



AMIC response: EC consultation on the EU Ecolabel for retail financial products

17 April 2020

Executive summary

The EU Action Plan on Sustainable Finance has put in motion several ambitious initiatives to shift more investments into sustainable assets. The EU Ecolabel for financial products (investment funds, deposits, and insurance-based investment products) is the most recent of these and we welcome the opportunity to comment on this new draft proposal.

We believe positive changes have been introduced since the first draft version, but we are still concerned that some of the main requirements might compromise the success of this initiative.

- **Company threshold, eligible investment universe and risk management:** The need to award the EU Ecolabel to best-in-class environmental products has pushed the EC to set a strict and high level of taxonomy alignments both at the level of the portfolio and underlying assets. Some members' estimates suggest that the revised company thresholds are still too high, in particular for equity funds: only 2% of all companies in the MSCI World index could potentially qualify for the first threshold (at least 50% of turnover derived from taxonomy compliant activities) and less than 10% for the second threshold (20%-49% turnover derived from taxonomy compliant activities). As a result some have estimated that less than 2% of sustainable funds would potentially be eligible for the label, which is far from the EU Ecolabel objective of a 10-20% target for environmental friendly investment funds. These estimates do not take into account the DNSH objective which further reduces the number of eligible issuers: only 9% of MSCI ACWI IMI (which represent 99% of the global equity investment opportunities) could potentially be involved in eligible activities and meet the DNSH requirement. Bearing in mind that retail funds need to be sufficiently diversified to comply with the UCITS directive and more importantly to protect investors, establishing a fairly sizable eligible investment universe should be a key priority.
- **Social, governance, and ethical aspects:** In an attempt to capture sustainable aspects more broadly, the EC is proposing a detailed exclusion list based on social, ethical, governance and human rights matters (zero tolerance). This will inevitably further shrink the investable universe, as all criteria are cumulative. This is particularly true for global companies (and therefore equities), which are, given the breadth of their activities, more likely to find themselves facing difficulties with the DNSH objective or these

screening criteria. Designing such an exhaustive list may create a litigation risk for fund managers, which will compromise the success of the label in the equity space, where a quality stamp would be valuable.

In light of these two main observations we would therefore propose for **equity funds** to: (1) keep the portfolio threshold as is, but lower the company threshold and consider not only turnover but also CapEx, (2) amend the environmental exclusion criteria to further allow investments into best-in-class companies transitioning to lower-carbon business models, (3) align social and governance criteria on the safeguards as defined under the Taxonomy but take into account legal impediments for companies operating in third countries and (4) create and update at EU level a list of issuers to be excluded.

For bonds, meeting the requirements would probably be more feasible in the case of use of proceeds bonds as they can facilitate the mitigation of the legal risk associated with the DNSH objective and screening criteria. We would suggest however to extend the list of eligible assets to bonds issued by pure-play green companies and green bonds recognised by current standards (i.e. the Green Bond Principles - GBP) as they strongly contribute to environmental objectives and will favour the take-up of the EU Ecolabel. Creating and updating at EU level a list of sovereigns to be excluded would also be helpful.

AMIC input to the debate

1. Scope

We understand from workshops organised by the EC that the EU Ecolabel (1) will only apply at this stage to a limited number of retail financial products, excluding pension products, and (2) cannot legally apply to institutional products (like AIFs). This comes as disappointment as we believe that the entire range of retail products and eco-system could have benefited from a European quality stamp.

2. Thresholds

Minimum levels of investments in eligible assets have been used more or less successfully to ensure alignment with the objectives of existing European labels. In designing these thresholds, the objectives considered are often to (1) channel funding towards specific asset classes and (2) ensure that the investors are indeed buying what they are being sold and therefore protect them. Reconciling these two objectives is key to ensure the success of a label. It is especially important to ensure that thresholds are well grounded in market reality otherwise the label will not be used (e.g. ELTIFs and the Juncker plan). AMIC members doubt that the currently contemplated thresholds for the EU Ecolabel are realistic, given the anticipated small amount of taxonomy compliant assets available on the market.

A. Bonds

When it comes to bond funds, we think the Ecolabel should not rely exclusively on the EU GBS, as it will most probably not cover all taxonomy aligned bonds and bonds more broadly contributing to a more sustainable economy. It was estimated by MSCI in June last year that around 17% of the market value of bonds contained in the Bloomberg Barclays MSCI Green Bond Index could be in line with the EU GBS.

Indeed, some green bonds might be funding green projects in line with the EU taxonomy but will not be EU GBS compliant from a procedural perspective (e.g. no Green Bond Framework). It could also be that a green bond broadly in line with the EU taxonomy won't be able to qualify to the EU GBS as the activities/projects it funds are not yet covered by technical criteria and therefore are not verifiable. Although considerable work has been achieved by the TEG to identify technical criteria by sector types of activities and metrics, it only covers at this stage the two first objectives (climate mitigation and adaptation) and does not include yet for these objectives significant activities such as maritime shipping, energy efficiency.

There is therefore a concern that by relying exclusively on the EU GBS the Ecolabel might substantially reduce its investment universe and compromise its success due to the lack of eligible asset available. In these conditions, we suggest to allow a portion of the portfolio to be invested in green bonds complying with existing and widely used standards and taxonomies (e.g. ICMA GBP, CBI taxonomy). We would also suggest allowing vanilla corporate bonds from leading green companies to contribute to the "environmental" threshold.

Suggested requirements for bond funds:

At least [70%] of the portfolio shall be invested in corporate bonds with an environmental focus. These include:

- Bonds complying with the EU GBS; or***
- Bonds aligned with current standards such as ICMA's Green Bond Principles and Climate Bonds Standard; or***
- Corporate bonds issued by companies with at least:***
 - 20% of their turnover derived from products/services associated with the EU Taxonomy; or***
 - 50% of their CapEx related to asset/processes associated with the EU Taxonomy.***

The remaining part of the portfolio shall consist of other assets, provided that they comply with ESG exclusion criteria, or cash.

B. Equities

For equities, aligning with the EU taxonomy will prove to be a lot more challenging than for green bonds.

Some members estimate that:

- Only 2% of all companies in the MSCI World index would potentially qualify for the first threshold (at least 50% of turnover derived from taxonomy activities) and less than 10% for the second threshold (20%-49% turnover derived from taxonomy activities). This is without considering the DNSH objective, which would most probably bring these numbers further down.
- Only 9% of MSCI ACWI IMI constituents (99% of the global equity investment opportunity) are likely to be involved in eligible activities and meet DNSH requirement.

We note in this respect that most of the asset managers contacted by the JRC to test the first version of the label, could not verify that the DNSH and exclusions criteria are being met by the issuer and that they had difficulty to determine which activities were taxonomy compliant, indicating that “highly granular company-level research would need to be conducted” and that “this process is rather time- and resource-intensive”.

Taking into account estimates of the potential eligible investment universe and bearing in mind that retail portfolios need to be sufficiently diversified to comply with the UCITS directive and protect investors, we would recommend lowering the company threshold and to consider CapEx as well as turnover. It also important to clarify that cash is not covered by the exclusion criteria.

Suggested requirements for equity funds:

At least [60%] of the portfolio shall be invested in equities complying with the exclusions lists and issued by companies with at least:

- ***20% of their turnover derived from products/services associated with the EU Taxonomy; or***
- ***50% of their CapEx related to asset/processes associated with the EU Taxonomy.***

The remaining part of the portfolio shall consist of other assets, provided that they comply with ESG exclusion criteria, or cash.

C. Cash and derivatives

Another issue is that derivatives and cash are excluded as an eligible green asset class but are included in the calculation of total portfolio.

3. Exclusion criteria

To our knowledge, for most of the exclusion criteria, issuers do not report the information, and no screening solution is in place as of today.

Moreover, there are still uncertainties on how these exclusion criteria will work in practice for fund managers. For instance how should a fund manager act when there are suspicions and uncertainty, based on allegations that a company in the portfolio don't complies with these exclusion criteria? Can he keep the holding until all facts are known?

Under these circumstances and in order to mitigate the litigation risk for fund managers, it might a good idea to have at EU level a common list of issuers excluded.

A. Environment

Power generation

We would see merit in allowing more companies transitioning based on a guided best-in-class approach. This is already possible for transportation (aviation/maritime transport and car manufacturers) and could be extended to electricity generation, which, like transport, has a strong carbon footprint. A guided best in class approach for electricity generation could be based on standards already used:

Use of solid, liquid or gaseous fossil fuels for electricity generation unless the electricity utility company has carbon intensity aligned with a below 2 degrees scenario:							
	2019	2020	2021	2022	2023	2024	2025
Max. gCO ₂ /kWh	429	408	393	374	354	335	315

We note that JRC assumes that nuclear energy has been excluded from the taxonomy regulation. This is not the assessment we made in [our ICMA note](#) on the final compromise text: *“Nuclear energy is neither explicitly excluded nor included in the list of eligible environmentally sustainable economic activities. The importance of “climate-neutral energy” for the transition has been explicitly recognised in a recital. The decision to include or exclude nuclear energy has been left to the detailed rules based on technical expert input, subject to “do no significant harm criteria”, in particular with regards to the disposal of waste, as well as specific references to life-cycle considerations.”*

Car manufacturers

Emission targets for commercial and passenger vehicles are mandatory and set “in line with the Union’s long-term climate goals”. In line with the TEG report on technical criteria, we believe car manufacturers exceeding these reduction emission objectives according to criteria set under the second draft proposal should be eligible under the green threshold and not just the “other assets” threshold.

Sovereign bonds

Members do not see the added value of requesting an external climate risk rating. The fact that a rating agency has analyzed climate risks of a sovereign bond does not mean that the issuer has taken action regarding those risks. We would suggest sticking exclusively to signatures of environmental agreements as screening criteria and would suggest for the EC or Competent Bodies to publish and update a list of sovereign bonds eligible based on this criterion.

B. Social and Governance

Given the breadth of their activities, companies and therefore equities are more likely to find themselves facing difficulties with the DNSH principle or screening criteria. It is therefore very important to test the impact of exclusion criteria based on social and governance aspects and clarify their scope not to overly shrink the investment universe of the EU Ecolabel. Under the new proposal it is unclear whether the social and governance exclusion criteria will have to be applied looking through the supply chain (“The investment portfolio shall exclude companies if they, through their business activities [...]”). This needs to be clarified, bearing in mind that depending on the answer the investment universe of the EU Ecolabel could be significantly further limited and the verification process made much more burdensome for fund managers.

Collective bargaining

It is required that a company shall be excluded unless it upholds the freedom of association and the effective recognition of the right to collective bargaining (ILO Convention, UN Global Compact). With this proposal, there is a risk of seeing some global companies participating in the taxonomy objectives and operating in certain third countries excluded from the EU Ecolabel (e.g. Tesla). Not all third countries have indeed signed up to the ILO Declaration on Fundamental Principles and Rights at Work, allow freedom of association or recognise collective bargaining. We therefore suggest rephrasing this sub-criterion as follows:

Uphold the freedom of association and the effective recognition of the right to collective bargaining when it is legally possible. [ILO Convention, UN Global Compact]

Ethical exclusion

Ethical exclusions (e.g. tobacco, weapons) rely on a strict ban (0% tolerance). This seems disproportionate given that the Ecolabel is supposed to focus on environment matters and is likely to open a Pandora's box, broadening this conversation to other popular taboo areas such as alcohol and gambling. Our suggestion would therefore be to simply align social and governance criteria on the safeguards as defined under the Taxonomy.

4. Passporting

Currently funds using national sustainable labels are not always allowed to be marketed on a cross-border basis. The possibility to passport Eco-labelled funds would be extremely valuable and needs to be clarified. We understand the EC intends to rely on existing passports (UCITS

and AIF), but we would rather support on the contrary the creation of new passport tied to the EU Ecolabel (as for ELTIFs).

5. Verification

Verification processes for national labels can sometimes be lengthy and not always transparent. An EU Ecolabel based on transparent and swift verification process would be a strong argument in favour of this label.

The assessment/verification criteria for equity and bond funds requiring 12 months of portfolio holdings means that this does not allow for new and innovative products to be eligible for the label. If the funds' investment objective and policy are approved as part of the prospectus and explicitly meet the requirements as described by the EU Ecolabel, it would be ideal if these were to be awarded the label (perhaps on a provisional basis if necessary). This will encourage investor flows into new products and hence scale them up more quickly.

6. Engagement criteria

New engagement requirements have been introduced in the second draft. If engagement should be encouraged, the EC should refrain from being too prescriptive. We would suggest leaving it to the asset managers to decide which companies to engage with (it is important to understand that most asset managers engage at firm level and not at fund level). At some point in time asset managers may want to focus on companies at risk of breaching thresholds and at another point in time it may want to engage with green companies. Mandatory engagement with specific companies might divert resources where they are most needed at a specific point in time. Furthermore some of the engagement activities required are not always feasible: AGM voting process and filing of resolutions on a cross-border basis can be very cumbersome in some EU countries. The reference to selling shares in companies that do not make progress is not always possible: when the asset manager is using an index the portfolio manager does not have the discretion to sell assets. Lastly, cooperating with other shareholders to push a specific resolution is not always possible from a legal standpoint. We would therefore suggest making the following changes.

~~The fund manager~~ ***An asset management company managing an investment fund approved for an EU Ecolabel*** 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.

An asset management company managing an investment fund approved for an EU Ecolabel shall engage regularly ~~with at least half of the~~ with companies ***which constitute the underlying assets of the relevant investment fund*** ~~that have less than 50% green activities.~~

Engagement activities ~~shall~~ **may** include voting at general assemblies and other related actions such as communication and dialogue with the company and other shareholders/stakeholders (to push a climate resolution, for instance), with a clearly stated aim of improving the environmental performance of the company, notably to encourage companies to:

~~– upgrade, improve the quality (from environmental/social point of view) or change their existing economic activities to make them compliant with TEG Taxonomy criteria, expand their existing economic activities that are already TEG Taxonomy compliant.~~

~~– reduce and stop economic activities that are not TEG Taxonomy compliant by selling or closing those activities.~~

~~– Measure and assess the impact on the environment of their activities and changes their behaviour with respect to environmental issues;~~

- take steps to respond to shareholders/stakeholders engagement with respect to the companies' environmental and social 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).~~

Assessment and verification

The fund manager or product provider applying for the EU Ecolabel shall provide the verifier with the following information:

1. Evidence showing ~~the percentage of engagement with companies with which the manager has engaged.~~

2. Specific key environmental topics raised via engagement.

3. Voting behaviour in compliance with the engagement policy.

4. Use of other engagement mechanisms with the companies, such as evidence of a constructive company dialogue developing a business case for change and keeping up a good level of interaction with companies.

~~5. Other engagement practices with other shareholders/stakeholders (e.g. cooperating with other shareholders to push a specific climate resolution).~~

Contact

Email: regulatoryhelpdesk@icmagroup.org

Telephone +44 20 7213 0339