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DerivSource Podcast Transcript

Environmental, Social and Governance (ESG): Spotlight on ESG Derivatives & Futures

Julia Schieffer: Hello and welcome to this DerivSource podcast. I'm Julia Schieffer, the founder and editor of derivsource.com. This is the second episode in our ESG podcast series, where we are exploring the growing trend towards environmental, social and governance investing. People are more focused than ever on the environment and social issues and there has been a significant increase in interest among ESG-focused derivatives and futures in particular.

In this episode, I'm speaking to Zubin Ramdarshan at Eurex about how client demand has led to the introduction of ESG index derivatives and the successful launch of several ESG-related products. Welcome to the podcast, Zubin.

Zubin Ramdarshan: Thank you. Happy to be here.

Julia Schieffer: And Zubin, can you tell us a little bit about yourself first?

Zubin Ramdarshan: Yes, of course. So I'm Zubin Ramdarshan, responsible for the equity and index product design team at Eurex. I've been in the role for just coming up to three years now. Prior to that, I was a customer of the exchange for 18 years, so on the derivative trading side. And so I guess I bring that practitioner point of view to the exchange.

Julia Schieffer: So let's start a little bit at the beginning here. Can you tell us a little bit about the main drivers behind the initial launch of the ESG futures?

Zubin Ramdarshan: I think as always an exchange, one of the benefits is we sit in between all different types of members and the wonderful benefit of that of course is we source ideas from those members. And one of the elements was of course we were approached by certain regional - I'd say specifically Nordic - members who requested us to look into index derivatives related to ESG strategies. The other thing that really drove us is looking at trends in ETF launches. So looking at what themes had been prevalent in recent launches. And we definitely caught that the ESG was very much a trend that was supported by growing assets under management. And as I said, latent client demand.

Julia Schieffer: So tell me a little bit about the kind of traction that you're getting with the ESG derivatives or futures at this time.

Zubin Ramdarshan: To put it in a brief statement, it's been really a fantastic start. You know, having seen a few product launches since I've been in my role, this is definitely one of the more successful ones. Uptake has been progressive and actually very steep in terms of growth trajectory. We have seen, in in the three features we've launched, which were the STOXX Europe 600 ESG, the EURO STOXX 50 Low Carbon, and the third index future, which is the STOXX Europe Climate Impact. All three have traded. That said, there's really a picture of concentration in the ESG-X index. So the light exclusion methodology, where we've had the bulk of the volume. So 250,000 contracts since launch in mid-February and an open interest of 56,000 contracts, which equates to just shy of EUR 800 million notional. So track traction wise, very happy, hoping to kick on from this point. And I think it's really one of the more successful examples we've had where as I said, uptake and participation from members has been really quite rapid.

Julia Schieffer: So you mentioned ESG-Xand that it's the most popular. Can you tell me a little bit about why you feel the light exclusion method is most popular?

Zubin Ramdarshan: You're quite right, it is the most popular. The reason I think is because of its simplicity. So in terms of an entry point into ESG investing, a light exclusion method is clearly removing noncompliant names or names that don't satisfy ESG criteria – it’s very easy to understand. And in most cases, you know, certainly in our STOXX Europe 600 ESG-X version, you're removing only a handful of the names, so you don't significantly change the benchmark. I think that's key as well. Investors will track a benchmark and removing more than 5% to 10% of a basket is quite an active decision and you start to have tracking error at that point. And so I think light exclusion has been successful because A it is easy to understand, and B, it doesn't change the risk reward dynamics of the benchmark too significantly. And as I said, it is an entry point into the ESG investing and the SRI (socially responsible investing) theme, where it's very clear that you're satisfying criteria.

Julia Schieffer: And looking at your members, as you mentioned, this is quite popular with them. What are the growth opportunities for asset managers?

Zubin Ramdarshan: What Eurex has done by listing these three index futures is we further enhanced the toolkit available to asset managers. So I think prior to the arrival of the launch of our futures, if you wished to implement, let's say an ESG theme or an ESG mandate, there was really, I'd say two primary routes you could take. One was of course, executing a basket, which adhered to ESG criteria and ESG rules on a cash basis. The second way was really through OTC total return swaps. So approaching your prime broker, your banking relationships and constructing a bespoke basket and then executing via total return swap. I think with the future, we simply enhance the range of products you can use to implement an ESG strategy. So I think that opens a number of avenues for asset managers in terms of A) cash management - futures are often used as a cash management tool. I think also, you know, naturally with futures you do get that leverage exposure because they're a margined instrument. There's also the liquidity aspect. I think one huge advantage is having an order book with continuous pricing during the trading day gives that visibility, transparency and comfort in ensuring best execution when it comes to utilizing the futures.

Julia Schieffer: So it makes sense because this is obviously a huge trend, especially as you mentioned in Europe. And so more asset managers need products at their disposal to support this trend and this need. Can you talk to me a little about, a little bit about any plans to list other ESG-related products this year or next year?

Zubin Ramdarshan: Absolutely, yes. Certainly we do have plans to extend the product range. As you know, we started with the three STOXX-based futures. At Eurex where we're typically agnostic in terms of the index partner we engage with. STOXX is traditionally a strong partner. We have other partners, namely MSCI. We also look at a natural extension, once you have listed futures where there's liquidity, is asking ourselves the question, when do we launch the respective options? And I think at the moment the team is looking into what makes sense on launching options on the three index products. We're also looking at extending the range of index providers we use. I already mentioned one of the names we’re closely associated with already. One of the observations we'd say from the structured products market is there's a very successful STOXX benchmark, which is the Select benchmark. This is really actually a combination of two factors. It's low volatility and high dividend yield. The reason being is on the structured products side, that has the effect of making the call option particularly cheap, which then can be embedded into a structured product. So, there is also a version which has an ESG component methodology to it. And we're also looking closely at the potential to list products based on that benchmark.

Julia Schieffer: And talking about all these plans that you have for more product launches, what do you view as the growth potential of these?

Zubin Ramdarshan: I think the growth potential is bringing, in the first instance, the light exclusion methodology to other country or other regional benchmarks. I think, that's the one that has the most success. We have it on our main European STOXX 600 benchmark. I think there's a good reason to believe extending that to other country benchmarks or other regional benchmarks would make sense. The other areas where growth potential exists, and probably a little bit further down the listing phase for us would be to move into narrower themes. And this could be, if I look at the ESG themes where there is, let's say, assets being gathered, it would be in things like water waste management, plastics, green real estate. They are definitely more than niche end, but there is demand for Delta-one solutions there.

Julia Schieffer: We've talked a lot about the trends, the opportunities and of course, what this means to the asset managers and future product plans. Can you tell us a little bit about some of the challenges that you faced and you experienced with launching these ESG products?

Zubin Ramdarshan: I think the first one we came across was validating methodologies. I think that's the key one. In the ESG space, there are many ways it can be approached. One of the features which I think has enabled ESG expansion is the immense amount of data that's been collected by various sources, particularly really in the last even two or three years. I'm pointing here to, you know, STOXX partners with one company, Sustainalytics, also CDP, the carbon disclosure project, and also ISS Ethics. So there are numerous sources of ESG or climate impact scoring. I think here, the challenge is to have standardization - it doesn't quite exist. There are many examples of companies where on one methodology they score, a one; on a different methodology, they may score a five, i.e. from being the best to being the worst in class.

So there's an inconsistency feature of certain ESG methodology. So I think one of the things we spend our time doing before we launched our products was we had an independent analysis and verification of the respective index methodologies, just to satisfy ourselves as Eurex that these were appropriate and the right products to, to initiate the ESG segment on. Because I think as an exchange, members in the marketplace do look to us as a brand where if we were to launch futures, there's an assumption behind it that we've done our homework and performed our due diligence. So that was one of the challenges that we had to satisfy ourselves, that the due diligence was completed.

Julia Schieffer: And presumably this focus on data and being able to validate the methodologies is an ongoing effort that you have to continue through.

Zubin Ramdarshan: If you ask me what will happen going forward, I think there'll be some convergence in terms of methodology, standardization of scoring, but that takes time. You know, as you said, it takes time. I think empirically, you know, how does it actually work when you implement the various options in terms of running an ESG strategy - of which futures is one of the ways you can now do that.

Julia Schieffer: So you've already alluded to a little bit about how this space will be evolving. Talking about that more generally, how do you see the trend for ESG or sustainable investing evolving say in the next two years?

Zubin Ramdarshan: I think the key benchmarks will all start to incorporate some form of ESG criteria, ESG screening, essentially incorporate an ESG component into the methodology. You know, we have obviously on Eurex, the big benchmark being Euro STOXX 50, recently you would have seen the news that STOXX licensed EuroSTOXX 50 ESG-X index to UBS. They have their own large internal ETF platform. I think that will happen around the globe in terms of benchmarks in the US, in Asia, in developing markets as well. I can certainly see a landscape where those benchmarks have ESG methodologies incorporated and you get a wholesale migration of existing open interest and existing positions into the new ESG compliant benchmarks. I could see that being a feature of financial markets going forwards.

Julia Schieffer: Well, that's been very insightful. Thank you very much for joining us on this podcast.

Zubin Ramdarshan You're welcome. I really enjoyed the conversation. Thank you.

Julia Schieffer: We hope you found this podcast useful. Please do stay tuned for the next installment on ESG and asset management. And to find out more on this topic, please go to derivsource.com for our show notes and related articles. You can also contact us via editor@derivsource.com to give us feedback or suggest what you would like us to cover in the future. Thank you again and join us next time.