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ICMA feedback on the application of Paris-aligned Benchmarks (PAB) exclusions to sustainable bond investments under the recent ESMA Guidelines

On behalf of ICMA and its constituents, especially by the [Asset Management & Investors Council](#) and the [Executive Committee of the Principles](#), we wanted to provide feedback on the application of the PAB exclusions to green and sustainable bond investments under the recently finalised [ESMA Guidelines on funds' names using ESG or sustainability-related terms](#).

Under these Guidelines, funds with “sustainable”, “ESG”, environmental or impact-related names, other than those that are social or transition-related, should follow the exclusions of the PAB. This implies that many “green bond funds” or “sustainable bond funds” would either need to divest from green use-of-proceeds (UoP) bonds¹ of utilities and other companies with legacy fossil fuel revenues or incorporate the term “transition” into their fund names if, as required by the Guidelines, the fund manager can demonstrate that *“the investments are on a clear and measurable path to social or environmental transition”*.

For green bonds, such an outcome would be inconsistent with the approach of various EU regulations that assess the sustainability of such instruments at UoP level. It would also cause significant disruption in this market and in sustainable bond funds since utilities are large issuers of green and sustainable bonds. Moreover, various EU regulations such as the Corporate Sustainability Due Diligence (CSDD) Directive and Corporate Sustainability Reporting Directive (CSRD), as well as the guidance of the Principles already address issuer-level transition concerns on top of the greenness/sustainability of UoP. We therefore believe an exception to the application of PAB exclusions at issuer level would be both consistent and appropriate when investing in green bonds.

Secondly, several of our members have also recommended that ESMA consider providing an exception for sustainability-linked bonds (SLBs) which are fully aligned with the [Sustainability-Linked Bond Principles](#) and incorporate ambitious targets² and material KPIs, which can be drawn from the [Illustrative KPIs Registry](#). These instruments are complementary to UoP instruments and are designed to incentivise issuers towards sustainability. Investment flexibility in all types of sustainable bonds is essential for advancing environmental objectives and ensuring a comprehensive approach to sustainable finance.

¹ While green UoP bonds include both green bonds aligned with the [Green Bond Principles](#) and sustainability bonds aligned with the Sustainability Bond Guidelines, we refer to “green bonds” aligned with the “GBP” throughout the text for ease of reference.

² In June 2022, the Principles released the [Methodologies Registry](#) to help issuers, investors, or financial intermediaries identify the relevant resources to guide their transition. This is a non-exhaustive, yet comprehensive list of available tools, methods, scenarios, and initiatives dedicated purely to the validation of specific emission reduction trajectories/pathways, especially in the context of the Element 3 of the ICMA’s Climate Transition Finance Handbook which requires transition strategies to be science-based.

Lastly, for funds with transition-related names, we seek clarification on the application of the criterion to “*demonstrate that the investments are on a clear and measurable path to social or environmental transition*”. ESMA could confirm that this criterion could be pursued and satisfied at the fund-level too, but not uniquely at the level of each underlying investments. Among other things, this would allow investments in already sustainable issuers (e.g. renewable energy companies) and green instruments in transition funds.

The attached additional comments provide our more detailed views and analysis on these points. Annex I and Annex II explain the background on the recent ESMA Guidelines and ICMA’s role in sustainable bond market, respectively.

Yours faithfully,

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1. We argue that there should be an exception to this restriction when investing in green bonds from such companies for the following reasons:

EU sustainable finance regulations recognise that the sustainability characteristics of green bonds should be assessed at the UoP level.

When assessing the relevance of green bonds, the primary focus should be on the greenness of the financed project(s) rather than organisations' historical entity-level environmental performance or business model. This is because, the proceeds of green bonds finance green projects creating clear environmental benefits. Issuers of green bonds commit to report on an annual basis on the allocation of proceeds to green projects and are expected to report on the environmental impact of such allocations.

This is indeed the approach under various EU sustainable finance regulations. For example, the EU Green Bond Standard (EU GBS) does not restrict issuers from utilities and energy sectors, who may otherwise be part of the PAB exclusions, from using the standard when issuing green bonds. To the contrary, utilities financing renewable energy projects are in fact among the best candidates to use the EU GBS, as also [demonstrated](#) by their relatively high taxonomy alignment in terms of capital investment.

Also, as per the [SFDR Delegated Regulation](#) and [Article 8 Delegated Regulation](#), the Taxonomy accounting of green bonds are made at the level of the financed project(s) rather than issuers' organisation level Taxonomy alignments. As another example, the [SFDR Q&A document](#) states that to demonstrate that a project meets the DNSH condition of the definition of sustainable investment set out in Article 2(17) SFDR, financial market participants could adjust the metrics to reflect the fact that project financing bonds finance only specific activities and not the entire undertaking.

The re-categorisation of green bond investments could cause significant disruption to sustainable funds and to the sustainable bond market.

Generally, the article "[EU Guidelines on ESG Funds' Names: A Great Reshuffle Ahead](#)" by Morningstar Sustainalytics indicates that ESMA Guidelines may force more than 1,600 funds, which represent around two thirds of funds with ESG or sustainability-related terms, to rebrand or divest up to \$40 billion-worth of stocks. The sectors most affected by the potential divestments include energy, industrials, and basic materials.

While this report does not specifically look at green and sustainable bond funds, we would expect considerable impact for these funds too. The PAB exclusions list would apply to many utilities as the list captures companies as they derive 50% or more of their revenues from electricity generation with a GHG intensity of more than 100g CO₂e/kWh. Utilities have historically been among largest green bond corporate issuers, and their green bond issuance amounts to USD384 billion representing over 15% of the total green bond issuance to date (USD2.5 trillion).

2. Moreover, both EU regulations and the guidance from the Principles provide disclosures and transparency on issuer-level transition concerns.

We note that the EU's recently adopted CSDD Directive will already require many large EU and non-EU companies, including those who enter within the scope of the PAB exclusions due to their legacy fossil fuel revenues, to develop entity-level transition plans compatible with the 1.5°C objective of the Paris Agreement. The CSRD, on the other hand, will require the disclosure of transition plans, where entities have them, in a standardised format³ and with restrictions on the use and disclosure of carbon credits towards decarbonisation targets.

As a globally accepted standard, the [Green Bond Principles \(GBP\)](#) provide the necessary transparency and disclosure and help avoid investor deception. At entity-level, the GBP recommend issuers to provide information on their overarching sustainability goals and strategies that provide context for their green projects. Particularly relevant to hard-to-abate sector issuers, guidance may be sought from the [Climate Transition Finance Handbook \(CTFH\)](#) when financing projects towards implementing a net zero emissions strategy aligned with the goals of the Paris Agreement. The CTFH clarifies the issuer-level practices, actions and disclosures which are recommended to credibly position the issuance of use of proceeds or sustainability-linked instruments to finance the transition.

ICMA's report "[Transition finance in the debt capital market](#)" (February 2024) also points to the importance of transition plans as these would provide a strategic context to evaluate the consistency of issuer level transition and sustainability commitments with their UoP, and help issuers avoid controversy related to potential carbon lock-in risk in their individual projects and investments. Accordingly, transition plans would help issuers address the risk of "strategic inconsistency", as explained in ICMA's October 2023 report "[Market integrity and greenwashing risks in sustainable finance](#)".

3. Several of our members have also recommended that ESMA consider providing an exception for SLBs which are fully aligned with the [Sustainability-Linked Bond Principles](#) and incorporate ambitious targets and material KPIs which can be drawn from the [Illustrative KPIs Registry](#).

SLBs aim to incentivise issuers' organisation-level sustainability journey and are complementary to the UoP instruments in sustainable bond markets. SLBs should therefore not be prohibited from funds with environmental or "sustainable" names when they are fully aligned with the [Sustainability-Linked Bond Principles](#) and incorporate ambitious targets, which for GHG reduction objectives rely on science-based pathways provided by recognised third-party sources where they exist⁴, and material KPIs such as those provided under the [Illustrative KPIs Registry](#).

³ EFRAG is currently [working towards](#) a transition plan implementation guidance in line with ESRS standards.

⁴ In June 2022, the Principles released the [Methodologies Registry](#) to help issuers, investors, or financial intermediaries identify the relevant resources to guide their transition. This is a non-exhaustive, yet comprehensive list of available tools, methods, scenarios, and initiatives dedicated purely to the validation of specific emission reduction trajectories/pathways, especially in the context of the Element 3 of the ICMA's Climate Transition Finance Handbook which requires transition strategies to be science-based.

Furthermore, given the sustainable bond market comprises both UoP and SLB instruments, a fund manager investing in both product types may simply prefer to replicate the name of this market (e.g. “X Sustainable Bond UCITS Fund”). Such SLBs should also be allowed to qualify and count into fund managers’ commitment to “meaningfully invest in sustainable investments”, which is required by ESMA for funds with “sustainable”-related names. Investment flexibility in all types of sustainable bonds is essential for advancing environmental objectives and ensuring a comprehensive approach to sustainable finance.

- 4. Lastly, for funds with transition-related names, we seek clarification that a fund manager can also demonstrate that “*the investments are on a clear and measurable path to social or environmental transition*” at the fund level, but not uniquely at the level of each underlying investments.**

Among other things, this would allow investments in already sustainable issuers (e.g. renewable energy companies) and green instruments in transition funds. It will also clarify the wider investible universe of funds with transition-related names which will support their operational and liquidity requirements while maintaining their integrity.

Annex I - Background on the ESMA Guidelines and the application of PAB/CTB exclusions

On 14 May 2024, ESMA published its [final report](#) containing Guidelines on funds’ names using ESG or sustainability-related terms (ESMA Guidelines)⁵. The aim of these Guidelines is to specify the circumstances where the fund names using ESG or sustainability related terms are unfair, unclear or misleading. ICMA previously [responded](#) to the ESMA’s consultation on these Guidelines on behalf of its constituencies, and especially the Asset Management & Investors Council (AMIC).

For new funds, the Guidelines apply three months after the date of the publication of the guidelines on ESMA’s website in all EU official languages while for existing funds, they allow an additional 6-month transitional period on top of that. Also, competent authorities must notify ESMA whether they (i) comply, (ii) do not comply, but intend to comply, or (iii) do not comply and do not intend to comply with the guidelines.

The table below summarises the key content of the Guidelines:

Name categories	Examples for relevant terms	ESMA recommendations
Funds using transition-, social-, governance-related terms	“transition”, “improve”, “progress”, “evolution”, “transformation”, “net-zero”	<ul style="list-style-type: none"> • Minimum 80% of investments used to meet E or S characteristics or sustainable investment objectives in accordance with binding elements of the investment strategy • Application of the Climate Transition Benchmarks (CTB) exclusions • Funds using transition-related terms should ensure that investments are on a clear and measurable path to social or environmental transition
Funds using environmental- or impact-related terms	“green”, “environmental”, “climate”, “ESG”, “SRI”	<ul style="list-style-type: none"> • Minimum 80% of investments used to meet E or S characteristics or sustainable investment objectives in accordance with binding elements of the investment strategy • Application of Paris-aligned Benchmarks’ exclusions (PAB) • Funds using impact-related terms should ensure that investments are made with the objective to generate a positive and measurable impact alongside a financial return

⁵ ICMA previously [responded](#) to the ESMA’s consultation on these Guidelines on behalf of its constituencies, and especially the Asset Management & Investors Council (AMIC).

Funds using sustainability-related terms	“sustainable”, “sustainably”, “sustainability”	<ul style="list-style-type: none"> • Minimum 80% of investments used to meet E or S characteristics or sustainable investment objectives in accordance with binding elements of the investment strategy • Application of PAB exclusions • Commitment to invest meaningfully in sustainable investments as per SFDR
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Hence, the Guidelines requires the application of the PAB exclusions to funds with environmental⁶, impact-related⁷, “sustainable” or “ESG” related- terms in their names. On the other hand, when using any “transition”-related word⁸, fund managers should demonstrate that *“the investments are on a clear and measurable path to social or environmental transition”* and apply the exclusions of the Climate Transition Benchmarks (CTB).

Both PAB and CTB exclusions are directly listed by the [Commission Delegated Regulation 2020/1818](#):

Exclusions under PABs	Exclusions under CTBs
<p>(a) companies involved in any activities related to controversial weapons;</p> <p>(b) companies involved in the cultivation and production of tobacco;</p> <p>(c) companies that benchmark administrators find in violation of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises;</p> <p>(d) companies that derive 1 % or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite;</p> <p>(e) companies that derive 10 % or more of their revenues from the exploration,</p>	<p>(a) companies involved in any activities related to controversial weapons;</p> <p>(b) companies involved in the cultivation and production of tobacco;</p> <p>(c) companies that benchmark administrators find in violation of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises;</p>

⁶ “Environmental” terms mean any words giving the investor any impression of the promotion of environmental characteristics, e.g., “green”, “environmental”, “climate”, etc. These terms may also include “ESG” and “SRI” abbreviations.

⁷ “Impact”-related terms mean any terms derived from the base word “impact”, e.g., “impacting”, “impactful”, etc.

⁸ “Transition”-related terms encompass any terms derived from the base word “transition”, e.g. “transitioning”, “transitional” etc. and those terms deriving from “improve”, “progress”, “evolution”, “transformation”, “net-zero”, etc.

<p>extraction, distribution or refining of oil fuels;</p> <p>(f) companies that derive 50 % or more of their revenues from the exploration, extraction, manufacturing or distribution of gaseous fuels;</p> <p>(g) companies that derive 50 % or more of their revenues from electricity generation with a GHG intensity of more than 100 g CO₂ e/kWh.</p>	
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These rules do not foresee however any exception for green bond funds. In other words, an asset manager who, in the past, included green bonds from utility and energy sector issuers (caught by the PAB exclusions) would either need to divest from such bonds. Alternatively, the name of the fund would need to change to either remove any “green” or environmental, “sustainable” or “ESG” term or include a transition-related term if it can demonstrate that *“the investments are on a clear and measurable path to social or environmental transition”*.

Annex II – ICMA and its role in sustainable bond market

ICMA is a trade association headquartered in Switzerland with over 620 members who are active in all segments of international debt capital markets in 68 jurisdictions globally. These include private and public sector issuers, financial intermediaries, asset managers and other investors, capital market infrastructure providers, central banks, law firms and others worldwide. In pursuit of its objectives, ICMA prioritises three core fixed income market areas – primary, secondary, repo and collateral, with two cross-cutting themes of sustainable finance and FinTech and digitalisation. See www.icmagroup.org.

ICMA hosts [the Principles](#) that underpin sustainable bond issuances globally. In 2023, 97% of the global sustainable bond issuance volume [aligned](#) with the Green, Social, Sustainability, and Sustainability-linked Bond Principles (the Principles). As globally accepted market standards, the Principles are the fruit of extensive work and input from over 380 organisations including issuers, investors, underwriters and other stakeholders from the market, the official sector and civil society.