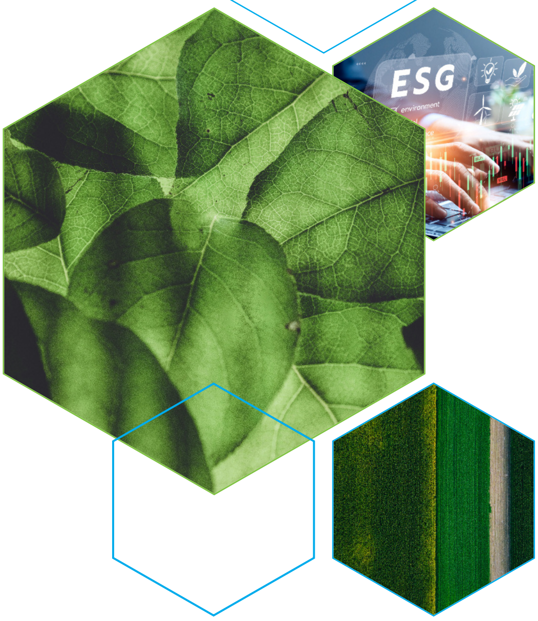
What's in a sustainability fund name? In Europe, increasing rigor

PERSPECTIVES REPORT JUNE 2024



The European Securities and Markets Authority (ESMA) has released its final guidelines on fund names, which will strictly govern whether financial products can be labeled with certain sustainability-related terms.[1]

The new naming rules – designed to mitigate the risk of greenwashing – concern the use of specific words such as "ESG," "sustainable" or "impact." ESMA has provided detailed requirements for funds that want to use those terms, a summary of which appears in Figure 1.

Figure 1: ESMA naming guidelines

The scope of the ESMA guidelines encompasses the following ESG or sustainability-related terms:

	Sustainable	Environmental/ ESG/SRI	Social	Governance	Transition	Impact
Meet an 80% threshold of investments used to meet environmental or social characteristics or sustainable investment objectives in accordance with the binding elements of the investment strategy, which are to be disclosed in Annexes II and III of CDR (EU) 2022/1288	✓	✓	✓	✓	✓	✓
Apply Paris-aligned Benchmark (PAB) exclusions	✓	✓				✓
Apply Climate Transition Benchmark (CTB) exclusions			✓	✓	✓	
Invest meaningfully in sustainable investments defined in Article 2 (17) SFDR	✓					
Ensure that investments used to meet other thresholds are on a clear and measurable path to social or environmental transition or are made with the objective to generate a positive and measurable social or environmental impact alongside a financial return					✓	✓

Source: STOXX, ESMA. Transition-related terms include "transition", "improving", "progress/ion", "evolution" and others.

While this move aims to protect investors and offer greater clarity, it adds to the burden for fund managers and marketers, who already face the challenge of navigating European Union-wide and national-level rules that potentially clash with ESMA's directive.

[1] The guidelines apply to UCITS management companies.

These guidelines tie the implicit promise in a fund's name to a minimum investment in the stated objective. One of their more contentious aspects is the "minimum safeguards" provision, which bans investments in industries excluded from Paris-aligned Benchmarks (PABs). In essence, this means no funds branded as "ESG" or "sustainable" can invest in oil and gas. This exclusion will be onerous on many of those funds and deprive investors of stewardship action with energy companies.

Could SFDR Article 8 funds be in breach of ESMA's guidelines?

The new rules add to regional and national policies that are continuously evolving at a time when almost EUR 5 trillion has switched to sustainability-related funds.[2]

In particular, the ESMA rules will coexist with (and draw from) the EU's Sustainable Finance Disclosures Regulation (SFDR), which has become a de-facto fund labeling framework since implementation in March 2021.

SFDR outlines disclosure rules relating to sustainability risks, the consideration of principal adverse impacts (PAIs) of investment decisions on sustainability factors, and the publication of sustainability-related information when a sustainability objective is targeted. SFDR also requires asset managers to classify their funds in specific categories.

Two SFDR categories stand out: Article 8 investment products are those that seek to **promote ESG characteristics**. The more stringent Art. 9 is for products that **seek to contribute** to the achievement of an environmental or social objective, **while doing no significant harm** to another "E" or "S" objective.

Because there is no obligation for Art. 8 funds (which, in Europe, currently manage EUR 4.6 trillion in assets) to invest in sustainability objectives, many of them may fail the quantitative investment threshold and exclusionary screens in ESMA's naming rules.

SFDR, together with the EU Taxonomy Regulation and EU Benchmark Regulation, are the pillars upon which the EU's Sustainable Finance Action Plan is being built.

[2] Source: ISS Market Intelligence Simfund. Data reflects investments in long-term EU-domiciled Art. 8 and Art. 9 funds as at end of March 2024.

Policymakers are currently working on a comprehensive assessment of the SFDR framework that may lead to a fundamental revamp. In parallel, authorities are considering changes to SFDR-related product disclosures and entity-level PAI indicators and their "do no significant harm" assessments.

The current naming landscape

Figure 2 shows the frequency of restrictive terms in the names of Art. 8 and Art. 9 funds. The table shows that the ESMA guidelines are likely to have a large effect given in particular the high number of funds with "sustainable"-related and "ESG" terms in their names. Around 24% of Art. 8 assets under management is in named funds.

Figure 2: Art. 8 and 9 funds – Top 10 terms used in names

Names	Count	AUM as of March 2024 (EUR millions)	Passively Managed (%)
Sustain-	1,221	394,130	9.6
ESG	1,217	484,180	67.0
SRI	378	173,441	46.2
Climate	279	78,739	45.3
Respons-	215	93,674	20.5
Impact	177	33,489	2.3
Green/Earth	162	34,827	22.5
Paris	103	47,675	96.2
Transition	95	26,982	28.9
Carbon	74	22,516	75.5

Source: ISS Market Intelligence Simfund. Total labeled funds covered: 3,926. Covers Art. 8 and Art. 9 EU-domiciled long-term UCITS only. AUM figures exclude funds-of-funds. Double counting will occur where funds use multiple sustainability / ESG terms in the name.

Figure 2 also shows that indices play an important role in the ESG funds landscape. About 37% of AUM in sustainability-named UCITS funds track an index.

Complying with national regulations might not be enough

Country-level labeling regimes are also important reference points for fund issuers to consider, especially in the EU's larger markets. For example, the recently updated French SRI (Socially Responsible Investment) label has exclusion criteria that appear similar to those in the PAB rulebook, but they are not as restrictive. France's SRI bars companies that derive 5% of their revenue or more from thermal coal; for PABs, that threshold is just 1%.

The consequence is that a fund that received the French SRI label may not be able to use the SRI acronym in its name as it complies with the ESMA naming guidelines.

An 'impossible product'?

With a lack of consensus in Europe around what activities should be excluded, cross-border, scalable product creation poses a difficult challenge. This is of crucial relevance given the EU's aspiration to integrate its member states' financial-services markets.

A STOXX report published in 2022 compared the exclusionary criteria and portfolio-construction techniques used in the 12 most important European frameworks at the time for sustainable-investment products.

The report's authors detailed a highly divergent and fragmented landscape in fund labeling and argued that this lack of harmonization may slow the mainstreaming of sustainable investing. The application of the highest common denominator in the various criteria, including obligations in fund naming, could remove many systemically important companies from the sustainable transition.

A need for convergence

"The current arc for global product- and entity-level sustainability reporting risks unnecessary fragmentation, making it challenging for global financial market participants to operate seamlessly across globalized markets," ISS ESG analysts wrote in a notable report earlier this year.[3]

"Investors are likely to increasingly call for equivalence or other pathways to achieve global interoperability among regulatory frameworks and to seek further collaboration between regulatory authorities to avoid costly and unnecessary regulatory divergence," the authors wrote.

Rather than see a path towards convergence, many market participants might justifiably expect overlapping and conflicting regulation to continue.

Rapidly approaching timeline

The ESMA guidelines will start applying three months after their publication in all EU official languages, and managers of existing funds will get an additional six months for compliance.

The path of least resistance will likely see many sustainability buzzwords disappear from fund names, at least in the short term. With a less pressing deadline, in coming years more funds will likely update their methodology books to comply with naming rules.

It is also conceivable that cross-border funds will offer different marketing literature in different jurisdictions. That's additional weight for a category where costs are already higher than single-country funds.[4]

Language matters

ESG terms can have an impact as a marketing tool. Fund naming conventions (and other language used throughout supporting documents) are used to communicate a fund's investment strategy.

Having "ESG" in a fund's name is no guarantee that its ESG credentials will exceed those of a non-labeled fund. But it does raise an expectation that the fund will meet its ESG objectives, says Benjamin Reed-Hurwitz, Head of EMEA Research at ISS Market Intelligence.

"Language matters," Reed-Hurwitz says. "A fund name alone can set expectations for what a fund can deliver."

"Setting expectations, however, is not a risk-free proposition," he adds. "Live up to the expectations set by your fund's name and your potential of having a winning narrative rises; fall short of expectations and your reputation may falter. These latest rules seem targeted at lowering the risk of sustainability expectations being missed, but at what cost? The question is whether the rules, particularly where exclusions need to be applied,

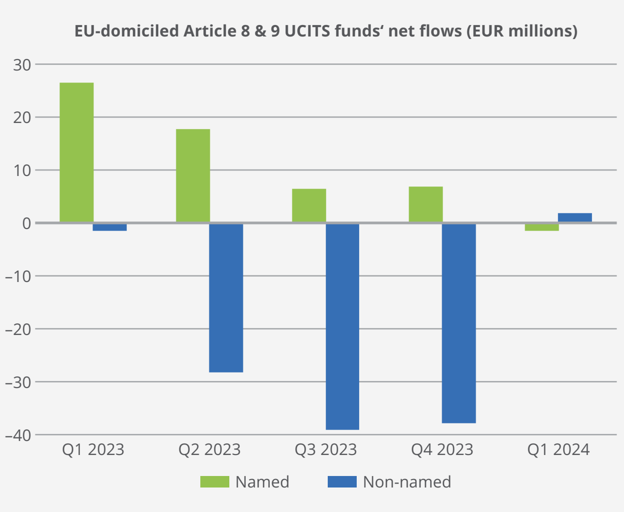
[3] ISS ESG, "Actionable Insights – Top ESG Themes of 2024".

[4] See ICI, "Ongoing Charges for UCITS in the European Union, 2021", October 2022, for a comparative analysis of fund costs.

in fact align to a diverse set of investors' values, or whether instead, the rules create additional barriers / costs to product development and investors finding a fund satisfying their sustainability criteria."

Last year, European funds with an ESG label significantly outsold non-named peers with an ESG objective. The former raised almost EUR 60 billion in new money, while the latter suffered redemptions of over EUR 100 billion (Figure 3). This trend paused in the first quarter of 2024, given limited flows. Going into 2024, Art. 8 and 9 fund flows remain muted compared to the highs seen in 2020 and 2021. The naming rules appear to be coming into force during a period of reduced interest for such funds.

Figure 3: Flows into Art. 8 and 9 EU funds



Source: ISS Market Intelligence Simfund. Covers Art. 8 & 9 EU domiciled UCTIS only. Excludes money market and funds-of-funds.

Indices and regulation

ESMA's naming guidelines apply to funds, but not for the indices that, as discussed earlier, many of those funds track. However, indices may still be impacted in two ways:

- **Light impact:** an index-fund manager changes the fund's name (keeping the underlying methodology intact) and requests a change to the index name for consistency.
- **Strong impact:** a manager keeps the fund's name but changes the methodology. In this case, they will need a new index aligned with the updated methodology.

Since launching its first sustainability index in 2001, STOXX has collaborated with clients in the design of indices that meet very specific criteria. The flexibility and customization potential has enabled pioneering indexing products in the area of sustainable investing. With the growth of sustainability objectives and of ESG data, that partnership has become more important in recent years.

To help investors in the construction of portfolios following the introduction of SFDR, STOXX published a methodology guide for reporting the sustainable investments (SI) percentage of STOXX and DAX indices.

Work ahead

In summary, public policies designed to bring about market clarity and foster trust are a welcome development. They should ultimately create an additional layer of protection for investors and should benefit the 'greening' journey of financial markets.

For the moment, there continues to be a patchwork sustainable finance environment in Europe, hindering the growth of a European sustainable finance hub. The fragmented labeling landscape limits the ability of investors to make informed investment decisions.

Further synergies among regulatory frameworks and national policies are needed – not just to promote efficiencies in the asset-management industry, but to ensure the simple viability of many funds. In the current environment, the risk is that investment firms concerned about obsolescence may put planned ESG funds on hold, waiting for more regulatory stability.

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