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TRANSCRIPT

ESG Now Podcast

"Stop! In The Name Of Sustainability Funds (Aka ESMA's New Guidelines) "

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Bentley Kaplan

Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society, and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode. A little over a week ago, the European Securities and Markets Authority, or ESMA, published its final guidelines on the naming of sustainability or ESG-related funds. The guidelines are trying to address rising concerns over greenwashing by specifying what characteristics are needed by funds to be able to use words like sustainable, or environmental, or impact in their name. The idea being that a fund's label will tell investors exactly what's in the box, or what's not in the box. So, in this episode, we're going to look at the key parts of this new guidance, what might be of particular interest to fund managers and investors, and where all of this fits into a sustainability landscape that is evolving rapidly. Thanks for sticking around, let's do this.

Do names matter? Shakespeare, speaking to us through Juliet, made the point that when it comes to the rose at least, we shouldn't be too fussed about its name. Roses smell pretty great, whatever you decide to call them. And sure, that's all very well, and even better if you can get that point across in iambic pentameter. The problem with that idea is when we flip it around and apply the name rose to something that doesn't smell all that great, say a skunk cabbage, something that I promise is a real flower. But when we do that, then a name really does matter, and that's one key theme coming out of the recently published guidelines from ESMA, the EU's markets regulator and supervisor. Names matter. Not so much the names of flowers, but of investment funds, and specifically funds wanting to use sustainability or ESG-related terms. At its simplest, these new guidelines are looking to strengthen the connection between a specific term and the investment approach or criteria that a fund is using.

And also to promote more consistent naming, making sure that environmental, in one fund's name, will reflect the same minimum requirements as it would for another fund. This would make it easier for end users or investors, people whose pensions and personal finances are being invested, to easily understand what different funds are doing, or aiming to do by how they are named. These new guidelines, once implemented, would affect fund managers marketing their products in the EU, which as we'll get to later, could be a sizeable number of funds. But don't let me get ahead of yourselves, before we roll up our sleeves and get into the weeds of what's in ESMA's final guidelines, let's just take a quick sweep of the landscape.

Because although ESMA's final report may have implications for a lot of European investment funds, it's just one component of a much bigger sustainable investment ecosystem, one that extends beyond the EU. And it's an ecosystem that has evolved pretty quickly over the past decade or two. Someone that has seen this evolution firsthand is Meggin Eastman, out of MSCI's London office. Meggin is MSCI's Head of Sustainable Finance Research, and among other things, is a long-time editor of our annual research paper, Sustainability and Climate Trends to Watch. Now, my first question to Meggin was about the importance of names. About the weight that words like environmental or sustainable are carrying today, and how different that is to, say, 10 years ago, when they might've been used with relative ease or even interchangeably, and how ESMA's recent guidelines serve to highlight this difference.

Meggin Eastman

Your point about the specificity of wording is an important one, and it really is key to what we're seeing here. And with that in mind, it's worth taking a little bit of a step back to remember what the purpose of the rules is, and if you ask the regulators, if you look at their materials, if the purpose behind the rules is to make it easier for end investors, your mom and dad, and their pension fund, or your neighbor saving for retirement, whatever it is, to understand what they're getting in a particular fund, and to make sure that the fund actually delivers on what it says it does. This desire that's driving the new rules, it's emerged out of this period where ESG and sustainable investing and climate investing, all of this went from being something very niche to something that's more mainstream, more widely applied, there are lots of funds out there, and there weren't any rules about what any of those frequently used words mean.

And so, in that context, everything was growing. You had so many investment products developed in that environment, some of them did a better job than others at actually delivering on what this typical end investor might have assumed or thought they were promising. And so, that's how we entered into this age of all the worry and concern about greenwashing. And the naming rules are meant to be an antidote to that. I'm not going to opine on whether the ESMA rules do that well or do that badly, in any case, I think we're not really going to know what the practical effects of the rules are on the marketplace until they've been in place for a while, and we can actually see the results. But coming back to the specificity around wording, that's something rather new and different for the whole space, so we see it in the EU from ESMA. And the only other place so far that we're seeing something quite that specific about vocabulary is in the UK, where the SDR is going into effect this year.

Bentley Kaplan

Okay. So, I'm going to stop Meggin's tape just for a second there, because even though this was supposed to be all about ESMA, it's hard pick your way through these regulations without drawing comparisons from different markets. The SDR is the UK's sustainability disclosure requirements, and as Meggin explains, it's a framework that is also quite specific about what words are used and what they mean. And if, like me, you're struggling to keep tabs on these acronyms, well, the UK's SDR is completely independent from ESMA's new sustainability fund guidelines. It's also independent from the EU's SFDR, or Sustainable Finance Disclosure Regulations, which mandates specific sustainability disclosures from asset managers, and it's also independent from the EU's CSRD, or the Corporate Sustainability Reporting Directive, that requires large companies to publish regular reports on their environmental, social, and governance activities. So, anyway, back to the SDR, because next, Meggin took me through some of the key aspects of the SDR, especially because the timing of its rollout is happening so close, both in space and time, to ESMA's new fund guidelines.

Meggin Eastman

I think about ESMA and the SDR, or the EU and the EU reporting requirements and the SDR kind of together, because even though they have a lot of distinctions between them, they're coming into effect in the same year, and directionally in terms of how they shape the market, there are some commonalities. So, the SDR has a bunch of different components, it's not just a naming rule. One of those components is a naming and marketing rule, and that governs the use of sustainability-related wording in product names and marketing. And I'm talking about financial products here. That comes into effect in December this year. There's a fund labeling regime that comes into effect at the end of July, so that's very soon. It's voluntary, nobody has to apply a label to their fund, it's meant to again communicate to the end consumer, and each label comes with specific criteria and specific disclosure reporting requirements.

And then, finally, and coming into effect soonest, and by soonest I mean this month, there's the anti-greenwashing rule. And that one has wide applicability, it's not limited to the finance sector, and it basically says that any sustainability claims about products, including financial products, that those claims have to be clear and fair and not misleading. The devil will be in the details and in the enforcement, but what it means for the investment sector is that even though technically the rules around labeling and fund naming and marketing don't come into effect quite as soon, fund managers are already having to take a pretty close look at what kinds of claims they're making, what kinds of words they're using, and whether they can produce the receipts, so to speak, to show that they actually do what they say.

Bentley Kaplan

So, for Meggin, the upshot of all of these very recent developments in Europe and the UK, between ESMA's fund name rules and different components of the SDR, is that the operating environment for fund managers is really shifting. And for fund managers active in the EU, or selling in the EU, ESMA's new guidelines will have been a pretty big topic for the week, and something that we are going to look to summarize next. And by we, I actually mean my colleague Simone Ruiz-Vergote. Simone is based in MSCI's Frankfurt office, and she's been keeping a close eye on the development of this guidance since ESMA's first consultation, 18 months ago. In addition to being a colleague, Simone is also a member of ESMA's consultative working group to the Sustainability Standing Committee for the past two years. The Sustainability Standing Committee both consults and coordinates on sustainable finance, including with the EU's standing committees across many different sectors. So, my first question for Simone was about whether any of ESMA's final guidance had changed a lot since the original consultation, 18 months ago, and how its publication was broadly received by the market.

Simone Ruiz-Vergote

The market has been, I think, generally supportive of more clarity on certain use of names, and in that sense it was to be expected that this was coming, even though, then in December, the European Commission consulted on the broader picture related to SFDR Article 8 and 9, and the potential to create new labels. So, I suppose there was a bit of a feeling that given that there is this broader picture consultation, the guidelines may be put on a back burner, given that there is elections in Europe this year. And so, the market was probably rather surprised to see that they were coming now in that shape and form. However, they are really identical to what was already pre-announced in a public statement in December after the consultation had closed. I see it also from the working group that I'm a member of, that consults the Sustainability Committee and ESMA, that this is a key concern for many of the national supervisors, and I felt there was some pressure on ESMA to actually act now.

Bentley Kaplan

Okay. So, with these guidelines fresh of the printing press, or more likely downloaded as a PDF, I thought we could leverage some of Simone's expertise a little further. So, before you tackle the 60-odd pages in ESMA's final report, maybe let Simone's highlighter do a little bit of the heavy lifting first.

Simone Ruiz-Vergote

So, as to the key takeaways, the interesting part here is that there are three categories, they split up the E, S, and G name into two separate buckets. So, the S and the G are grouped together with the transition category, and there are also environmental and impact names together, as the second and the third is related to sustainability, as it is defined in the SFDR Article 2.17. So, three different buckets, all of them have as a minimum criteria that 80% of investments need to be meeting the name connotation, so they have to be relevant investments. However, ESMA did not introduce a quantitative threshold for the sustainable investment portion. They had suggested 50%, there was a lot of pushback from the consultation responses, and they did not introduce that. And a third key takeaway is minimum safeguards, as they call it, or baseline criteria. So, for the transition social governance names, there is a slightly lower set of criteria that climate transition benchmark criteria apply, and so they actually allow for investment in an oil and gas company, for instance, as long as this company satisfies the climate transition benchmark criteria.

As it comes to environmental or impact-related names, and the sustainability-related names, those will have to satisfy the criteria from the Paris Alliance Benchmark Regulation, which is more extensive, and introduces a number of criteria linked to the oil and gas sector, coal-related activities, and also power generation. And as a last point to mention, if you have an impact or a transition related fund name, you also have to show and measure that you can actually achieve progress on either of these notions.

Bentley Kaplan

Right. So, based on these guidelines, the wording that a fund manager uses to name a fund would trigger a Choose Your Own Adventure format, in terms of what needs to be included or not included in that fund. And to underscore Simone's point about minimum safeguards or exclusions, it looks like any fund that uses a word on ESMA's list will need to exclude specific investments. In some cases, these exclusions won't affect energy transition activities, and would follow the climate transition benchmark. But for other funds, those using some version of the word sustainability, or environmental, or ESG, or impact, or SRI, the exclusions would be much more wide-ranging, taking the form of the Paris-aligned benchmark. That would restrict investments into things like oil and gas, fossil fuel power generation, and activities with significant environmental impacts, like mining. In terms of timeline, from here ESMA's guidelines will be published into the EU's official languages, for asset or fund managers that will be affected, ESMA's guidelines will come into effect within three months of these published translations for new funds, and within nine months for existing funds, which some might see as quite a short runway.

Each EU market's financial regulator or national competent authority will be required to respond to ESMA to say whether they do currently or plan to implement the guidelines as written, whether that will include some deviations, or why they intend not to implement the guidelines. But let's leave that process for other podcasts out there that have a knack for EU administrative processes, because we are not that podcast. With these guidelines moving into gear, I thought it would be helpful to get Simone's sense of whether the market has pointed out any aspects of the guidance that may present challenges, either through ESMA's various consultations or discussions that she's had with a range of fund managers and industry bodies.

Simone Ruiz-Vergote

Most asset managers that we talk to know pretty much what product would fit what category, broadly speaking, but then you do need to look at the screen, specifically for your PAB or CTB exposures depending on the category you're targeting. You'll find Article 9 funds that will fail such as green, we have done our work because we're preparing actually a screen that clients could use for that purpose. 7% of our broadest ACWI IMI index would fail a Paris-aligned benchmark criteria screen, and just below 1% would fail the CTB exposure. And then, there is all this room for interpretation as well, how do you meet the 80% threshold? And what is actually a meaningful sustainable investment exposure, as there is no definition of it? I guess each compliance team will have a different interpretation. And there is a particular pain point here that is around the treatment of funds with ESG-related names, because you don't have a possibility to actually use the transition finance element, they're grouped together with the environmental terms, they will all be subject to the more restrictive exclusions, and that is probably something the market hasn't seen coming.

There was a lot of pushback in the consultations and ask also by ESMA's larger stakeholder group, to use an approach that better meets the investment strategies that are in the market, but ESMA has been reluctant, and has also said that this would introduce a lot of complexity. So, they went for an approach that they're well familiar with, which is the PAB and the CTB screens, and that is, in a sense, it's unfortunate, because a lot of the funds with ESG-rated names are necessarily after climate themes or decommunization of their portfolio. And so, that is a limitation I suppose the market will have to handle. At the same time, there is also a feeling that this could help and bring transparency, but some of the underlying concepts would probably need to be further clarified.

There is no regulatory definition currently as to what good transition finance fund should actually try to achieve. From our own research, the net-zero tracker, we know that more than half of listed companies have published climate targets, but where do they stand in achieving these targets? Tracking progress? Are these targets aligned with established standards out there? There are so many ways of measuring that, and then in the end, help with where the finance is actually most needed, which is really getting the dirty industries on a clean path, really.

Bentley Kaplan

Okay. So, there may well be some challenges ahead as these new guidelines are rolled out. In some EU markets, existing regulations may have helped asset managers to prepare for these new guidelines, but others may have much bigger bridges to cross. And as we talk about these challenges it may be helpful to simultaneously reflect on just how rapidly funds have grown, one of the driving factors behind these new guidelines in the first place. So, ESMA's own research found that the proportion of funds using ESG-related names had grown more than four times over 10 years, from 2013 to 2023. And that funds with ESG-related language made up 14% of total assets under management in the EU in 2023, that comes to just under 7 trillion euros, compared with just 3% in 2012. And the thing is, it's not only new funds that have taken these names, but existing ones that have changed their names to include sustainability-related terms. More than 1300 funds had done this since 2018, with ESMA's data showing that 2021 and 2022 had the sharpest growth.

Now, some of our own colleagues are busy looking at fund-related data as we record this. Rumi Mahmood, out of MSCI's London office, told me that yes, according to our internal data, the proportion of European funds using sustainability-related labels has grown very sharply. He also told me that when you start looking at more specific terms in the context of ESMA's guidelines, a pretty high proportion of funds could be using sustainability and environmental-related terms, or impact-related terms. And as Simone had told us earlier, for either of those two scenarios, stricter exclusions would apply in the form of the Paris-aligned benchmark. With so many funds potentially coming under scope for ESMA's guidelines, asset managers may be considering various ways to respond, and working along timelines that are getting shorter and shorter. So, to give us a sense of how MSCI might be looking to help our clients who would be affected, I asked Simone if there was any kind of sneak peek that she could offer.

Simone Ruiz-Vergote

We are working on a screen that allows our clients to assess which companies in their portfolio meet these minimum safeguards with regards to the Paris-aligned benchmark criteria, and with regard to the climate transition benchmark criteria, that will be available both for individual companies, as well as at the fund level, and that will help, I think, with this very first sorting out. There is currently no further requirements from ESMA, so this is really focusing on the name, not on any marketing material, for instance. So, given that the name is really the topic here, I would see that once clients have identified what name would require what sort of screen, that will be helpful to have such an easy access to say do this first triage.

And then on top of that, we have worked on an SI approach. So, we have an approach whereby companies can be identifying, or clients can be identifying companies on the grounds of their sustainable revenues, and added to that, a layer of do no significant harm, and good governance in line with Article 2.17 of the SFDR. And then, there is some work starting on the topic of transition finance, and helping our clients then to identify what companies are best placed in a transitioning world, and then also maybe to help finance those companies that would otherwise fall through the grid when applying the PAP screen, which is really most of the oil and gas sector, and some utilities.

Bentley Kaplan

Right. So, while I am busy swanning around in the recording studio, a lot of my colleagues are working on ways to help our clients respond to these new guidelines. And word on the street is that responding to regulations is sliding higher up the to-do list for fund and asset managers, and investors too. And that's not just in Europe, but globally. Now, at the top of this episode, Meggin drew a comparison between ESMA and the SDR, especially because of the relative importance of specific names. But regulations on sustainable finance, or climate change, or ESG, or impact investing aren't always neatly contained within a single market. And the patchwork of fund naming regulations and requirements that are emerging globally might be causing an increasingly unpleasant headache. So, in lieu of ibuprofen, and to finish this episode off, I brought Meggin back, to see if she could try and simplify a very complex picture, and to tell me whether any of these new guidelines have some themes in common, or whether it's still too soon to say.

Meggin Eastman

I think in some ways it is still really early days. The main thing that you see in other markets outside of Europe and the UK, and especially outside of the EU, is that the naming rules are designed to make it relatively intuitive to understand a fund's strategy based on what it's called. They're not necessarily prescriptive about specific words, they're not necessarily prescriptive about how you go about achieving whatever objective it is. If we're talking about Canada, or South Korea, or Australia, or Singapore, there's lots of others, they tend to be backed up more by disclosure requirements, disclosures that back up the claim rather than requiring certain approaches to investing, or necessarily applying labels to things. The US SEC fund name rule, you do see that apply to a much wider range of fund types, it's not in any way an ESG or sustainability specialty rule, it's for fund names generally.

It shares with what you see in Europe, it shares that 80% rule, meaning that 80% of a fund's holdings need to support the goals implied in the name. And that's a common criterion across many markets, actually, that 80%. And that applies to all sorts of things that might be implied by a fund name. So, it could be geographies, it could be industries, it could be factors, or dividends, it could be sustainability, whatever, it doesn't set out explicit criteria or definitions for particular word choices, but it does require that fund prospectuses explain what they mean in language that can be understood by a layperson. So, it seems like most of the other jurisdictions are following a little bit more of that kind of approach, than the more prescriptive linguistic criteria that you see in Europe.

So, in that sense, not as much convergence, on the other hand, the idea that a fund should say in its name roughly what it does, or not mislead, that's quite common across a lot of jurisdictions, and frankly, it makes good sense. We started out this episode talking about the ESMA fund name rules because they were just finalized, and we all knew they were coming, but until they were finalized, we didn't know exactly what they were going to look like. Even though the final version's not wildly different to earlier drafts, and everyone knew this was coming, I would say as we go out and talk to our clients in the marketplace, it does seem like the reality of it is hitting fund managers pretty hard. The compliance timeline is pretty short, it's months, it's not years, and the rules are quite strict. So, even though there's room and there's time to make adjustments if needed and decide what to do, suddenly a lot of people are coming directly face-to-face with that question. Okay, this is real, what do I do now?

Bentley Kaplan

And that is it for the week. It's been a real pleasure to talk with Simone and Meggin as always. And a big shout-out to Rumi, who, since these guidelines dropped, hot off the press, has been knee-deep in data, and NLP, and charts. To our listeners, thank you always for tuning in, we know things can get a little technical when it comes to regulations, but we love working to make all of it a little more digestible, and to give you a little head start before you have to tackle the original texts. If you like what we're doing then let us know, drop us a review, rate the show on your platform of choice, and tell a friend or a colleague about this episode. Thanks again, and until next time, take care of yourself and those around you.

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