

16 September 2021

Proposal by the FBF and AMAFI on synthetic hedging of ESG funds

The French Banking Federation (FBF) and the French Association of Financial Institutions (AMAFI) would like to thank the AMF for including in its proposals, the possibility for market participants to work together to suggest a robust and common framework for the development of the offer of ESG exposure products.

These instruments (Total Return Swaps as defined below) are developed by banks to meet the needs of their fund manager clients, who in turn serve investors seeking diversified investments, enabling them to benefit from growth cycles in different areas of the world. These instruments serve several purposes: they enable exposure to ESG securities with a difficult direct access to managers and allow efficient management of securities transactions without having to be part of all the settlement-delivery systems. All these operational simplifications benefit end clients.

Bank's centralized management allows them to optimize their risks and offer competitive prices to clients. It is important to note that this centralized management does not have a negative impact on fund performance, and therefore the end investor, for which the counterparty has undertaken to take the synthetic replication risk (excluding contract costs).

Finally, in general, the development of derivatives markets contributes to the development of the markets for the underlying securities on which these derivatives are based, considering the increase in buying/selling interests in the securities for the counterparties, and increases the liquidity of the instruments in question and thus the prices of the assets available to investors.

I. Proposal of a marketplace charter

In response to the publication, in December 2020, of the AMF's third report on non-financial approaches in collective investment management, the FBF and AMAFI suggest a mechanism aimed at ensuring that the use of derivatives (total return swaps, in this case) remains in line with the ESG objectives used to qualify the CIU as such, without undermining investor confidence in "synthetic" ESG funds.

The AMF can check the compliance with this mechanism at any time, either before fund authorization or during its lifetime.

- a) Banks that are the counterparties of these operations have to be engaged in the sustainable development area, they have to be PRB signatories or any other equivalent commitment.
- b) Banks undertake to meet a number of **specific requirements** for TRS concluded with collective investment undertakings (CIUs) that apply synthetic exposure strategies to asset performance, basket of funds or indices identified as "green" or "ESG".

The purpose of these specific requirements, which will complement the general terms of the TRS and will form an integral part of the contractual clauses between CIUs and banking counterparties, is to enable the CIU to make the consideration of non-financial criteria of the performance provided by the CIU a "**key aspect**" of its communication, subject to compliance with the conditions set out in Position 9 of AMF Position-Recommendation DOC 2020-03.

The **specific requirements** are as follows:

The portfolio of the trader in **charge of transactions on financial instruments for hedging the TRS** (the "Portfolio") **acquires, throughout the duration of the TRS, at least 90% of the securities that make up the performance of the index provided to the CIU (i.e. the relative replication spread is limited to 10%. This commitment covers the level of the index as well as each line that makes up the index, except in exceptional cases that can be duly justified to the counterparty** (for example, a temporary ban or an internal volume limit for very small buy orders). **The trader also commits to be able to identify this commitment throughout the duration of the TRS.** This portfolio is integrated into the counterparty's trading portfolio.

That is:

1. At index level:

$$\sum_{i=1}^N |Exposure_i^{Index} - Exposure_i^{Portfolio}| \leq 10\% \cdot Exposure^{Index}$$

$$Exposure^{Index} = \sum_{i=1}^N Exposure_i^{Index}$$

2. For each security:

$$\forall i, 1 \leq i \leq N, |Exposure_i^{Index} - Exposure_i^{Portfolio}| \leq 10\% \cdot Exposure_i^{Index}$$

Where:

- $Exposure^{Index}$: amount in € invested in the index via the TRS
 - $Exposure_i^{Index}$: amount in € invested in the i component of the index via the TRS
 - $Exposure_i^{Portfolio}$: amount in € that the counterparty has acquired on the i component of the index through its TRS hedging portfolio
- **NB 1:** to specify that the commitment thus made for the concerned portfolio does not mean that the counterparty of the TRS permanently holds at centralized level the same percentage of securities, as this commitment may be added or be offset against commitments made otherwise by the counterparty with other clients. The counterparty's holding of the concerned securities will therefore vary over time and can thus be higher or lower than the minimum percentage stated above and held by the portfolio. Given the centralized management of all of the counterparty's securities positions, the counterparty may lend these securities to third parties at any time, at its discretion, especially to optimize its balance sheet.

NB 2: should the counterparty, for exceptional reasons, only be able to commit to a percentage lower than 90% (such as, for example, the specific prohibition to hold a particular security due to regulatory conflicts applicable to the counterparty), it will justify this situation precisely and objectively to the CIU.

- The TRS counterparty undertakes to provide the CIU with quarterly reports on the compliance with its commitments, using the model defined in the Annex or as defined by the parties.
- The holders of the CIU are informed, where applicable, that the voting rights attached to the securities will not be exercised, except for specific conditions defined between the parties.

II. Management of conflicts of interest and supervision of the banks' own accounts

It is worth reminding that, pursuant to Articles L511-47 *et seq.* of the Monetary and Financial Code (which codified Act No. 2013-672 of 26 July 2013 on the separation and regulation of banking activities), **French banks may not take speculative positions.**

The following transactions are prohibited within the bank:

1° Transactions corresponding to the constitution of purely directional positions, through which an intermediary acquires an increasing quantity of financial instruments (or sells an increasing quantity of financial instruments) according to a trend detection (upward or downward), in order to generate a margin through the capital gain realized;

2° Transactions corresponding to pure arbitrage activities, which aim to exclusively benefit from market inefficiencies between two different assets or between the same asset which might be traded on several markets, instead of aiming to provide additional liquidity.

Banks have set up compliance systems, leading to the review by the control functions of the mandates of trading units (including risk limits) and the monitoring of daily indicators. These systems have undergone extensive document-based and on-site audits by the ACPR, and their adequacy is reviewed on at least an annual basis by the institutions' permanent control.

Annex

Example of report

NXSEXEMPLE						Index			Portfolio Inventory		
Security Name	Bloomberg Code	ISIN Code	Spot	Currency	FX	Weight	12 186 469		99,71%	12 150 700	
							Exposure €	Shares equivalent	Delta Indicator	Shares	Exposure €
Gecina SA	GFC FP	FR0010040865	117,2	EUR	1,00	1,9%	226 782	1 935	98,14%	1 899	222 563
Enel SpA	ENEL IM	IT0003128367	8,326	EUR	1,00	1,0%	127 871	15 358	98,32%	15 100	125 723
Orsted AS	ORSTED DC	DK0060094928	976,4	DKK	7,44	1,7%	206 541	1 573	98,98%	1 557	204 440
Schneider Electric SE	SU FP	FR0000121972	128,4	EUR	1,00	1,2%	140 726	1 096	99,00%	1 085	139 314
Pennon Group PLC	PNN LN	GB00818V8630	959	GBPp	85,62	3,4%	415 547	37 101	99,09%	36 762	411 750
KBC Group NV	KBC BB	BE0003565737	57,7	EUR	1,00	1,5%	182 332	3 160	99,75%	3 152	181 870
Continental AG	CON GY	DE0005439004	113,5	EUR	1,00	0,8%	92 049	811	99,75%	809	91 822
Vestas Wind Systems AS	VWS DC	DK0010268606	1189	DKK	7,44	1,1%	131 752	824	99,76%	822	131 432
Mondi PLC	MNDI LN	GB0081CRLC47	1830	GBPp	85,62	0,9%	109 216	5 110	99,77%	5 098	108 960
Kuehne + Nagel International AG	KNIN SE	CH0025238863	252,1	CHF	1,11	5,6%	679 096	2 982	99,77%	2 975	677 502
Covivio	COV FP	FR0000064578	73,25	EUR	1,00	1,5%	188 326	2 571	99,77%	2 565	187 886
CocaCola HBC AG	CCH LN	CH0198251305	2351	GBPp	85,62	0,7%	82 649	3 010	99,77%	3 003	82 456
Verbund AG	VER AV	AT0000746409	66,95	EUR	1,00	2,0%	238 342	3 560	99,78%	3 552	237 806
Assa Abloy AB	ASSAB SS	SE0007100581	238	SEK	10,13	1,8%	221 319	9 420	99,78%	9 399	220 825
Siemens Gamesa Renewable Energy SA	SGRE SM	ES0143416115	30,23	EUR	1,00	1,2%	149 276	4 938	99,78%	4 927	148 943
ANDRITZ AG	ANDR AV	AT0000730007	39,4	EUR	1,00	2,5%	301 095	7 642	99,78%	7 625	300 425
Volvo AB	VOLVB SS	SE0000115446	236,4	SEK	10,13	2,1%	252 432	10 817	99,78%	10 793	251 872
Svenska Cellulosa AB SCA	SCAB SS	SE0000112724	156,6	SEK	10,13	4,2%	512 853	33 175	99,78%	33 102	511 725
Stora Enso Oyj	STERV FH	FI0009005961	16,755	EUR	1,00	2,6%	312 648	18 660	99,78%	18 619	311 961
Terna Rete Elettrica Nazionale SpA	TRN IM	IT0003242622	6,028	EUR	1,00	2,6%	313 565	52 018	99,78%	51 904	312 877
Royal Mail PLC	RMG LN	GB008DVZYZ77	495,5	GBPp	85,62	4,0%	486 040	83 987	99,78%	83 803	484 975
DS Smith PLC	SMDS LN	GB0008220112	403,2	GBPp	85,62	0,4%	49 507	10 513	99,78%	10 490	49 398
E.ON SE	EOAN GY	DE000ENAG999	8,858	EUR	1,00	2,7%	324 079	36 586	99,78%	36 506	323 370
Geberit AG	GEBN SE	CH0030170408	576	CHF	1,11	3,9%	476 096	915	99,78%	913	475 055
PSP Swiss Property AG	PSPN SE	CH0018294154	112,1	CHF	1,11	4,6%	556 852	5 499	99,78%	5 487	555 637
UPM Kymmene Oyj	UPM FH	FI0009005987	32,76	EUR	1,00	3,2%	390 630	11 924	99,78%	11 898	389 778
Castellum AB	CAST SS	SE0000379190	208,4	SEK	10,13	2,4%	293 097	14 247	99,78%	14 216	292 459
Boliden AB	BOL SS	SE0012455673	333,8	SEK	10,13	2,7%	333 207	10 112	99,78%	10 090	332 482
Suez SA	SEV FP	FR0010613471	17,975	EUR	1,00	5,2%	636 836	35 429	99,78%	35 352	635 452
EDP Energias de Portugal SA	EDP PL	PTEDPOAM0009	4,903	EUR	1,00	1,9%	230 387	46 989	99,78%	46 887	229 887
Nestle SA	NESN SE	CH0038863350	100,46	CHF	1,11	4,5%	543 498	5 989	99,78%	5 976	542 319
Kingspan Group PLC	KSP ID	IE0004927939	71,9	EUR	1,00	3,5%	432 407	6 014	99,78%	6 001	431 472
Fortum Oyj	FORTUM FH	FI0009007132	22,09	EUR	1,00	2,0%	246 370	11 153	99,78%	11 129	245 840
Deutsche Wohnen SE	DWNI GY	DE000A0HNSC6	38,99	EUR	1,00	2,8%	346 699	8 892	99,79%	8 873	345 958
RollsRoyce Holdings PLC	RR/ LN	GB00863H8491	113,8	GBPp	85,62	0,1%	15 010	11 293	99,79%	11 269	14 978
Koninklijke Philips NV	PHIA NA	NL0000009538	47,365	EUR	1,00	1,7%	203 433	4 295	99,79%	4 286	203 006
Veolia Environnement SA	VIE FP	FR0000124141	23,19	EUR	1,00	0,8%	100 181	4 320	99,79%	4 311	99 972
Legrand SA	LR FP	FR0010307819	77,36	EUR	1,00	1,5%	186 824	2 415	99,79%	2 410	186 438
Signify NV	LIGHT NA	NL0011821392	40,01	EUR	1,00	1,7%	212 613	5 314	99,79%	5 303	212 173
Deutsche Post AG	DPW GY	DE0005552004	44,55	EUR	1,00	2,8%	345 663	7 759	99,79%	7 743	344 951
Safran SA	SAF FP	FR0000073272	120,65	EUR	1,00	0,6%	69 132	573	99,83%	572	69 012
Getlink SE	GET FP	FR0010533075	13,25	EUR	1,00	0,2%	18 471	1 394	99,86%	1 392	18 444
AP Moller Maersk AS	MAERSK DC	DK0010244508	14270	DKK	7,44	3,0%	366 527	191	100,00%	191	366 527
UnibailRodamcoWestfield	URW NA	FR0013326246	70,98	EUR	1,00	0,2%	24 062	339	100,00%	339	24 062
Iberdrola SA	IBE SM	ES0144580Y14	10,875	EUR	1,00	3,3%	403 430	37 097	100,10%	37 133	403 821
Electricite de France SA	EDF FP	FR0010242511	10,97	EUR	1,00	0,1%	11 003	1 003	100,70%	1 010	11 080

NB: as mentioned above, this report will relate to the acquisition of the securities by the portfolio, and not by the counterparty.

Given the centralized management of all of the counterparty's securities positions, the counterparty could lend these securities to third parties at any time, at its discretion, in particular to optimize its balance sheet.

Except in specific cases, holders of the CIU are informed that the voting rights attached to the securities will not be exercised.