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EACB Answer to

ESMA's consultation on Guidelines on funds' names using ESG or sustainability-related terms

February 2023

The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 27 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 2,700 locally operating banks and 52,000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 223 million customers, consumers, retailers and communities. The co-operative banks in Europe represent 87 million members and 705,000 employees and have a total average market share of about 20%.

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Introduction

The EACB welcomes the opportunity to provide feedback to ESMA's consultation on the setting up of guidelines proposing quantitative thresholds criteria for the use of ESG- and sustainability-related terminology in the names of UCITS (Undertakings for Collective Investment in Transferable Securities) and AIF funds, to combat the risk of greenwashing.

Co-operative banks inherently consider the value of proximity to the real economy of the EU's countries, regions, localities and communities by way of financing SMEs and families, which helps maintain a lively and sustainable community-focused society. This is important when considering the importance of co-operative banks in the communication channel with clients, even though it is normally the product manufacturers that would be involved in the naming of the funds. That said, even if the communication from co-operative banks is done in good faith and without any gross negligence, the banks are still open to risk of misleading ESG and/or sustainability claims. This is why the EACB is interested in responding to this consultation because we do see merit in standardising the concepts that investors first look at when deciding whether to invest in ESG/sustainable funds (e.g. the fund names seem to be a first port of call for investors), but there are several reservations we wish to address with the proposition being made for guidelines by ESMA in this regard.

General comments

Before answering the consultation questions, we wish to make some general statements concerning our priorities:

- **Underlying definitions:** Because sustainability and ESG (environmental, social, and governance) characteristics are not clearly defined in EU law, our members find that introducing quantitative minimum thresholds for the proportion of investments sufficient to support related terms in funds' names would be premature. At present, linking the use of sustainability and ESG terminology in funds' names to concepts that are vaguely defined in the Sustainable Finance Disclosure Regulation (SFDR) and fragmented across Member States would likely fail to hinder greenwashing and kick off a series of adverse knock-on effects instead. Before introducing said quantitative minimum thresholds, the SFDR, therefore, needs to be revised, and its concepts standardised. ESMA should then expressively advise National Competent Authorities (NCAs) to abstain from adapting, adding, and supplementing any guidance already set by the ESAs.
- **Contradictions:** Apart from definitional ambiguity, the present guidelines suffer several internal contradictions that we anticipate could thwart their objective. Firstly, while ESMA argues that the thresholds should be upheld "at all times" during the product life cylce, the SFDR, to which they are linked, posits that they should be specified "in accordance with the binding elements of the investment strategy". To accommodate for variation in a product's ability to meet the present minimum committments, we believe it should be conditional on certain events like the expiration of a denied start-up phase. Secondly, it is entirely unclear how the minimum safeguards that ESMA presumes connect to the remaining portfolio assets after the 80% threshold for ESG and impact-related naming is set, given that SFDR does not provide for such minimum safeguards criteria. Before any threshold can be effectively set, these discrepancies have to also be addressed.
- **Thresholds:** We consider the 80% threshold for ESG and impact-related terms and the 50% threshold for sustainability-related terms too high. An 80% minimum across all fund types and circumstances will excessively restrict the room for liquidity managament and hedging, unreasonably driving up liquidity requirements. A 50% minimum will likely be too high for

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most investment strategies that are suitable foir retial investors such as broadly diversified equity funds, failing to reach the most vulnerable consumers. Therefore, we suggest that thresholds should be lowered and introduced gradually.

Section 4.2. Proportion of investments for funds' names using ESG or sustainability-related terms

Q1. Do you agree with the need to introduce quantitative thresholds to assess funds' names?

Generally, the EACB agrees that there is a need for quantitative thresholds to verify fund names. At this point, however, we consider their introduction premature. That is, because the concepts that would underpin said fund names, namely "sustainable investment" and "ESG characteristics", are neither clearly defined nor easily distinguishable (e.g. some terms such as “climate” can fall under both categories, but the two terms should not be used interchangeably as they have different meanings). Linking the possibility of using sustainability terms in funds' names to concepts that are laid out in the Sustainable Finance Disclosure Regulation (SFDR) could, in fact, have adverse knock-on effects on consumers.

With the concepts that underly fund names not being clearly defined, their implementation will likely vary across firms. The task of assessing these "sustainable investment" and "ESG characteristics" claims will fall to consumers. Where funds with a small proportion of sustainable investments can be more sustainable than funds with a large proportion of sustainable investments because of methodological differences, such a task will be challenging. For professionals, this assessment will be barely feasible. For retail investors, it will be impossible. Rather than reliably linking funds' names to sustainable qualities of consumers' investment options, prematurely introducing quantitative thresholds could therefore overcomplicate their decision-making, mislead them, and ultimately discourage investment in sustainable funds.

Further, suppose national competent authorities (NCAs) adapt the present guidelines to the domestic context. In that case, the meanings of "sustainable investment" and "ESG characteristics" are bound to fragment further, aggravating asset managers and consumers. ESG-dedicated funds already face a highly complex environment marked by uncertainties as NCAs apply diverging requirements. And consumers already face invalid, misleading fund names. Introducing thresholds that are tied to poorly defined terminology with space for interpretation by NCAs will not remedy but exacerbate these problems, possibly fostering greenwashing and making it even more challenging to control in the future. Even later on, ESMA should, therefore, expressively articulate the expectation that NCAs should transpose the guidelines without adaptions, additions, and supplementary guidance.

Whilst we empathise with ESMA that definitions are a Level 1 issue and not within their remit, we have a final reservation about these guidelines. They circumvent Level 1 by attributing meaning to terminology that lacks legal certainty.

Still, we agree that there is a need for a fund name to reflect the purpose of the fund to which it has been assigned. A fund's name could be verified, for example, by conditioning its name on the majority (> 50%) of its net asset value (NAV) being invested in corresponding assets.

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Q2. Do you agree with the proposed threshold of 80% of the minimum proportion of investments for the use of any ESG-, or impact-related words in the name of a fund? If not, please explain why and provide an alternative proposal.

Regarding the 80% threshold as a minimum proportion of investments for the use of any ESG or impact-related words in the fund's name, too, the EACB is concerned that its introduction would be premature. In our opinion, basing the percentage threshold on the planned asset allocation in the pre-contractual templates might lead to greenwashing if the actual asset allocation in the periodic reporting templates is below the threshold for a fund with terminology linked to ESG, sustainability and impact.

Furthermore, introducing this threshold across all fund types and circumstances would likely be excessive for two reasons.

Firstly, from a risk management perspective, limiting the share of instruments available for liquidity management and hedging to 20% would be counterproductive. Cash and money market instruments used as liquidity buffers do not typically have ESG characteristics. Index futures and other derivatives commonly used in hedging will likely fail to meet the criteria of an individual ESG strategy as laid out in the prospectus. And, finally, ESG derivatives are inferior in terms of liquidity and pricing.

Secondly, an 80% share might unreasonably restrain the funds' liquidity, while they are obliged to hold sufficient liquidity to, for example, be able to meet ad hoc redemption requests.

To be workable for all fund types and in various market conditions, the threshold should therefore be lowered and could be introduced gradually. In line with the principle of fair, clear, and non-misleading communication, we consider it feasible to set the threshold at 50%, where its name will correspond to the investment strategy by which it is backed.

Q3. Do you agree to include an additional threshold of at least 50% of minimum proportion of sustainable investments for the use of the word "sustainable" or any other sustainability-related term in the name of the fund? If not, please explain why and provide an alternative proposal.

The EACB finds that introducing a threshold that designates a fund as "sustainable", an ambiguous word in EU law, premature (see Q1). Because of these unclarities about the criteria that define sustainable investment and the correct approach to calculating their share at the portfolio level, the determination of a minimum quantitative requirement should be postponed.

Pending answers from, amongst others, the Commission will reshape our understanding of sustainable investment. Once set and harmonised, discussing a minimum proportion of sustainable investment for using the word "sustainable" will then make sense. Calculations of sustainable investments could, for example, be based on the proportion of revenue derived from sustainable business activities. In this scenario, the 50% threshold would likely be too high for most investment strategies that are suitable for retail investors, such as broadly diversified equity funds.

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Q4. Do you think that there are alternative ways to construct the threshold mechanism? If yes, please explain your alternative proposal.

As explained in our responses to questions 1 through 3, we generally support the introduction of thresholds. It is, however, too early, given especially the vague and thus varying definitions of sustainability and methods for calculating the proportion of sustainable investment at the portfolio level, which could ultimately discourage consumers from seeking these investment opportunities.

After the methodology for assessing "sustainable investments" and "ESG characteristics" have been clarified through an SFDR review and these labels' applicability assured, we fully support the direct linking of the present thresholds to the portfolio composition commitments envisaged by the SFDR (ESG Annex). This linkage yet still suffers from two inconsistencies, which should be removed.

Firstly, ESMA has expressed that the present minimum commitments should be maintained "at all times" during a product's lifecycle. At the same time, the SFDR details that they should be specified "in accordance with the binding elements of the investment strategy". It should therefore be legitimate to make the commitment itself conditional on specific events like the expiration of a denied start-up phase following the fund launch.

Secondly, the relationship between minimum safeguards presumed by ESMA to apply to all portfolio assets and the 80% commitment in terms of environmental and/or social characteristics is entirely unclear. The SFDR does not impose material requirements for environmental or social features that can be promoted as binding elements of the investment strategy. It is evident that exclusion criteria, if based on specific environmental or social considerations, qualify as relevant environmental and/or social characteristics and are sufficient for a product to disclose under Article 8 SFDR. This means, however, that a binding commitment in terms of minimum exclusions (the minimum safeguards provided for the remaining 20%), if applied at minimum to 80% of investments, would already meet the relevant threshold for environmental or social characteristics and qualify a fund for using ESG-related words in the fund name. From the consultation paper, it seems that ESMA expects additional criteria to apply over and above the 80% threshold for which there is no separate reference point under SFDR.

Before any threshold can effectively be set, these discrepancies must also be treated. The EACB would, therefore, once again express its concern that their introduction would presently be premature.

Q5. Do you think that there are other ways than the proposed thresholds to achieve the supervisory aim of ensuring that ESG or sustainability-related names of funds are aligned with their investment characteristics or objectives? If yes, please explain your alternative proposal.

As an alternative, our members have also considered to base the naming of sustainable funds on the existing MiFID II Framework. Accordingly, a fund can only be offered to a client with sustainability preferences if the fund either considers: (i) the principal adverse impact of investment decisions on sustainability factors (PAI), (ii) makes sustainable investments within the meaning of Article 2 (17) SFDR or (iii) makes environmentally sustainable investments within the meaning of Article 2(1) of the Taxonomy Regulation. However, we consider that each case (i) to (iii) this should be without a specified minimum quota because MiFID II allows investors to

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pick investments according to their personal preferences (e.g. the client might have particular impacts in mind when selecting PAIs), and such preferences cannot be generalized: especially a fund that is fitting the preference of one client might not match with the preference of a different client.

Before this solution is workable, however, three conditions must be met. Firstly, definitions under the SFDR (e.g. sustainable investment) and methodologies under the Article 8 Taxonomy alignment requirements, have to be clarified. Secondly, it must be ensured that the "Do No Significant Harm" principle is respected and aligned between the concepts now under Taxonomy (minimum safeguards) and SFDR. Thirdly, it is important to ensure that transition funds, as well as underlying products such as green bonds relying on international standards (e.g. ICMA green bond principles) will not be discriminated against using this proposal.

Q6. Do you agree with the need for minimum safeguards for investment funds with an ESG- or sustainability-related term in their name? Should such safeguards be based on the exclusion criteria such as Commission Delegated Regulation (EU) 2020/1818 Article 12(1)-(2)? If not, explain why and provide an alternative proposal.

The EACB disagrees that there is a need for minimum safeguards to be put in place by investment funds with an ESG or sustainability-related term in their name. We do not support their introduction, especially through an undifferentiated reference to the Paris-Aligned-Benchmark (PAB) framework, for the following reasons:

The application of minimum exclusions would discriminate against widely valued funds-of-funds funds and multi-asset funds, which would have difficulties in ensuring a commitment to exclusion criteria that involve quantitative thresholds because they lack, for example, up-to-date information on the target fund's portfolio composition.

The PAB exclusions that ESMA proposes would not be an appropriate market standard for all ESG strategies, especially those with other climate change unrelated, environmental or social objectives. They could discourage investment strategies that aim at supporting a sustainable transition where they are most needed. With fund managers being required to divest from these strategies, especially the energy sector could be affected, as large utility providers have already started on their sustainable transition plans but still rely for a large part of their revenue on GHG-intense forms of energy generation.

Alternatively, then, ESMA could consider proposing specific exclusions as good practice standards without prescribing their use. This list should be restricted to ESG investment- relevant good practice exclusions. Concerning the proposed PAB standard, this would apply to the exclusion criteria in Art. 12 (1)(a), (b) and (c) of DR 2020/1818.

Q7. Do you think that, for the purpose of these Guidelines, derivatives should be subject to specific provisions for calculating the thresholds?

The EACB believes that ESMA should abstain from introducing specific provisions for calculating the thresholds presented in these guidelines in relation to derivatives or any other assets. This is because although the treatment of derivatives in the consideration of commitments to environmental/social characteristics or sustainable investments is not outlined under SFDR Level

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1, there exists the transparency provision mandated under the SFDR Level 2 templates for pre-contractual disclosures, whereby managers would normally have to explain whether and under which conditions a fund can invest in derivatives as part of its sustainable finance investment strategy. Therefore, if further clarification on the treatment of derivatives in ESG investments is required, then this should only be sought under Level 1 or Level 2 legislation (although we are further reflecting whether to do this under SFDR, Taxonomy, MiFID II or another legislation).

a) Would you suggest the use of the notional value or the market value for the purpose of the calculation of the minimum proportion of investment?

b) Are there any other measures you would recommend for derivatives for the calculation of the minimum proportion of investments for naming purposes?

No, there are no other measures that the EACB would like to recommend to this end, as we do not support the prescription of a dedicated calculation method through the fund naming guidelines. But this should not prevent working on the marketplace to set standards that could be endorsed in future regulations.

Section 4.3. Additional recommendations related to fund names

Q8. Do you agree that funds designating an index as a reference benchmark should also consider the same requirements for funds names like any other fund? If not, explain why and provide an alternative proposal.

The EACB agrees that index-replicating funds should follow the same rules as actively managed funds as regards ESG naming to keep the playing field level.

In order to do so, ESG benchmark and ESG index providers should be subject to the guidelines.

Q9. Would you make a distinction between physical and synthetic replication, for example in relation to the collateral held, of an index?

We would not make a distinction between the physical and synthetic replication of an index. For example, the exposure to be considered is made up of the assets held by the fund in a physical replication, while it is the index exposure provided through the total return swap leg in a synthetic replication. Therefore, in the case of a synthetic replication, the assets held by the fund (unduly named collateral) would be disregarded for the proposed thresholds.

Q10. Do you agree with having specific provisions for "impact" or impact-related names in these Guidelines? If not, please explain why.

The EACB does not concur with having specific provisions for "impact" or impact-related names in the present guidelines, unless a clear definition of what constitutes "impact" or impact-related is defined. Whilst the consultation attempts to define "impact" as *"funds investing their minimum proportion with the intent to generate positive, measurable social or environmental impact alongside a financial return"*, we think that this or any other definition should be determined under Level 1 regulation, for example, by reviewing the SFDR. This argumentation is an extension of the same issue with defining "sustainable investment", "sustainable" and "ESG" in

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the Level 1 of the sustainable finance framework. It is already unclear what "sustainable" and "impact" means, let alone the distinction between sustainable and ESG, as well as related terms to sustainability, ESG and impact.

Q11. Should there be specific provisions for "transition" or transition-related names in these Guidelines? If yes, what should they be?

We believe ESMA should not include specific provisions for "transition" or transition-related names in these guidelines. As elaborated upon in our response to question 6, large commercial enterprises that could make a big difference towards a sustainable economy must remain invisible for this change to come through. In our view, specified provisions for "transition" and transition-related names would hinder investment in these big players and, by extension, their transition, wherefore we oppose their introduction.

Q12. The proposals in this consultation paper relate to investment funds' names in light of specific sectoral concerns. However, considering the SFDR disclosures apply also to other sectors, do you think that these proposals may have implications for other sectors and, if so, would you see merit in having similar guidance for other financial products?

At this point, the EACB finds it difficult to judge the outcome of these options. We believe that an in-depth evaluation by ESMA is required regarding broadening the scope only after the sustainability-related clarifications previously mentioned have been made.

Section 4.4. Application and transitional period

Q13. Do you agree with having a transitional period of 6 months from the date of the application of the Guidelines for existing funds? If not, please explain why and provide an alternative proposal.

As explained above, the EACB believes that the immediate introduction of the present guidelines would be premature. In any case, however, a transitional period of 6 months from the date of their application for existing funds would be too short. The period should be at least 12 months, given that changing fund names involves contacting and informing customers, is a time-consuming process and should only ensue once national supervisory authorities have translated them into national law.

Q14. Should the naming-related provisions be extended to closed-ended funds which have terminated their subscription period before the application date of the Guidelines? If not, please explain your answer.

Naming-related provisions should not be extended to closed-ended funds that have terminated their subscription period before the application period of the present guidelines. These funds will have already closed all of their investments by the time that these guidelines become effective. To still comply with them, asset managers would have to either change their funds' names or the assets allocated to these funds. This post hoc change could negatively impact the closed-ended funds' performance by damaging investors' trust as they will have signed for something else.

Therefore, the EACB supports grandfathering in current rules for closed-ended funds that will have terminated their subscription period before the application period of the present guidelines.

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Q15. What is the anticipated impact from the introduction of the proposed Guidelines?

From our venture point, the introduction of the herein proposed guidelines would be premature at the present time. They will fail to effectively counteract greenwashing, overcomplicate the decision-making process for retail investors, and potentially reduce sustainable investment options' attractiveness. They will likely entail additional costs in terms of staff training and IT systems for the purpose of compliance.

Q16. What additional costs and benefits would compliance with the proposed Guidelines bring to the stakeholder(s) you represent? Please provide quantitative figures, where available.

We see costs accumulating in various areas as a consequence of the proposed guidelines, mainly because all rules need to be applied to all funds at once. Marketing materials, amongst others, need to change, monitoring of the thresholds needs to be put in place, data needs to be bought and processed to verify them.

Contact:

The EACB trusts that its comments will be taken into account.

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