Frankfurt am Main,
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JRC Technical Report 2.0: Development of EU Ecolabel criteria for Retail Products
Final 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 allow for a sufficiently large pool of assets to invest in, and thus, enable diversification needed to manage the investment risks for the end-investors. Given that the investment criteria shall be based on the Taxonomy as an entirely new set of rules, they need to be reliably tested in practice, at best on a range of currently offered products, in order to ensure their practicability.

After having analysed the 2nd JRC Technical Report, we fear that the proposed criteria, even if reviewed to an extent, would still result in a very narrow pool of qualifying investments and funds that are suitable for the retail market. In this regard, we ask the JRC to take into account the following comments and suggestions for alternative solutions:

Ad Section 3: Product group name, scope and definitions

We strongly disagree with limiting the product group potentially qualifying for the EU Ecolabel to equity, bond and mixed investment funds without accounting to real estate funds. Even though real estate investments by retail investors might not be equally popular throughout the EU, in some Member States they account for a very relevant segment of the retail market. This is certainly true for Germany as the largest national retail market in the EU where the assets under management of retail real estate funds have reached an all-time high of EUR 109 billion by the end of 2019. Last year, they also accounted for EUR 10.7 billion net sales (out of a total of EUR 17.5 billion net sales of retail investment funds in Germany). These numbers demonstrate very clearly the importance of real estate funds as vehicles for retail investments in Germany.

Moreover, acquisition and holding of real estate will be directly recognised as an eligible sustainable activity under the EU Taxonomy. Unlike equity or bond funds, funds investing in real estate will be able to apply the Taxonomy criteria directly upon their holdings and to assess their compliance with the technical thresholds and other criteria. Therefore, we request a rapid resumption of the discussions about possible investment criteria for real estate in order to be as soon as possible included in the scope of the products qualifying for the EU Ecolabel.

[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 trillion euros for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 22%, 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.

BVI
Bundesverband Investment
und Asset Management e.V.

Contact
Phone +49 69 15 40 90 0
www.bvi.de

BVI Berlin
Unter den Linden 42
10117 Berlin

BVI Brussels
Rue du Trône 14–16
1000 Bruxelles

BVI Frankfurt
Bockenheimer Anlage 15
60322 Frankfurt am Main

Executive Board
Thomas Richter CEO
Rudolf Siebel MD

Ad Section 5.1. Criterion 1: Investment in green economic activities

The proposed thresholds for investments in line with the Taxonomy are far too ambitious. In particular:

- **Equity funds:** The requirement to invest 20% of a portfolio in companies deriving at least 50% of their revenues from green economic activities results in a very restricted investment universe. According to research performed by one of our members, barely 2% of all companies compositing the MSCI World index would potentially qualify as investments under this threshold (based on the current preliminary set of technical criteria). When accounting for the second threshold (20% of revenues from green economic activities), the investment universe would still be restricted to less than 10% of MSCI world. **Such limited approach would prevent proper diversification and hence, not enable distribution of risk that is generally considered a core feature and benefit of retail funds.**

- **Bond funds:** Requiring minimum 70% investments in bonds that comply with the EU GBS is entirely impracticable, given that the EU GBS does not yet exist and it is uncertain whether and how fast it will be accepted as a market standard. The approach to bond funds needs thus to be widened in order to encompass (1) other already established green bond standards such as the ICMA principles and (2) investments in conventional bonds issued by companies that derive certain proportion of revenues from green economic activities.

- **Funds of funds:** The threshold of 90% for investments in target funds that have been awarded the Ecolabel means that in the next few years, there will be no prospect for funds of funds to qualify for the label itself.

- **In relation to all asset classes, there is the general problem with insufficient availability of data for assessing compliance with the EU Taxonomy**. Even though the Level 1 framework imposes obligations on corporations to report KPIs based on the Taxonomy criteria, three major challenges will remain:

    - The current reporting obligations are linked to the scope of application of the NFRD and apply effectively only to large public interest entities. Even though discussions about widening the scope have commenced, it will take several years before any effects will be visible in practice.
    - Reporting obligations under NFRD apply only to EU issuers. There is a huge data gap in respect of information about ecologically sustainable activities by non-EU companies that will very likely not be closed by the current review. Investments in non-EU equities represent on average nearly half of the retail fund assets[2] and thus are hugely relevant for assessing the sustainability criteria in a portfolio.
    - There is a timing issue in the phasing-in period of the Taxonomy: While disclosure obligations for financial products seem to apply from 31 December 2021, the requirements for corporations to report KPIs based on the Taxonomy first kick in after 31 December 2021. This means that reporting will probably be required for the business year starting after 31 December 2021, with first reports due in the course of 2023. With this sequencing of events, providers of financial products will have no reliable data for assessing thresholds foreseen in terms of the Ecolabel until 2023.

[2] Assessed for German retail equity and balanced funds on the basis of holdings in 2019; source: German Bundesbank.

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Proposed solution: The thresholds for green investments in line with the Taxonomy should be set much lower at least for the phasing-in period of the Taxonomy and taking into account the expected evolvement of technical criteria as well as persisting problems with the availability of ESG data to assess compliance with the Taxonomy. **We suggest setting the threshold for "green" investments in line with the Taxonomy generally at a maximum of 50% while requiring that selection of the remaining assets follows a determined and transparent ESG approach.** This could specifically mean:

- For equity funds, investments of at least 50% of AuM in companies deriving certain percentage of their revenues from green economic activities (and applying transparent ESG criteria for selecting the remaining 50%). We recommend starting with a relatively low percentage, e.g. 15%, with the option to increase it over time in case provided improved data coverage from issuers and completion of the work on the technical criteria for other industrial sectors.
- For bonds funds, investments of at least 50% of AuM in EU GBS, green bonds issued in accordance with other recognised market standard or bonds issued by companies deriving certain percentage of their revenues from green economic activities (and applying transparent ESG criteria for selecting the remaining 50%). Also here, we recommend starting with a relatively low percentage, e.g. 15%, with the option to increase it over time in case provided improved data coverage from issuers and completion of the work on the technical criteria for other industrial sectors.
- For funds or funds, investment of at least 50% of AuM in funds being awarded the Ecolabel (or other national green label and applying transparent ESG criteria for selecting the remaining 50%.

- **Eligible assets:** We have the following suggestions as regards the requirements for other eligible assets:

    - It should be made clear that the term "bonds" as defined under 3.1 includes **convertible bonds**. The market for hybrid funds investing into convertibles or participation papers ("Genussscheine") in Germany totalled € 5.6bn per December 2019 and should not be neglected. The definition so far neither mentions convertibles or participation rights. It should also be made clear that fixed income in general refers to all kinds of debt issued by corporates or sovereigns (investment grade and high yield)
    - Use of **derivatives**: The use of derivatives to increase exposure must not be restricted to temporary situations in response to significant subscriptions. Highly concentrated ESG indices may only be managed in an actively managed fund with the use of derivatives (certificates, warrants or structured notes) as the fund has to comply with the 5%/10%/40 % concentration rule under the UCITS framework. For many mutual fund managers this is not a temporary but strategic risk management decision.
    Moreover, the requirement that "the underlying assets shall comply with EU Ecolabel criteria" should not apply to index derivatives. As of today, no single index is in compliance with the EU Ecolabel. This would preclude any possibility to invest in index futures.

- **Revenues versus CapEx:** The current JRC proposal provides for the use of revenues from EU taxonomy compliant activities as a metric. To include transitioning companies, which have few or no EU taxonomy aligned activities, we would suggest allowing also the use of CapEx as a future-oriented metric. For equities, we would suggest that if a company has less than 10% of revenues from EU Taxonomy aligned activities, CapEx could be used as an alternative, as long as it provides at least 50% of investments in EU Taxonomy compliant activities at the portfolio level.

- **Unit-linked insurance products:** In practice, unit-linked insurance contracts generally work as wrappers for very flexible and adaptable selection of investment funds and/or managed portfolios. The results of investment selection are individual and differ from client to client. So, there is no way of ensuring that the individual investment choice by a client will meet the Ecolabel thresholds, unless each investment option in a unit-linked product to be selected on an individual basis or in combination with other investments is itself in compliance with the Ecolabel requirements.

- **Assessment and verification:** In the phasing-in time of the EU-Ecolabel, it is inappropriate 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. A requirement for a track-record of 12 months will mean that the first applications for the Ecolabel will be even more delayed. Moreover, such long track-record would prevent new and innovative products to qualify for the label.

Proposed solution: The Ecolabel could be awarded on a provisional basis for the first 12 months, with a second phase of scrutiny thereafter.

Ad Section 5.2: Criterion 2: 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.

In detail, we have identified the following exclusion criteria as problematic:

- **Energy sector:** Combination of the second and third criterion would exclude basically all companies from the energy supply sector. This means that EU Ecolabel products would not be able to participate in, or foster, transition opportunities in utility companies. In order to avoid this undesired consequence, we suggest starting with a higher threshold, e.g. 15%, with a perspective to lower it in future taking into account the progressing transition.

- **Transitionary exclusions for transportation:** We do not understand why manufacturers that meet all EU targets for CO_2 reduction shall be excluded if they do not undercut those targets. This would effectively mean a total exclusion of investments in the passenger car industry. Also, EU targets apply only to car ranges sold in the EU which creates a problem for the evaluation of the overall equity/bond investment.

- **The following exclusion criteria are not matched by data providers** according to the feedback by our members:
  - **timber production** with the requirements for certification are not systematically tracked by data providers,
  - **asbestos** as raw material within “manufacturing” sector is not tracked (and to our knowledge not used any more in the listed equities space)

- Agricultural production of **vegetable oils** can only be approximated (in particular palm oil only with a set of assumptions regarding RSPO-certification etc.). Production of palm oil is also not precise enough in the definition of scope. In particular, it is unclear whether vendors and sub-contractors, or equity stakes of large corporations in small landowners are to be considered.
- **Waste management** in general is not tracked by data providers.

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 exclusion criteria for **sovereigns or sub-sovereigns**, we would strongly encourage allowing investments in sub-sovereign bonds in the event that at national level, the sovereign issuer were excluded in order to maintain a sufficiently broad investment universe for retail funds. However, this would entail a data challenge because neither sub-sovereigns nor municipals are tracked by conventional ESG rating agencies. Therefore, asset managers should be able to use their own assessment and scoring schemes on sub-sovereigns and municipals as long as they disclose their approach for classifying these issuers as being eligible. In this regard, we consider it problematic to require asset managers to make available annually to consumers a climate or environmental risk rating for each sovereign issuer (cf. criterion 5, section 5.2). For licensing reasons with vendors of ESG ratings, asset managers must not pass on rating information externally and can only use it for their internal operations and investment management decisions.

Ad Section 5.2: Criterion 3: 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.

In any case, **we disagree with the proposed full exclusion in terms of production or sales of either tobacco or weapons in general** (without restriction to controversial weapons). 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. Due to the absence of any de minimis thresholds, many unintended exclusions would apply or would create disproportionate efforts for due diligence.

Proposed solution:

- To replace mandatory exclusions based on social and governance considerations by the requirement that all portfolio undertakings (as issuers of equities or bonds) adhere to the minimum social safeguards as defined in Article 18 of the Taxonomy Regulation.
- Only if this option proves not feasible, to introduce the following modifications:
  - allow for a de minimis threshold of at least 5% of revenues (at the company group level)
  - specify 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 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.

Lastly, some of the proposed exclusion criteria are too vague for practical implementation. This pertains in particular to "corporate activities that violate minorities' and indigenous communities' rights" (which minorities are relevant in this regard?) and to non-existence of "good corporate governance practices". As regards the latter there is no uniform and undisputed definition of "good corporate governance" that could be used by data providers since the interpretation of the term varies by country and region (e.g. difference between one-tier and two-tier board, presence of a lead independent director, etc.) even in Europe, let alone at international level.

Ad Section 5.4: Criterion 4: Engagement

The proposed requirements for engagement activities are far too ambitious and seem to disregard the currently established market practices. In particular:

- **Engagement has a long-term perspective:** As minority shareholders, asset managers are not in a position to micromanage companies or influence specific business decisions. Engagement is rather useful to encourage long-term alignment in terms of strategies and operations by companies.

- **Engagement is not effective in relation to individual portfolios.** There are different practices in the market in terms of whether engagement is coordinated at a firm level or in a more granular way. Predominantly, engagement in terms of ESG issues is being coordinated by fund managers for several portfolios with dedicated ESG strategies. Some firms start thinking about introducing more granular engagement processes, but in case of large firms managing hundreds of funds such approach appears neither cost-effective nor efficient. Moreover, the management of the investee companies may find it confusing to deal with hundreds of different strategies and divergent engagement requests from one asset manager. This would marginalize the influence potential in a company and go against the interest of the end-investor and other stakeholders.

- **Engagement should not focus exclusively on the Taxonomy.** Since the Taxonomy applies to economic activities capable of making the biggest contribution to the EU goals, it would be erroneous to conclude that any activity not captured by the Taxonomy counteract those goals and companies should be discouraged from offering those activities. Most economic activities are not even being considered by the Taxonomy which means that they must be currently deemed as environmentally neutral. Instead of evaluating specific activities, it makes often more sense to encourage development of multi-year transition roadmaps involving key milestones to be achieved in the short, mid and long term. Moreover, in line with our arguments above, fund managers should remain able to engage with companies on a broad range of ESG issues with the general objective of promoting more sustainability in the company's operations without being bound to the specific criteria of the Taxonomy.

- **The quantitative thresholds proposed for engagement are far too high.** In order to transform the economy to a more sustainable one, engagement is most needed with the most polluting companies. In light of our arguments above, it would be counter-productive to require engagement with all companies that are less than 50% Taxonomy-compliant as the resources necessary to engage with companies that are in bad need of improvement would be diverted to companies that are on the right path.

- **Engagement on ESG relevant issues is considered a dedicated ESG investment strategy.** It should not be presumed for all products wishing to qualify for the EU Ecolabel in the intensity suggested for criterion 4. For instance, in ETFs following passive strategies, the fund manager has no discretion to divest from low performing companies which means that his engagement may be not very effective in terms of environmental outcomes. Generally, it should be noted that engagement takes place not solely in terms of non-financial objectives but needs to be integrated with strategic and financial issues.

- **Engagement is very resource-intensive**, since it requires fund managers to vote at general meetings and have a dialogue with their portfolio undertakings. In globally invested portfolios, engagement can be quite costly and affordable only for large fund managers which would disadvantage small and medium local EU providers in terms of qualifying for the Ecolabel. Moreover, in many cases engagement with non-EU undertakings is not considered to be in the best interest of investors due to high associated costs on the one side and low expected benefits on the other. Setting a quantitative threshold for engagement would override this cost-benefit-evaluation. There would be also little flexibility to evaluate the success prospects depending on the weight of the portfolio holding in terms of the overall voting rights in a company.

- **Engagement does generally not encompass activist measures** such as submission of resolution to the AGM, but rather focuses on constructive dialogue with companies. Having a policy for such submissions should therefore not be required in all cases.

- **Collective engagement cannot be taken for granted for EU fund managers**. Some Member States have in place very strict rules on "acting in concert" that effectively prevent any kind of collective shareholder engagement, including on very specific matters such as climate resolutions. These rules must not disadvantage asset managers in terms of their ability to qualify for the Ecolabel.

- **Selling off investments should always be an approach of last resort**, since it does not result in companies becoming more sustainable but simply in passing the ownership to other investors.

Proposed solution: Against the background of the above arguments, we suggest to modify the wording of criterion 4 as follows:

The fund manager shall have a documented engagement policy describing at least:

1. clearly identified key environmental issues on which to engage with companies;

2. the method and reasons for selecting companies and specific key issues on which to engage;

3. ***~~submission and~~*** *voting of resolutions at AGM to address these issues;*

4. regular monitoring and evaluation of companies and the achievement of specific environmental outcomes.

In case engagement is explicitly described as part of the dedicated ESG investment strategy in the fund's sales prospectus, t~~T~~*he fund manager shall engage regularly with* ***~~at least half of the~~*** *companies that have less than* ***~~5~~10****% green activities. Engagement activities shall include voting at general assemblies and other related actions such as communication and dialogue with the company and****, where possible,*** *other shareholders/stakeholders (to push a climate resolution, for instance), with a clearly stated aim of improving the environmental* ***and social*** *performance* ***as well as governance*** *of the company, notably to encourage companies to:*

- upgrade, improve the quality (from an environmental point of view) or change their existing economic activities ***~~to make them compliant with EU Taxonomy criteria~~****;*

- expand their existing economic activities that are already ***considered environmentally sustainable*** ***~~EU-Taxonomy-compliant~~****;*

- ***~~reduce and stop economic activities that are not EU-Taxonomy-compliant by selling or closing those activities~~****;*

- ***where appropriate,*** *measure and assess the impact on the environment of their activities and change their behaviour with respect to environmental issues;*

- take steps to respond to shareholders/stakeholders' engagement with respect to the companies' environmental strategies.

*The fund manager shall set specific key topics raised via engagement with the companies in planning actions in terms of environmental strategies and green activities****. ~~within a specific period of time, failing which the fund manager may decide to sell (some of the) shares from the company (or reconsider inclusion of the company within the fund).~~***