Frankfurt am Main,
11 December 2020

JRC Technical Report 3.0: Development of EU Ecolabel criteria for Retail Products
Comments by BVI

BVI[1] is supportive to the general goal of introducing an EU-wide recognised common label for green investment products. We believe that an EU Ecolabel, if well designed, has the potential to facilitate the marketing of environmentally sustainable products to retail investors, especially in the cross-border context. However, to achieve this goal, we need a smart EU Ecolabel, with criteria that will balance the need for an adequate level of ambition in environmental terms on the one hand and for enabling diversification needed to manage the investment risks for the end-investors on the other.

Moreover, given that the investment criteria shall be based on the Taxonomy as an entirely new set of rules, the final set of rules needs to be reliably tested in practice, at best on a range of currently offered products, in order to ensure their practicability, also with regard to the data coverage.

After having analysed the 3rd JRC Technical Report, we fear that the proposed criteria would still fall short of these expectations. Therefore, we request the JRC to take into account the following comments and suggestions for alternative solutions:

Third proposal for Criterion 1: Investment in environmentally sustainable economic activities

<u>New formula for calculating contributions from companies investing in transition or green growth</u>:
We appreciate the JRC's efforts to facilitate the applicability of the Taxonomy by combining an investee company's contributions to environmentally sustainable activities in a new formula. Indeed, an isolated consideration of revenues, CapEx and OpEx figures will in many cases not be helpful, since it does not allow for a holistic view on a company's activities relevant for achieving the environmental objectives of the Taxonomy.

However, **the proposed formula as such has several downsides** that in total render it impractical:

- Two relevant elements of the formula – cumulative Green CapEx and cumulative projected Green Revenue Growth – shall be based on estimations of future developments in terms of green investment or green activities provided by a company. The Green CapEx ratio shall be based on a commitment apparently to be made by a company for a minimum forward-looking period of three years; the Green Revenue Growth shall be linked to a company's strategic investment plan for a minimum forward-looking period of 5 years. These would then be purely theoretical numbers based on nothing more than expectations and targets by a company. We

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset Managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 114 members manage assets more than 3.6 trillion euros for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 27%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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doubt that such projected figures can be treated as a reliable basis for calculating green contributions of investments.

- Even if considered adequate, there is absolutely no data available in the market for assessing companies against such projected indicators. The JRC apparently assumes that a commitment to reach a certain level of green revenues or green CapEx in the next years needs to be made by a relevant company. However, data on such commitments, if available at all, are currently not being collected by commercial vendors. The only way asset managers could obtain access to such data in theory would be by means of fundamental analysis, e.g. based on research reports obtained from brokers. However, this would overstain most asset managers and would certainly not be feasible as part of the general investment approach that needs to rely on automated processes and technical integration of ESG relevant data.

Nonetheless, the idea underlying the new formula is very welcome, since it aims at a holistic assessment of companies and at capturing a broader investable universe. Therefore, **we would like to encourage the JRC to continue its work on this formula, but with two important caveats**:

- **First, the formula should be based on data that will become available in the near future under Art. 8 of Taxonomy Regulation**. Companies within the scope of NFRD will be obliged to report about the proportion of their revenues from, but also CapEx and OpEx relating to, environmentally sustainable activities. According to the recently consulted proposals by ESMA, non-financial undertakings which are in the focus of the Taxonomy shall provide this information first in 2022 for the financial year 2021 (as regards the first two environmental objectives) and after the first year of application, shall report figures for the current and the preceding financial year for comparability reasons. This set of data should be made operational in order to evaluate a company's contribution to environmental objectives in a wider manner. In particular, the reported CapEx figures over the last two years can be taken as a proxy for the development of CapEx in the near future.

- **Second, the assessment of environmentally sustainable activities should be based solely upon the Taxonomy without inventing new criteria for eligible companies** to be applied exclusively for the purpose of the EU Ecolabel. The formula for the holistic assessment of a company's activities should be applied based on the Taxonomy-relevant KPIs, given that the Taxonomy applies at the economic activity level. Additional criteria to be applied at the company level would render the assessment process overly complex and due to their current focus on projected future outcomes for which no data exists, not feasible in operational terms (cf. our comments on the new proposal for Criterion 2 below).

<u>Thresholds for investments in environmentally sustainable economic activities</u>:
We welcome the adaptations to the thresholds for the proportion of the total portfolio value to be invested in environmentally sustainable activities. Especially with regard to UCITS bond funds and UCITS mixed funds, the 50% threshold in combination with the widened scope of eligible assets could be a significant progress in terms of diversified portfolio construction. Nonetheless, our members feel currently not able to test the revised thresholds due to the additional complexity introduced by the proposed formula and the lack of data to apply it. Against this background, it is even more **important to accompany any further development of concepts by rigorous practical testing in order to verify both, availability of any data needed for calculations and a satisfactory market coverage**. We view practical testing, especially of the specific thresholds for green activities, as essential for ensuring viability of the EU Ecolabel.

Assessment and verification:
In the phasing-in time of the EU-Ecolabel, it is not appropriate to require evidence of the monthly averages for the 12 months preceding the application to conform to the Ecolabel criteria. Given that the evolvement of the technical criteria to the Taxonomy will continue in the next years and needs still to be accompanied by the disclosure of corresponding data by corporations, it is clear that viable investment solutions based on the Taxonomy are not yet there and will be only launched progressively in future following those developments. Moreover, the proposed requirement for a track-record of 12 months discriminates against already existing funds while allowing newly launched products to explain the fund strategy based on the sales prospectus. Given that the Ecolabel criteria follow an entirely new concept, it should be clear that no relevant track record can be provided from the outset and that existing "green" funds will need to adapt their investment strategy to be compliant with the Ecolabel requirements. This puts already existing and newly launched funds on an equal footing meaning that no distinction in terms of assessment criteria should be made.

New proposal for Criterion 2: Investment in companies investing in transition and in green growth

We strongly disagree with introducing new company-level criteria for eligible investments in investee companies to be applied exclusively in the context of the EU Ecolabel. The reasons for our reservations are as follows:

- Introduction of new criteria at the company level is not in line with the approach under the EU Taxonomy that allows for consideration of environmentally sustainable activities as long as the "DNSH" and minimum social safeguards at the activity level are fulfilled.

- We do not understand why the new types of companies cover only some of the eligible sectors under the EU Taxonomy. When it comes to defining "investing in transition", the Taxonomy itself provides for consideration of "transitional activities" in relation to the objective of climate change mitigation. We believe that the Taxonomy criteria are fully sufficient and should not be overlaid by additional criteria at the company level.

- We understand that there is the need to ensure ESG integrity of the company that performs to a certain extent environmentally sustainable activities. However, this should be sufficiently done by applying Taxonomy safeguards and environmental/social exclusions as proposed under Criteria 3 and 4. There is no need to provide for an assessment of "greenness" at the company level beyond the EU Taxonomy.

- The proposed criteria for companies investing in transition and companies investing in green growth comprise formal commitments by a company to either close down certain detrimental activities or to expand investments in/revenues from green activities. Information on such commitments according to the proposed criteria is not being systematically covered by any commercial ESG data vendor and thus, is currently not available. The only way asset managers could obtain access to such data in theory would be by means of fundamental analysis, e.g. based on research reports obtained from brokers. However, this would overstain most asset managers and would certainly not be feasible as part of the general investment approach that needs to rely on automated processes and technical integration of ESG relevant data.

- Differentiation of two new types of eligible companies solely for the purpose of applying the Ecolabel criteria is too onerous and disproportionate for most asset managers. We already see declining interest in the Ecolabel project in the asset management community due to the narrow focus on purely “green” investments. If the current level of complexity were to be retained, we fear that most providers will be discouraged to apply their products for the EU Ecolabel.

For these reasons, we urge the JRC to get rid of the additional assessment of eligible investee companies as proposed in the new Criterion 2. As explained above, the formula for calculating a company’s contributions to environmental objectives should be based on data that will be reported in the near future under Art. 8 of Taxonomy Regulation, especially on the Taxonomy-relevant KPIs for revenues and CapEx that can be taken as proxies for future developments. This approach would operationalise the EU Taxonomy for evaluating a company’s contribution to environmental objectives in a wider manner, but while avoiding another layer of complex evaluations.

Third proposal for Criterion 3: Exclusions based on environmental aspects

We have significant reservations to compiling such an extensive list of exclusions. In combination with the investment thresholds under criterion 1, **exclusions lead to a material reduction of assets eligible for investment**. Products wishing to qualify for the Ecolabel would thus have very limited opportunities for risk diversification as well as for selecting investments that have the prospects to outperform the market. Therefore, the **practical testing of the EU Ecolabel criteria** should not focus exclusively on the thresholds for portfolio “greenness”, but **must also take into account the effects of compiled exclusions** for the asset manager’s possibility to offer products with an attractive risk-reward profile.

In detail, the **following exclusion criteria** have been flagged by our members as **problematic**:

- Agriculture: Basically the whole food and chemical sector seems to be excluded.
- Forestry: The entire paper sector is excluded.
- Energy sector: The whole energy and utilities sector is excluded, unless the company meets the criteria for “investing in transition”. In this regard, we urge the JRC to waive the additional criteria for eligible investment companies (cf. our recommendations on Criterion 2 above). The qualitative requirements for not applying the exclusion (revenue from excluded activities below 30%, phase-out, closure or fuel-switching plan) should be considered relevant on their own, without assigning the company a specific “status”.
- Transportation: Most of the auto sector and auto parts are currently excluded. Also here, the transitional aspects relevant to transportation activities should be addressed specifically in the context of the relevant exclusion, not by introducing additional assessment criteria at the company level.

In general, the **complexity of multinational corporations’ value chains** is not sufficiently taken into account. It is not clear if issuer’s supply chains are part of the restrictions or if investment activities (e.g. a conglomerate holding a stake in farmland or suppliers or vegetable oil) are in scope or not.

As regards the exclusions for **sovereigns or sub-sovereigns**, we are worried about the new requirements linked to the ratification of the Paris Agreement. An issuer shall be excluded if it has not published a credible CO_2 reduction trajectory compatible with a 2 degrees scenario. It is entirely unclear, however, how asset managers shall assess whether a reduction trajectory published by a state is “credible” and “compatible” with the goals of the Paris Agreement. In the absence of reliable scientific evidence on these points, most sovereign issuers would be excluded under the proposed criterion; this would currently pertain also to most EU Member States.

Third proposal for Criterion 4: Exclusions based on social and governance aspects

As the EU Ecolabel is aimed at promoting environmentally sustainable investments, **we do not deem it appropriate to require explicit exclusions based on social or governance aspects.** Minimum social safeguards are already provided for by the Taxonomy (cf. Art. 18 of the Level 1 Regulation) and are based on international treaties providing for very comprehensive and stringent safeguards, amongst others dealing with bribery and corruption and excluding controversial weapons.
Compliance with minimum safeguards can be assumed for all investments in undertaking providing Taxonomy-compliant activities. Hence, instead of applying additional social or governance exclusions, **the requirements of Art. 18 should be extended to all investments in Eco-labelled portfolios.** This approach would also result in more consistency and clarity for retail investors.

As regards exclusions in general, we have **significant reservations to compiling such an extensive list of criteria**. In combination with the investment thresholds under criterion 1, exclusions lead to a material reduction of assets eligible for investment. Products wishing to qualify for the Ecolabel would thus have very limited opportunities for risk diversification as well as for selecting investments that have the prospects to outperform the market. Therefore, the **practical testing of the EU Ecolabel criteria must also take into account the effects of compiled exclusions** for the asset manager’s possibility to offer products with an attractive risk-reward profile.

In any case, while appreciating the amendments to the exclusion criterion based on production and trade of weapons, **we still disagree with the proposed full exclusion of any tobacco-related activities.** It must be clear that a hard exclusion of companies deriving even small proportions of revenues from those activities (without allowing for any de minimis thresholds), including in a corporate group, would once again materially reduce the investment opportunities for Eco-labelled funds. This is particularly relevant with regard to distribution of tobacco products which means that whole sectors like retailers, hotels, trains, planes, but also airport infrastructure and passenger water transport, would be automatically excluded. It appears quite disproportionate e.g. to exclude investments in a modern airport that would qualify as environmentally sustainable under the EU Taxonomy because of a potentially negligible proportion of revenues derived from sales of tobacco products. A possible solution could be to **allow for a de minimis threshold of 5% at least for distribution activities** related to tobacco products.

Moreover, it should be specified that exclusions do not apply to the so-called “dual use” products. This is particularly relevant in terms of exclusion of production and trade of conventional weapons, but also for tobacco production and any tobacco-related activities that might apply i.e. to producers of paper used among others for cigarettes or filters.

Regarding norms based screening or screens aiming at **UN Global Compact compliance**: it should be noted that ESG rating providers classify violations of international conventions with varying degrees of magnitude: from allegations to confirmed violations and severe confirmed violations. It should be made clear that at least only confirmed violations are in scope.

Third proposal for Criterion 5: Engagement

We support the revised approach to engagement that focuses on ensuring quality of the engagement process rather than on setting quantitative criteria. Nonetheless, we still doubt whether it makes any sense to link requirements for active management to a certain proportion of assets under management. In the current market practice, ESG engagement is focused on promoting environmental or social goals that underly the relevant investment strategies. In order for engagement to be effective, asset managers should be able to react to new environmental or social challenges by adapting their engagement strategy and placing their focus on companies that represent the biggest problems or where they see the biggest potential for a change.

Moreover, asset managers should be transparent about their engagement activities, but in a focused manner that will help investors to understand the extent of engagement and any results linked to it. The information should not be required to be provided separately for each investee company, but should be linked to the **engagement reports to be provided under the EU Shareholders Rights Directive**. There, it could be envisaged to include a **separate section on ESG engagement** setting out targets and goals in environmental terms and outlining the main engagement activities. Such integrated reporting on ESG engagement would help investors to understand how ESG engagement is intertwined with the broader engagement strategy and thus, should be considered sufficient also for the purpose of informing investors in Ecolabelled funds.

New proposal for Criterion 6: Measures taken to enhance investor impact

We are very concerned by proposed requirement to produce a separate impact report on Ecolabelled funds. Funds and insurance products applying for the Ecolabel will not come from an unregulated environment, but will be subject to the SFDR regime and in most cases will qualify as Art. 9 products, i.e. as products having as their objective sustainable investments. Article 9 products will be bound to report on the overall sustainability-related impact of the product on an annual basis starting from 2022; such reports shall be based upon relevant sustainability indicators to be defined at the product level. Therefore, **the EU regulatory framework will already provide for dedicated impact reporting for funds and insurance products qualifying for the EU Ecolabel that should not be duplicated or overlaid by additional reporting requirements**. Moreover, there is an obvious risk that the concept of “investor impact” under the Ecolabel criteria might differ from the impact reporting approach under SFDR that will be further specified by regulatory technical standards expected in January 2021. Such outcome would likely lead to confusion and misapprehensions on the part of investors.