

Guidelines on funds' names using ESG or sustainability related terms

ESMA's Consultation

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AMAFI's answer

Association française des marchés financiers (AMAFI) is the trade organization working at national, European and international levels to represent financial market participants (FMPs) in France. It mainly acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI has 170 members operating in equities, fixed income and interest rate products, as well as commodities, derivatives and structured products for both professional and retail clients. Nearly one-third of its members are subsidiaries or branches of non-French institutions.

I. GENERAL COMMENTS

AMAFI welcomes the opportunity to answer ESMA's consultation paper on Guidelines on funds' names using ESG or sustainability related terms. Although AMAFI is not an association representing the fund industry, it takes the opportunity to respond to this consultation paper since it represents firms who work closely with asset managers and because it is involved in different initiatives regarding sustainable finance. Particularly, we are currently working on two initiatives:

- The development of a professional standard for ESG structured products,
- The treatment of derivatives in the sustainable finance regulation and more specifically how they should be accounted for in Taxonomy alignment ratios.

The treatment of derivatives is a topical matter which raises many questions as stated during the Open Hearing of the consultation and for which regulatory guidance is needed. AMAFI has been working for several months to clarify the role of derivatives in sustainable finance, starting with a paper explaining their main usage overall in the economy ([AMAFI / 21-47](#)). We also had the opportunity to provide comments on this matter to the European Union Platform on Sustainable Finance (PSF) in relation to its work on how to account for them in the Taxonomy GAR ([AMAFI / 22-37](#)). Currently, we are working on a methodology for the treatment of derivatives in the Taxonomy.

Some of the provisions of this consultation echo industry discussions at AMAFI. As such, we will focus on questions 6, 7 and 9 of the proposed Guidelines.

II. ANSWERS TO THE QUESTIONS

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.

AMAFI believes that the minimum safeguards proposed by ESMA, which are based on exclusion criteria and that would be applied to all investments of a fund, are not appropriate.

Firstly, PAB is a tool tailored to the Paris agreement aligned targets, which is mainly focused on climate. It is not suited for strategies that are not fully climate oriented.

Secondly, basing minimum safeguards on exclusion criteria is likely to result in limiting the selection to assets which are already eligible to the 80 % threshold category, requiring de facto from the “remaining investments” similar credentials as the other assets of the fund. This would go beyond the foreseen notion of minimum safeguards ESMA is seeking views on, especially in the current state of the transition of the economy. Finding the right balance to define these minimum safeguards is important, as these remaining investments should be flexible enough to allow for a workable constitution of the fund, while not authorising assets which significantly harm E, S or G criteria. This pocket of flexibility is a concept that exists in similar contexts: for example, the AMF authorises a fund to communicate prominently on its ESG characteristics if 90% of its investments are filtered, leaving the remaining 10% at the discretion of the asset manager ([see *Position-Recommandation AMF n° 2020-03*](#)).

Another solution could be to require the use of Principle Adverse Impacts that are mandatory according to SFDR. Such an approach would make it possible to take into consideration the E, S and/or G aspects of the assets suited to the investment objective of the product, and would therefore provide the necessary flexibility without hampering product innovation in the ESG space. This approach would also be more proportionate for “remaining investments”: although their characteristics would not enable them to be part of the 80% minimum threshold, they would show a level of commitment by considering the negative impacts.

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

AMAFI welcomes the consideration given to derivatives in the calculation of the minimum proportion.

Specific provisions are indeed needed because derivatives play a role in sustainability (1) and current EU legislation on sustainable finance does not have a consistent approach towards them (2).

(1) Further than hedging risks and facilitating financing in the economy, derivatives play an important role for investors in covering the risks of their portfolio, enabling exposure to ESG assets in a cost-effective manner and influencing the cost of capital of the companies they invest in or disinvest from¹.

In their hedging capacity, derivatives enable investors to cover the risks of their portfolio, contributing directly to their appetite to buy securities in the primary and secondary markets, hence contributing to their liquidity.

¹ See in this respect, [FCA's consultation CP22/20, section 4.10, Box 3](#), which describes the three main channels or mechanisms by which an investor may plausibly contribute to positive outcomes for the environment and/or society, its impact on the cost of capital being one of them.

Investors also use derivatives to manage their exposure to the equity market while gaining some form of market risk protection or to replicate exposure to indices such as ESG ones. Derivatives are essential tools for insurers and pension funds to seek exposure to the market in a cost-efficient way. In allowing for the consideration of investors' risk appetite, derivatives allow broader participation of end investors to the price formation of the securities concerned. Indeed, by taking economic exposure on the equity and corporate bonds markets, investors participate in sharing companies' business risk and contribute to the definition of their cost of capital/cost of funding. By influencing companies' cost of capital/cost of funding, investors signal directions to the market and entire industry sectors.

For these reasons, AMAFI strongly believes that derivatives should be considered for the calculation of the minimum proportion of investments used to meet the environmental or social characteristics or sustainable investment objectives.

(2) However, financial institutions and investors currently face inconsistencies and uncertainties in the treatment of derivatives in the sustainable finance regulation, for example, between ESG regulatory classification obligations in MiFID II and SFDR which acknowledge the contribution of derivatives in sustainability assessment criteria (e.g. "Sustainable Investments" or "PAI") however without providing guidance as to how to compute them. In addition, derivatives are currently penalized by Taxonomy-alignment ratios both at fund and entity level due to a lack of consensus on the methodology².

It is therefore important to have a consistent approach towards derivatives among the various pieces of sustainable finance regulations that clarifies how derivatives can be taken into account both positively and negatively. We therefore call for a coordinated approach between the various stakeholders involved (notably the European Commission, the ESAs and the EU Platform on Sustainable finance) and across the various regulations concerned.

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?

AMAFI considers the suggested measures to be ill-suited for the calculation of the minimum proportion.

The market value or "price" of the derivative contract provides no information on the exposure provided by the derivative to the underlying assets. For example, the "impact" or "responsible investment" of an investor buying a call option on shares is not the cash that it pays to buy that option.

The notional value of an option is the price of the underlying multiplied by the number of underlying securities referenced in the contract. For an equity option, it is the value of the shares that the contract refers to, but it is not a measure of the exposure of the option holder to the underlying shares.

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

AMAFI believes that using the delta is the best method for this calculation because it provides a measure of the exposure gained through derivatives to the underlying shares or bonds. The exposure of the investor to the assets is what ultimately needs to be considered in the minimum proportion of investments, as the investor supports the risk of these assets, which shows its contribution to the corresponding companies.

² Financial institutions are required to compute the Green Asset Ratio (GAR) by excluding derivatives from the numerator, i.e. assets financing and invested in Taxonomy-aligned economic activities, while including them in the total assets value of the denominator. This means that derivatives are seen as harmful for the emergence or development of sustainable activities and that the institutions offering them could not, even in theory, achieve a green asset ratio of 100%. This approach wrongly signals an incompatibility of derivatives with sustainability.

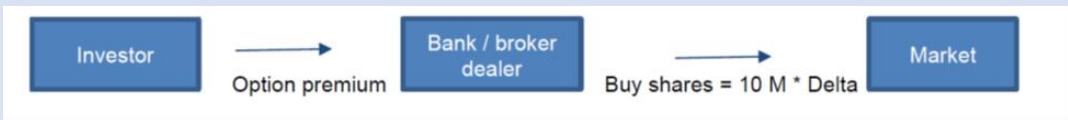
The delta represents the amount by which the derivative’s value increases or decreases for a given change in the price of the underlying. All financial institutions (such as banks, investment firms, asset managers and insurers) using derivatives compute the delta of their derivative positions on a daily basis for risk management purpose.

For the sake of clarity, it should be noted that both positive and negative delta exposures need to be considered, as this is key to reflect the true picture of all positions held by the various stakeholders.

The example below illustrates how this would work for a call option.

Example

An investor, subject to the publication of the Green investment ratio and SFDR product Taxonomy ratio, purchases a call option on the shares of the company Windturbine for a nominal of 10M euros.



	Investor	Bank / broker dealer	Seller of the share in the market
Economic exposure to the shares	10 M x Delta	Zero (as the bank/broker dealer is delta hedged)	-10 M x Delta
Taxonomy exposure	10 M x Delta x Taxonomy alignment ratio of the company (this contributes to the GIR)	Zero (as the bank/broker dealer is delta hedged)	- 10 M x Delta x Taxonomy alignment ratio of the company

The above long call position results in the investor having a Taxonomy exposure, and the seller of the shares having the opposite Taxonomy exposure. Therefore, when both long and short delta exposures are considered, there is no Taxonomy inflation.

AMAFI is currently working on a methodology to include this approach based on the delta to measure derivatives’ contribution to sustainability. Please note that the exposure approach for derivatives based on the delta is already used in risk management frameworks and included in EU regulation – for illustration purposes, the UCITS guidelines issued by CESR on 28 July 2010, and the Commission Delegated Regulation 918/2012 on Short Selling³ (for the purposes of calculating the net short position in shares).

We are nonetheless aware that the details of the methodological aspects for sustainability purposes have to be discussed and determined in subsequent industry consultations and potentially in the

³ Annex II, Part 1: “Any derivative and cash position shall be accounted for on a delta-adjusted basis, with cash position having delta 1. To calculate the delta of a derivative, investors shall take into account the current implied volatility of the derivative and the closing price or last price of the underlying instrument. In order to calculate a net short position including equity or cash investments and derivatives, natural or legal persons shall calculate the individual delta-adjusted position of every derivative that is held in the portfolio, adding or subtracting all cash positions as appropriate.”

context of the work of the new ad hoc expert group on derivatives that we expect the PSF to launch in the coming months.

It is also expected that SFDR be revised. Hence, we would recommend extending the implementation timeline suggested by ESMA to take into account other regulatory timelines and revisions also addressing the treatment and methodology of derivatives in Taxonomy and SFDR/MiFID ratios.

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

No distinction is needed. When a Total Return Swap is used by a fund to replicate an index or a reference benchmark using derivative instruments, it benefits from the same exposure effects than if it directly replicated the index. That is because the assets in the portfolio held by the fund are swapped against the exposure to the assets held by the counterparty. The fund still holds the assets but transfers their performance through the TRS and unitholders do not have exposure to the assets held by the fund anymore.

In such a manner, unitholders are exposed to the risks and benefits associated to the exposure portfolio, not to the portfolio held by the fund. This must lead to the application of the same treatment between physical and synthetic replications.

