ISDA® Safe, Efficient Markets

Consultation Response

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

20 February 2023

Introduction

The International Swaps and Derivatives Associations (ISDA) appreciates the opportunity to provide comments to the European Securities and Markets Authority (ESMA) on its proposed guidelines on funds' names using ESG or sustainability-related terms (the "Consultation Paper"). ISDA is committed to supporting the transition towards a more sustainable economy and recognises that derivatives have an important role to play in achieving such transition. The Consultation Paper addresses a number of issues related to the manner in which funds and advisers incorporate environmental, social, and governance ("ESG") factors in to their investor disclosures, but given our role as the voice of safe and efficient global derivatives markets, our comments are limited to aspects of the Consultation Paper that reference derivatives instruments.

We are pleased to share our recommendations to inform the ongoing discussion regarding the calibration of the EU regulatory framework for derivatives from a sustainability perspective. We are therefore pleased to provide input into ESMA's important work regarding the usage of ESG or sustainability-related language in fund labelling. Additionally, we would like to note our endorsement of the response submitted by the European Fund and Asset Management Association (EFAMA) to Q7 under this consultation, given our shared interest to develop a common cross-industry methodology for the calculation of the minimum proportions of sustainable investments for derivatives transactions in the near future.

Executive Summary

- A common cross-industry methodology for the calculation of the minimum proportions of sustainable investments for derivatives transactions is paramount to attain ESMA's policy goal of promoting standardized disclosures that enable investors to compare information across firms and financial instruments but more time is needed to conclude such a homogenous regulatory methodology for derivatives.

- ISDA has been working towards reaching a consensus on the methodology to classify derivatives as ESG/sustainable/taxonomy-aligned and to include them into related ratios. ESMA should thus not impose a mandatory methodology for derivatives in the final guidelines on fund names before a final industry consensus has been attained.

- Derivatives whose underlying's are companies' equity and debt contribute to sustainability objectives / ESG characteristics proportionately to the exposure they offer to their underlyings. They should thus be included in threshold calculations based on this exposure, and their underlying assets' sustainability/contribution to ESG characteristics.

- Interest rate (IR), foreign exchange (FX), carbon and commodity trading derivatives have neutral underlyings with respect to the Taxonomy and SFDR definitions of sustainable investments as they are not linked to eligible economic activities, albeit they may still facilitate the implementation of a sustainable strategy.

- The EC is in the process of considering a review of the SFDR regime in a way that may directly affect many of the factors linked to the ESMA guidelines regarding fund names, including derivatives' inclusion. This needs to be carefully considered and puts into question any intention to adopt rules that would become effective early in the next year on the basis of assumptions that can be revisited within a very short timeframe.

- Derivatives are treated inconsistently within SFDR at product/fund level. We urge EU regulators to rectify the current treatment and take derivatives into consideration in funds' taxonomy ratios based on their underlyings, and in a consistent manner in the numerator and the denominator of the relevant KPIs.

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

ISDA's members' activities in derivatives are of paramount importance for their ability to answer their clients' needs both in terms of financing and investing. ISDA has been working over the past two years on the contributory role of derivatives to sustainable finance and was given the opportunity to provide comments on this matter to the EU's Platform on Sustainable Finance (PSF) in relation to its work on how to account for them in the A8 Taxonomy reporting for financial institutions.

The PSF's report[1] on Data and Usability of the EU Taxonomy did not reach consensus on the future treatment of derivatives and called on the European Commission (EC) to undertake further research via its successor (PSF 2.0) on the use of derivatives for Article 8 Taxonomy reporting by financial institutions until the 2024 review period of the A8 Taxonomy Delegated Act (DA). It suggested two options:

1) remove derivatives from both numerator and denominator in KPI reporting;
2) include the Underlying value*Delta in both numerator and denominator – for derivatives that provide an economic exposure to the underlying company.

It is important to note that the two options put forward by the PSF are based on coherent numerators and denominators (either both exclude derivatives, or both include derivatives with the delta approach). ISDA is currently assessing these options in collaboration with other industry participants.

Although the PSF's recommendations pertain only to the alignment of derivatives with the Taxonomy, they are of wider importance because of the needed consistency across all ESG/sustainability/taxonomy classifications and ratios, both at entity and product level.

Currently, the financial services industry is in the process of forming consensus around how to assess the ESG/sustainable classification of derivatives, and how to include them in the minimum proportion of sustainable investments. A common cross-industry methodology is paramount to attain ESMA's policy goal of promoting standardized disclosures that enable investors to compare

[1] Platform on Sustainable Finance's recommendations on data and usability of the EU taxonomy (europa.eu)

information across firms and financial instruments. Nevertheless, as mentioned above, more time is needed to conclude on a homogenous regulatory methodology for derivatives.[2]

We thus urge ESMA not to impose a mandatory methodology for derivatives in the final guidelines on fund names, before a final consensus is attained.

ISDA has been working towards reaching a consensus on the methodology to classify derivatives as ESG/sustainable/taxonomy-aligned and to include them into related ratios - we present below the current state of this ongoing work:

ESG characteristics and sustainable investment objectives can both be attained through the use of derivatives, as clearly acknowledged within the SFDR Regulatory Technical Standards (RTSs)[3]. Indeed, the RTSs require that Art. 8 and Art. 9 funds make specific disclosures to explain, where applicable, how derivatives are used to attain ESG characteristics or sustainable objectives, both in pre-contractual documentation and periodic reporting. Nonetheless, neither the SFDR (level 1 text), nor its RTSs or associated Q&As, detail the methodology to account for the ESG characteristics or the sustainable investment proportion of a derivative. In addition, derivatives are discriminated in the methodology set-out in Taxonomy and SFDR to calculate in the fund-level taxonomy-alignment (as they are included in the denominator but excluded from the numerator).

We propose the development of a methodological approach for derivatives ESG/sustainability classification and coherent inclusion in fund-level thresholds, in line with (i) ISDA's response to the ESMA MIFID ESG Product Governance guidelines consultation[4], and (ii) the PSF's report as regards the use of derivatives. This methodological approach could also apply to structured products that use derivatives with ESG characteristics or sustainable investment exposures in their cash-flows (i.e. in their "performance leg").

In particular, derivatives whose underlying's are companies' equity and debt contribute to sustainability objectives / ESG characteristics proportionately to the exposure they offer to their underlyings. Hence, they should be included in threshold calculations based on this exposure, and their underlying assets' sustainability/contribution to ESG characteristics .

Concurrently, as highlighted in the PSF's report, interest rate (IR), foreign exchange (FX), carbon and commodity trading derivatives have neutral underlyings with respect to the Taxonomy and SFDR definitions of sustainable investments as they are not linked to eligible economic activities.

It is very important to distinguish "neutral" (i.e. out of scope) from "non-sustainable" derivatives.

Indeed, an equity or bond could be considered as a non-sustainable investment, and thus duly have a nil contribution to the numerator of the sustainable investment thresholds, and signaling to investors that there are investments within funds in non-sustainable activities. Nevertheless, IR and FX derivatives do not expose investors to any kind of activities but are simply tools for asset managers to manage their own internal risks; they are thus outside the scope of sustainability considerations. Hedging IR/FX risks should thus be excluded from ESG considerations and from the minimum thresholds of ESG characteristics or sustainable investments – both from the numerator and the denominator. Not excluding them from these

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[2] Please refer to ISDA's response to the SEC Rule Proposal: ESG Disclosures by Certain Investment Advisers and Investment Companies: SEC-filed-ISDA-ESG-funds-letter-081622.pdf

[3] JC 2021 03 - Joint ESAs Final Report on RTS under SFDR.pdf (europa.eu)

[4] Please refer to ISDA's response to the review of ESMA's guidelines on the MiFID II product governance rules: https://assets.isda.org/media/96dd7ed5/2ea3b2a1-pdf/?_zs=5CRsN1&_zl=Vuor6

thresholds is confusing for investors, and impedes them from distinguishing between funds that (i) invest in non-sustainable activities vs. (ii) hedge IR/FX risks.

It is noteworthy however that, even though their underlying's are outside the scope of sustainability considerations, these derivatives may facilitate the implementation of a sustainable strategy, especially when including transparent, measurable and verifiable ESG KPIs that are aligned with such strategy.[5]

ISDA's views on suggested metrics for calculation thresholds

Before reaching a clear view on the appropriate methodology to assess derivatives' sustainability, current regulation requires that derivatives be included only in the denominator of taxonomy ratios (GAR and fund-level) with their Mark-to-Market value. We believe that the market value or "price" of the derivative contract does not in any case reflect/represent the economic exposure to the underlying. By way of illustration, the "impact" or "responsible investment" of an investor buying a call option on shares is not the cash that it paid to buy that option but the equivalent number of shares that that option entitles him to have i.e. the delta[6] equivalent of the shares that the option provides.

An exposure value that is readily available to be used is a delta equivalent approach which reflects the economic exposure that the derivative provides to the underlying asset(s) / companies. The delta of the derivative, already referenced in a variety of EU regulations, is the equivalent cash amount that would be invested in companies' debt or equities that would lead to similar price signal on the considered company financial instruments.

Banks that provide a derivative compute the equivalent market exposure of each derivative, through its delta, on a daily basis. The delta represents the amount by which a derivative value would increase or decrease for a given change in the price of the underlying financial instrument. Banks hedge their derivative positions by getting exposure to the underlying asset up to their delta amount (to be "delta neutral" i.e. a change in derivative price would be offset by a change in securities' price). As derivatives take many forms (e.g. swaps, options, etc.), using the delta approach to evaluate their ESG/sustainable classifications has the advantage of being easily applicable to all types of derivatives as it is a common metric already used by all financial institutions, and defined within the market risk management framework. It does not therefore require a specific definition to be used for SFDR or taxonomy classifications.

The use of the delta position is thus readily available to reflect the economic exposure gained through derivatives and may also be used for the purpose of the calculation of the minimum proportion of investment for derivatives transactions. However, as mentioned above, the industry is still working towards reaching a consensus on an agreed exposure metric that is representative across firms and across asset types.

Note that the notional amount[7] does not provide information on the economic exposure of the underlying financial instrument and will be misleading as it may cause funds to over disclose the actual amount of their minimum proportion of sustainable investments. Such an approach also runs the risk of greenwashing as it could cause funds that do not invest in derivatives to disclose lower proportion of sustainable investments than funds that do utilise derivatives, even though

[5] Please refer to ISDA's white paper outlining key performance indicators (KPIs) guidelines for Sustanability Linked Derivatives (SLDs): Sustainability-linked-Derivatives-KPI-Guidelines-Sept-2021.pdf (isda.org)

[6] Delta expressed as a fraction or percentage is the sensitivity of a derivative to movements in the underlying asset.

[7] Please refer to ISDA's research paper on the Use of Notional Amount in Derivatives Regulation: Notional-Based-Regs.pdf (isda.org)

the former may actually have a higher proportion of sustainable investments for naming purposes based on their direct investments in actual operating companies.

Moreover, ESMA should take note of the fact that the EC is in the process of considering a review of the SFDR regime in a way that may directly affect many of the factors linked to the ESMA guidelines regarding fund names, including derivatives' inclusion. This needs to be carefully considered and puts into question any intention to adopt rules that would become effective early in the next year on the basis of assumptions that can be revisited within a very short timeframe.

ISDA's views on the treatment of derivatives in the EU's Sustainable Finance framework

There is a need for consistency between the different regulatory provisions impacting the use of derivatives, calling for policy clarification without waiting for the first publication of the GAR in 2024 or the 2024 review of the A8 Taxonomy DA as suggested by the PSF. The Taxonomy alignment ratio is key for (i) MiFID ESG Preferences which is live since August 2022 and (ii) SFDR Level 2 which is live since 1 January 2023 and likely to be revised from October 2023.

Current EU legislation on sustainable finance does not have a consistent approach towards derivatives whereas it only provides ESG classification methodologies for securities. Hence, financial institutions and investors face inconsistencies and uncertainties between, on the one hand (i) ESG regulatory classification obligations in MiFID II and SFDR but missing methodological instructions on how to tackle derivatives either as part of a fund or when sold directly to clients, and on the other hand, (ii) penalizing treatment within Taxonomy-alignment ratios (at fund level and entity level).

While it has previously been recognised by ESMA that there may be legitimate cases for derivatives to be recognised for directly contributing to taxonomy-aligned economic activities, out of an abundance of prudence it has been preferred to exclude derivatives from the numerator of the Article 8 Taxonomy reporting KPIs for financial undertakings and the SFDR KPI and to reconsider this issue in the future once there would be more evidence in this area to allow a different conclusion. The SFDR Level 2 legislation notes in particular that *"Due to the lack of reliable methodologies to determine to what extent exposures achieved through derivatives are exposures to environmentally sustainable economic activities, such exposures should not be included in the numerator."* [8]

In particular, derivatives are treated inconsistently within SFDR at product/fund level: while allowing funds to use derivatives for their ESG characteristics or objectives, SFDR imposes that derivatives be fully penalised within the fund-level taxonomy-alignment ratio, i.e. they are excluded from the numerator, but included in the denominator – this is equivalent to considering them eligible instruments for taxonomy classification, but 0% aligned, in contradiction with the previous regulatory standpoints. The same asymmetric framework applies at entity level for all financial institutions when measuring their Taxonomy alignment. We believe that these inconsistencies regarding ESG derivatives need to be addressed rapidly, as they are highly confusing and unduly favour greenwashing accusations despite financial institutions' best efforts to comply with regulatory obligations. Moreover, this asymmetric framework would have detrimental/negative consequences on the EU derivatives market, among others:

- Financial institutions will not benefit from the same level of market risk protections / tailoring when investing in taxonomy aligned activities compared to other investments and will likely reduce their investments in taxonomy aligned activities;

[8] C_2022_1931_1_EN_ACT_part1_v6 (1).pdf (europa.eu)

- Investors may restrict their derivatives activities to cash equity/bond for the sake of achieving better Taxonomy alignment ratios;

- It ignores the role of derivatives to foster investments by providing companies with a reduction in their cost of capital and market risk tailored to their risk appetite and profile, and/or by opening them access to wider markets and investment opportunities;

- It ignores the role that derivatives play for retail investors helping them participate to the equity market via capital protected products. Retail appetite to Taxonomy aligned products may reduce as a consequence;

- It ignores the fact that banks selling to investors derivative instruments – e.g. bonds or shares issued by companies with taxonomy aligned activities – will invest directly or indirectly in these bonds or shares to hedge their position, hence contributing to the financing itself of these activities.

In view of the above, we urge EU regulators to rectify the current treatment and take derivatives into consideration in funds' taxonomy ratios based on their underlyings, and in a consistent manner in the numerator and the denominator of the relevant KPIs. We propose that the methodological approach to be developed for "sustainable investments" be applied for taxonomy purposes, i.e. Taxonomy alignment to a derivative underlying, whilst excluding out of scope derivatives both from the numerator and the denominator of all ESG/sustainability/taxonomy ratios.

The contributory role of derivatives in sustainable finance

The exponential growth of ESG markets over the past few years shows the need for forward prices for these assets and their related indices. Derivatives markets are a key component of mature secondary markets, and the recent growth in demand for listed and over-the-counter (OTC) ESG derivatives illustrates that these products are a core component of sustainable investment strategies, especially since the availability of liquid and transparent derivatives can fundamentally reduce funding and financing costs for share and bond issuers in the primary markets.

The role of derivatives in sustainable finance is explored in greater detail in a July 2020 paper published by the Centre for European Policy Studies ("CEPS") and the European Capital Markets Institute ("ECMI")[9] and has been aknowledged by the PSF in its recommendations on data and usability as part of Taxonomy reporting[10].

The financial sector is responding to the challenges in sustainable finance with a diverse range of product structures and transaction types in the derivatives market. A new wave of sustainability-linked derivatives (SLDs) and exchange-traded ESG derivatives has developed in recent years, alongside emissions trading derivatives, renewable energy and renewable fuels derivatives, and catastrophe and weather derivatives. In January 2021, ISDA published a research report that gives a valuable overview of such ESG-related derivatives products and transactions.[11]

We appreciate the opportunity to submit our comments in response to the Consultation Paper and stand ready to continue our engagement with EU policy makers and regulators to contribute

[9] Derivatives-in-Sustainable-Finance.pdf (isda.org)

[10] https://finance.ec.europa.eu/system/files/2022-10/221011-sustainable-finance-platform-finance-report-usability_en_1.pdf, (pp. 95-96)

[11] Overview-ofESG-related-Derivatives-Products-and-Transactions.pdf (isda.org)

to the development of meaningful methodologies to calculate derivatives' contribution to sustainability and help test and calibrate the relevant options currently under examination. We hope that ESMA will consider our suggestions, as they reflect the extensive knowledge and experience of financial market professionals within our membership.

We would be very happy to discuss any of our comments further or to assist in any way possible. We invite you to contact us should you have questions or comments.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.