioned by the respondents in the Survey, in particular, the sustainable collateral swaps that are constructed as back-to-back repos where parties exchange highly liquid assets with sustainable assets, and synthetic repos where the repo rate is based on an ESG index, giving the investor exposure to ESG risks and returns. However, both the collateral swaps and the synthetic repos are not sustainable investment on their own and would not increase any sustainable financing.

4 Data is unavailable for bilateral trades but, for instance, according to the data provided by Eurex in April 2022, the overall traded volume in Green Bonds is below 1% and CCP eligible green collateral is only about 3% of total eligible ISINs in the Eurex Repo Market (GC & Special).

5 In particular the principled-aligned collateral such as Green, Social, Sustainability and Sustainability-Linked bonds.

6 Current ESG related policies deal largely with incorporating ESG risks into securities, investments and operations as well as classification, disclosure and reporting, which do not impact repo directly but indirectly through the management of the collateral and counterparties.

7 For example, Eurex's Green Bond GC basket encompasses Euro denominated debt securities that are issued in adherence with guidelines for Green Bonds. However, the bonds in the basket varied in terms of type of issuers (i.e., government, financial/non-financial corporates) and credit quality.

further trading of the sustainable assets, i.e., reuse of assets. Whether the contribution of intermediaries to sustainable financing should be recognised and if so, how to measure it, is challenging and is something that requires much more discussion in the wider industry. Some believe that (marginal) contribution of intermediaries should be recognised because they are promoting price discovery, extending distribution of the sustainable assets, and adding liquidity to the market. Others argue the contribution, while valid, manifests itself in the form of better pricing (i.e., tighter credit spreads), which means better funding for sustainable issuers and may lead to more sustainable issuance. However, these are largely intangible benefits and difficult to quantify in terms of the intermediary's contribution.

Collateral quality and eligibility:

As mentioned in the initial [Consultation Paper](#), green does not mean better credit, and buyers need to balance the preference for green and sustainable securities with the credit quality of the collateral. The principal role of collateral is to hedge the credit and liquidity risk on a loan and there should be no fundamental trade-off with ESG considerations. Rather, ESG risks should be priced into the collateral. This is generally not the case at the moment and some official interventions are starting to emerge to address the issue. For example, the ECB is taking further action to incorporate climate change in its corporate bond purchases, collateral framework and risk management this year⁸. The Eurosystem aims to decarbonise its corporate bond holdings and only accepts collateral that complies with the [Corporate Sustainability Reporting Directive](#) (CSRD) in its credit operations. Furthermore, the Eurosystem will also start considering climate-related risks when reviewing haircuts on corporate bonds used as collateral. A question to keep in mind in this context is, if the pool of eligible collateral is further limited by regulators, central banks or even the firm's internal criteria, and non-ESG related collateral is deemed less preferable, what is the adverse impact on collateral fluidity and liquidity and efficiency in the overall market?

Preliminary conclusions:

- The use of sustainable collateral, the provision of sustainable finance and the involvement of sustainable counterparties (discussed in the next section) do not change the fundamental nature or purpose of a repo.
- Repo against sustainable assets fulfils the traditional and critical role of repo and contributes to the development of an efficient and transparent sustainable finance market by supporting the financing and liquidity of sustainable assets. It provides an indirect contribution to sustainability.
- Most of the sustainable collateral used in repo refers to sustainable bonds that are aligned with the market standard represented by the [Principles](#) supported by ICMA. Collateral screened with ESG criteria is also an approach considered by some firms.
- Trading volume of sustainable collateral is relatively low due to the sizeable gap in supply and demand for sustainable assets, the impact of buy-and-hold and the absence of direct regulatory requirements. This picture may change as issuance of sustainable assets continue to expand and regulators taking measures to encourage sustainable assets.
- Buyers of the repo should not claim a sustainable investment solely on the basis of taking the sustainable collateral.
- ESG risks should be priced into the collateral, which they are currently not. The official sector is taking further steps to incorporate climate change into its monetary policy operations. However, going forward it will be important to consider the potential adverse impact on non-sustainable collateral.

8 [ECB takes further steps to incorporate climate change into its monetary policy operations](#)

Counterparty considerations

Similar to market participants who steer their repo trading towards collateral that meets certain ESG criteria, there are also market participants who make choices on the counterparties they trade with. One approach could be considering only pure plays as counterparties. Another approach could be based on the assessment of their counterparties' ESG credentials. Investors may either choose not to trade with certain counterparties who fall below a specified internal ESG rating, or they may want to give priority to trading with counterparties who meet their ESG eligibility. Although there are already a number of data providers who measure companies' resilience to long-term industry-specific ESG risks, there are currently no agreed market standards on these metrics, similar to the ESG screening of collateral mentioned in the previous section. This is an issue that goes beyond the repo market and the current regulatory discussions such as CSRD and the EU Taxonomy may provide potential solutions. The counterparty approach, unless in the case of a "pure play", faces similar limitations from an additionality perspective, as the proceeds are not guaranteed to be invested for sustainable purposes. Currently, in the absence of agreed standards around ESG measures, it is difficult to tell whether such transactions can be labelled as truly "sustainable".

Current market observations

The counterparty approach has already been applied by many of today's "green" money market funds, where fund providers include or exclude securities from certain issuers in their investment. They essentially invest in green borrowers, rather than green short-term assets. Analysis⁹ on Green Money Market Funds (MMF) suggested that creating an entirely green MMF is challenging because short-term ESG issuance is limited, which leads to diversification constraints. However, there are some MMFs that started to take an integrated approach, i.e., some overlap with specific use of proceeds vs. general behaviour of the counterparty¹⁰.

Preliminary conclusions:

- Repo against a sustainable counterparty considers the ESG credentials of the repo counterparties, e.g., pure plays or counterparties that meet certain sustainability criteria.
- There are already several data providers who score firms based on their sustainability performance. However, similar to ESG-screened collateral, it is difficult to standardise sustainability criteria for these scorings/ratings across the industry, given that methodology and source of ESG data vary between data providers.
- Most of the green money market funds today focus their investments on green borrowers rather than green short-term assets, given the limited availability of such assets, although some green MMFs have started to incorporate the "use of proceeds" approach.

⁹ <https://www.fitchratings.com/research/fund-asset-managers/green-money-market-funds-22-07-2021>

¹⁰ For example, Blackrock's [Liquid Environmentally Aware Fund](#) claims at least 5% of the net revenue from BlackRock's management fee from the Fund will be used to purchase and retire carbon credits.

Repo providing sustainable financing

Sustainable Use of Proceeds Repo

A range of sustainable “Use of Proceeds” (UoP) repos have been transacted since the end of 2020¹¹, where the cash loaned in the repo is exclusively used to finance or re-finance, in full or in part, new and/or existing eligible projects or the borrower’s sustainable asset portfolio. UoP repos tend to follow well-established voluntary practices for the bond market represented by the [Principles](#), as there are many aspects which can be applied directly¹². ICMA also observed different forms of UoP repos in the market. For example, an integrated approach which combines the UoP with sustainable collateral¹³. Besides, there are structures in place where a firm acts as an intermediary and facilitates UoP repo transactions for its clients¹⁴.

| Terminology | Cash leg (Seller) | Securities leg (buyer) | Repo Rate |
|--|--|--|-----------|
| Sustainable Use of Proceeds Repo | 100% allocated to finance sustainable projects or assets (green, social or both) | Collateral does not necessarily need to be sustainable assets. | N/A |
| Sustainable Use of Proceeds combined with Sustainable Collateral Repo | 100% allocated to finance sustainable projects or assets (green, social or both) | 100% sustainable collateral | N/A |

Current market observations

The number of sustainable UoP repos in the market is growing, however it is still limited. Most of the UoP repos do not require the use of sustainable assets, as the underlying collateral as the focus is purely on the cash proceeds. However, there is a debate in the market as to whether ‘non-green assets’ should be excluded as collateral from such structures¹⁵. UoP repos tend to have longer-term structures when transacted independently, although they can also be used within an overarching sustainable finance framework to support the sustainable projects. For UoP repos which are used to fund green assets, it is also worth noting that in case of temporary shortfalls of assets in the green asset portfolio, some firms have invested the proceeds back into short-term money markets in the interim.

From a legal perspective, the cash proceeds, unlike conventional repos, have a specific usage. ICMA observed some bespoke contractual provisions that deviate from the GMRA standard terms. However, such changes need to be carefully discussed and considered to ensure they do not (unintentionally) impair the fundamental legal principles of the GMRA. From a margining perspective, whether there should be any restrictions on the investment of cash margin is something that has not yet been contemplated by the market.

11 In Dec 2020, the Agricultural Bank of China (SG branch) entered a \$50 million repo deal with BNP Paribas whereby the proceeds of the repo will be allocated to green projects based on the internal Sustainable Financing Framework (SFF) of the branch. ABC SG has engaged Sustainalytics to review the assets funded by this repo transaction and provide an assessment as to whether the projects met the Use of Proceeds criteria and the Reporting commitments outlined in the SFF as per our counterparty's request.

12 For example, the Commonwealth Bank of Australia (CBA) and Northern Trust completed a A\$50 million transaction utilising a new Green Repurchase Agreement as certified by the Climate Bond Initiative (CBI). The pre-issuance assurance report assesses the Green Repo products against 5 requirements: Use of proceeds, Processes for evaluation and selection of projects & assets, Management of proceeds, Reporting prior to issuance, and Sector eligibility Criteria – 4 out of 5 are in line with the core components of the [Green Bond Principles](#).

13 HSBC launched a green repo with Qatar National Bank (QNB) in Feb 2022 where HSBC borrows cash from QNB in exchange for ownership of green bonds. HSBC then allocates an amount equal to the purchase price to eligible businesses and projects.

14 For example, a bank may receive cash from client A and provide this cash to client B (or a pool of clients) to finance its (their) green assets. These assets are not on the bank's own balance sheet but are aligned with the bank's internal green assets framework. The bank facilitates these transactions as an intermediary and provides a formal disclosure to Client A.

15 Some firms recommend excluding assets that does not exclude carbon intensive investments.

From a reporting perspective, given the short-term nature of the product, UoP repos may require more frequent reporting than annually, as is standard in the sustainable bond market. Alternatively, they should be subject to a suitable reporting framework and report with other financing arrangements, given that one-off reporting requirements are not practical especially for short-term repos. However, this requires further discussion in the industry. Based on the observation on some market practitioners, reporting may include, but is not limited to a list of the following items:

- Confirm that nominated projects & assets meet eligibility requirements specified in the [Principles](#) or other recognised standards
- Confirm that business processes and controls are adequate to manage and track proceeds and/or unallocated proceeds
- Summary of the use of proceeds
- Summary of the management of unallocated proceeds, if applicable
- Summary of the portion of proceeds used for refinancing, if applicable
- Impact reporting includes details on the environmental performance of the projects or assets

Some market practitioners also consider the verification of the UoP by an independent external reviewer. The external verification requirement is at least annual, but the issuer has to have the processes and governance in place for more frequent monitoring.

Preliminary conclusions:

- A sustainable “Use of Proceeds” repo is a repo where the cash is used exclusively to finance or re-finance, in full or in part, new and/or existing eligible sustainable projects or the borrower’s sustainable asset portfolio.
- Sustainable “Use of Proceeds” repos build on well-established voluntary practices for use of proceeds bonds ([Green Bond Principles](#), [Social Bond Principles](#) and [Sustainability Bond Guidelines](#)) in the sustainable bond market.
- Most of the UoP repos do not necessarily use sustainable assets, as the underlying collateral as the focus is purely on the cash proceeds, although an integrated approach which combines the “use of proceeds” with sustainable collateral also started to appear in the market.
- Deviations from standard practice may arise from a legal and reporting perspective as discussed above.

Sustainability-linked Repo

Another repo product with a connection to sustainability that has emerged is a type of sustainability-linked (SL) repo in which the repo rate is linked to the seller’s performance with respect to a set of predefined Sustainability Key Performance Indicators (KPIs) or Sustainability Performance Targets (SPTs). If the predefined KPIs/SPTs are fulfilled, the seller benefits from a differentiated repo rate (i.e., cheaper cash). SL repos provide firms financial incentives to improve on their sustainability outcomes¹⁶. Although pricing rate adjustment is the only incentive mechanism in sustainability-linked repos currently, there may be other features or options available as the market develops. We may also start to see a combination of strategies, e.g., an integration of a “sustainability-linked” approach with sustainable collateral or “use of proceeds”.

| Terminology | Cash leg (Seller) | Securities leg (buyer) | Repo Rate |
|-----------------------------------|--------------------------|---|--|
| Sustainability-Linked Repo | Used for general purpose | Collateral does not necessarily need to be sustainable assets | Linked to the seller's performance on pre-set KPIs or SPTs |

Current market observations

Although voluntary practices such as the [Sustainability Linked Bond Principles](#) provide good guidance in terms of standards of transparency, selection, verification and reporting of KPIs/SPTs, further reflection is required on how these guidelines for sustainability-linked bonds can be applied to sustainability-linked repos. Currently, SL repos are usually used as part of an umbrella sustainable finance framework which enables firms to align their financing strategy with their ESG goals. It is unclear whether they can be transacted independently outside the framework due to the challenges of using short-term repo for long-term sustainable financing. From a collateral perspective, SL repos do not necessarily use sustainable assets, however, most of the trades avoid bonds stemming from issuers who belong to “brown” sectors.

The size of the spread between the discounted repo rate and the penalty repo rate is important for the credibility of the SL transaction, but there is no agreed standard on what a reasonable spread might be. The trigger for the differentiated repo rate also needs to be appropriately reflected in the legal documentation. In terms of maturity, some market practitioners confirmed that the trade does not need to be particularly long-dated but long enough for the seller to evidence certain progress on their sustainability goals, for example, to achieve a certain percentage of renewable energy usage at the end of the transaction. Yet others believe the maturity should be at least 1 year or above for these structures to be impactful and a linear regression methodology for the longer-term target can be adopted in annual maturities.

Preliminary conclusions:

- A “Sustainability-Linked Repo” is a repo transaction in which the repo rate is linked to the seller’s performance with respect to a set of predefined Sustainability Key Performance Indicators (KPIs) or Sustainability Performance Targets (SPTs). As the market develops, there may be other incentives available beyond pricing rate adjustment.
- Further reflection is required on how the voluntary guidance from the sustainability-linked bond market can be applied to sustainability-linked repos.
- There is limited market practice today and it is unclear whether a sustainability-linked repo can be transacted independently outside of an overarching sustainable finance framework.
- Information is limited regarding what a reasonable spread between the discounted repo rate and the penalty repo rate might be. The term of the trade is also debatable.
- The “variable rate” structure needs to be appropriately reflected in the legal documentation.

¹⁶ In August 2021, Deutsche Bank (DB) executes its first ESG-linked repo transaction with Akbank (AK). Throughout the life of the transaction, DB monitors AK’s performance with respect to certain ESG metrics and depending on AK’s performance, DB will adjust the pricing rate of the repo transaction. Choice of the metrics was linked to AK’s internal sustainability strategy.

Conclusions

As discussed in the paper, there are a number of ways in which repo can potentially contribute towards an overall sustainable finance strategy. On the one hand, more and more firms are starting to integrate sustainability considerations into their existing repo business via a differentiated treatment of collateral and counterparties. On the other hand, the large global capital flows seeking to support green and sustainable activities are catalysing the development of more innovative products in the market. Although we see some common features emerging, the market is still at an early stage with only a limited number of transactions. This paper raises a number of open questions that would require further considerations. However, ICMA believes that there is an important role for repo to play and that existing market standards such as the [Principles](#) could be adapted for use in sustainable repos. Along with the Taskforce members, ICMA will continue to closely monitor the market evolution as well as any forthcoming regulations with an aim to encourage standardisation of terminology and sustainability approaches within the repo market.

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