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Development of EU Ecolabel criteria for Retail Financial Products

Technical Report 3.0: Draft proposal for the product scope and criteria

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ABBREVIATIONS AND ACRONYMS

AIF	Alternative Investment Funds
AIFMD	Alternative Investment Fund Managers Directive
BIC	Bank Identifier Code
CAB	Climate Awareness Bonds
CBI	Climate Bonds Initiative
CVA	Credit Valuation Adjustment
EC	European Commission
EEA	European Economic Area
ESG	Environment, Social, Governance
ETD	Exchange-Traded Derivatives
ETF	Exchange-Traded Funds
FNG	Forum Nachhaltige Geldanlagen (Sustainable Investment Forum Germany)
GBP	Green Bond Principles
GBS	Green Bond Standard
GHG	Greenhouse Gas
ICMA	International Capital Markets Association
IDD	Insurance Distribution Directive
IDFC	International Development Finance Club
IF	Investment Fund
ILO	International Labour Organization
IPID	Insurance Product Information Documentation
JRC	Joint Research Centre
KID	Key Information Document
KPI	Key Performance Indicator
MDBs	Multilateral Development Banks
MiFID	Market In Financial Instrument Directive
MS	Member States
NFID	Non-Financial Information Directive
OTC	Over-The-Counter
OTF	Operational Trading Facility
PRIIPs	Packaged Retail Investment and Insurance-based Products
RAIF	Retail Alternative Investment Fund
RM	Regulated Markets
SPV	Special Purpose Vehicle
SRI	Socially Responsible Investment
UCITS	Undertakings For Collective Investment In Transferable Securities
TEEC	Transition Energétique Et Ecologique Pour Le Climat (Energy and Ecological Transition for the Climate (France))
TMI	Total Market Index
TR	Technical Report

FOREWORD

This report is part of the development of the EU Ecolabel criteria for financial products. Once developed, the criteria will be adopted through a Commission Decision under the EU Ecolabel Regulation. It summarises and updates the inputs received and the further research carried out by the working team and serves as a working document for the EU Ecolabelling Board (EUEB) meeting to be held on 18 November 2020 (virtual meeting). It takes as its starting point the information available in the Preliminary Report, the First Technical Report and the Second Technical Report, available on the project website: https://susproc.jrc.ec.europa.eu/product-bureau/product-groups/432/home.

The Preliminary Report and the First Technical Report were published in March 2019, and provided the technical background for the product group from a legal, political and market context for the first stakeholder (1st AHWG) meeting held in April 2019 in Seville, Spain. The First Technical Report contained draft criteria proposals which were presented to stakeholders during the 1st AHWG meeting and on which stakeholders were invited to comment during the consultation period. The comments received from the stakeholders have subsequently been collated, analysed, and, following further research, addressed in this Second Technical Report.

The Second Technical Report was published in December 2019, and provided the technical background for the product group for the second stakeholder (2nd AHWG) meeting held in March 2020 (virtual meeting). The Second Technical Report contained draft criteria proposals which were presented to stakeholders during the 2nd AHWG meeting and on which stakeholders were invited to comment during the consultation period. The comments received from the stakeholders have subsequently been collated, analysed, and, following further research, addressed in this Third Technical Report.

This Third Technical Report provides an update to the set of criteria proposals contained in the Second Technical Report based on additional research, and information provided by stakeholders including the subgroup set up to address issues on criterion 1 related to the thresholds on the green investment portfolio and EU taxonomy-eligible economic activities. This report also includes an update of the initial scope and definitions.

HOW TO READ THIS REPORT

The current revised third technical report provides an update on the criteria development, based on new information collected during the process and provided by the involved parties (i.e. through stakeholders' discussion at the 2nd AHWG meeting, further stakeholder inputs following the meetings and additional desk research).

This report consists of the following sections:

- **Section 1 - Introduction**: describing the goal and content of the document, and the sources of information used.
- **Section 2 - Background and Context:** presenting the process for developing EU Ecolabel criteria, the Action Plan on Sustainable Finance, the material scope of the criteria, as well as summarising the main conclusions obtained in the Preliminary Report.
- **Section 3 - Product group name, scope and definitions**: including the updated scope and definitions for the product group of financial products.
- **Section 4 - Structure and rationale for the criteria and criteria areas**: providing an overview of how the criteria set could be configured. The criteria set also includes requirements on the type of documentation required to show compliance with the criteria that shall be provided by applicants to the EU Ecolabel Competent Bodies.
- **Section 5 - Criteria proposal:** presenting the second draft of the proposed EU Ecolabel criteria for financial services. The proposal is written in a blue box and subsequently a rationale is given. Under each criterion, discussions are chronologically presented under the following headings:
    - Summary of the rationale and technical data discussed in the Preliminary Report and the first stakeholder questionnaire that led to the first criteria proposal, presented in the 1st AHWG meeting.
    - The outcomes of and suggestions made by the stakeholders during the 1st AHWG meeting and the subsequent commenting period.
    - Further research carried out on the points addressed by the stakeholders or any other point of relevance and main changes of the criterion in the second proposal.

Background on the EU Taxonomy and a comparison between the 1st and 2nd (revised) criteria proposals are provided in Annexes 1 and 2 respectively.

Should stakeholders require more information about the EU Ecolabel criteria proposed in the Second Technical Report, they are kindly request to download it from the project website: https://susproc.jrc.ec.europa.eu/product-bureau//product-groups/432/documents.

1 INTRODUCTION

The main objective of this project is the development of EU Ecolabel criteria for the financial products group. The study is being carried out by the Circular Economy & Industrial Leadership and the Finance & Economy Units of the Joint Research Centre (JRC) of the European Commission. The work is being developed for the European Commission's Directorate-General for the Environment (DG ENV) and in collaboration with the Directorate-General for Financial Stability, Financial Services and Capital Markets Union of the European Commission (DG FISMA).

The EU Ecolabel criteria are designed to promote the use of the most environmentally friendly products as articulated by the Regulation on the EU Ecolabel (Regulation (EC) No 66/2010 of the European Parliament and of the Council of 25 November 2009 on the EU Ecolabel), hereafter, the 'EU Ecolabel Regulation'. According to Article 2, this Regulation applies to 'products' (either goods or services) that are supplied for distribution, consumption or use on the Community market.

The main purpose of the technical report is to summarise the results of the prior analysis and propose appropriate and updated criteria in this Third Technical Report to serve as a background document for discussion with stakeholders during the EUEB meeting.

This technical report is supported and complemented by the Preliminary Report[1] published in March 2019. The Preliminary Report includes the scope and definition, market analysis, and technical analysis. Moreover, the First Technical Report[2] was published in March 2019 and formed the basis for the 1st AHWG meeting which took place in April 2019. Finally, the Second Technical Report[3] was published in December 2019 and formed the basis for the 2nd AHWG meeting which took place in March 2020.

[1] Preliminary Report. EU Ecolabel criteria for Financial Products. March 2019. Available at: https://susproc.jrc.ec.europa.eu/product-bureau//sites/default/files/contentype/product_group_documents/1581683024/20190315%20PR%201.0%20EU%20EL%20Financial%20Products_Final%20consultation.pdf.

[2] First Technical report EU Ecolabel Financial Products. March 2019. Available at: https://susproc.jrc.ec.europa.eu/product-bureau//sites/default/files/contentype/product_group_documents/1581683024/20190315%20TR%201.0%20EU%20EL%20Financial%20Products_Final%20consultation.pdf.

[3] Second Technical report EU Ecolabel Financial Products. December 2019. Available at: https://susproc.jrc.ec.europa.eu/product-bureau//sites/default/files/2020-02/20191220_EU_Ecolabel_FP_Draft_Technical_Report_2-0.pdf.

2 BACKGROUND AND CONTEXT

2.1 Process for developing the EU Ecolabel

The typical process of developing the EU Ecolabel criteria for any product group is set out in Article 7 of and Annex I to the EU Ecolabel Regulation. This entails the management of a process of stakeholder consultation to be supported by the development of the following documents by the party which is leading the process: (1) a Preliminary Report; (2) a proposal for draft criteria; (3) a Technical Report in support of the proposal for draft criteria; (4) a Final Report; and; (5) manuals for potential users of the EU Ecolabel and Competent Bodies (CBs), and for authorities awarding public contracts.

Moreover, the EU Ecolabel Regulation also stipulates that a minimum of two AHWG meetings shall be held along the criteria process, the first of which took place in April 2019 and the second which took place in March 2020. At the meetings the material contained in the Preliminary Report and the two Technical Reports were discussed. The feedback from these meetings, together with associated rounds of written consultations and multilateral consultations are used to further adapt the scope and criteria proposals.

This Third Technical Report has been drafted in accordance with Article 7 of the EU Ecolabel Regulation and will be updated during the criteria development process based on new information, stakeholder feedback and input from the EUEB meeting and the written stakeholder consultation. The Final Technical Report will incorporate all relevant scientific arguments substantiating the final criteria proposal.

2.2 Action Plan on Sustainable Finance

Sustainability has long been at the heart of the European project and the European Union (EU) is fully committed to reaching the EU 2030 climate and energy targets and to mainstreaming sustainable development into EU policies. Achieving EU sustainability goals requires major investments. A substantial part of these financial flows will have to come from the private sector and this requires redirecting private capital flows towards more sustainable investments as well as comprehensively rethinking the European financial framework.

In this context, in December 2016, the European Commission established a High-Level Expert Group (HLEG) to develop an overarching and comprehensive EU strategy on sustainable finance. This group published its final report in January 2018. As a follow-up, on 7 March 2018, the European Commission published an Action Plan: Financing Sustainable Growth (hereafter, the 'Action Plan')[4]. This Action Plan puts forward 10 actions whose main objectives are to:

1. Reorient capital flows towards sustainable investments to achieve sustainable and inclusive growth;
2. Manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
3. Foster transparency and long-termism in financial and economic activity.

Action 2 of the Action Plan refers to “Creating standards and labels for green financial products”. The Action Plan recognised that “labelling schemes can be particularly useful for retail investors who would like to express their investment preferences on sustainable activities [and] could facilitate retail investors' choice […]”. Hence, the Commission “committed to explore the use of the EU Ecolabel framework for certain financial products, to be applied once the EU sustainability taxonomy is adopted”.

[4] European Commission. 2018. Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions Action Plan: Financing Sustainable Growth. Available from: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097

This action was a follow-up to the specific recommendations of HLEG to establish "a voluntary European green label to spur market growth and enable retail investors to identify products that finance the climate and ecological transition". The HLEG report further recommended that "the Commission should develop a voluntary EU green label for green themed funds [which] should include specifications based on the use of the EU sustainable taxonomy".

Hence, the link between the EU Ecolabel criteria for financial products and the EU Taxonomy was already contained in the HLEG recommendations and the Action Plan. The Impact Assessment accompanying the Taxonomy proposal also recognises that the EU Ecolabel is one of the potential uses of the Taxonomy and is thus one mechanism through which the Taxonomy will have an impact:

"The use of the EU taxonomy for (financial) product standards and labels would improve environmental integrity of green investments within as well as outside the EU (as the taxonomy would also apply to EU investors investing globally). As such, it would help to minimise the risk of greenwashing and avoid the negative environmental impacts from investing in assets that are not in line with the EU sustainability goals". Annex 2 provides more details about the Taxonomy.

A further follow-up is the preparation of a Commission Decision defining criteria to be fulfilled by financial products in order to qualify for the EU Ecolabel. This happens in the framework of the EU Ecolabel Regulation, which provides guidance as to how criteria should be developed and implemented for products and services. The EU Ecolabel is a voluntary award scheme intended to promote products with a reduced environmental effect during their entire life cycle and to provide consumers with accurate, non-deceptive, science-based information on the environmental impact of products. It is a part of a broader EU Action Plan on Sustainable Consumption and Production and Sustainable Industrial Policy (European Commisison, 2008). This Action Plan was already adopted by the European Commission on 16 July 2008 and links the EU Ecolabel to other EU policies such as Green Public Procurement (GPP), the Ecodesign of energy-related products, and the EU Action Plan for the Circular Economy.

2.3 Material scope: financial services linked to a product

According to the EU Ecolabel Regulation, the label may be awarded to "goods and services" which are supplied for distribution, consumption or use on the Community market whether in return for payment or free of charge. Financial products fall within the scope of the EU Ecolabel Regulation where they can be considered as services for distribution or use. **Consequently, the EU Ecolabel will be awarded to the financial service being provided by the manufacturer of the green financial product,** rather than to the financial product. However, the EU Ecolabel logo can figure on the promotional material of the financial product itself.

Given the inclusion of savings accounts and deposits in the expanded scope of this revised criteria proposal due to their relevance to consumers and their market significance in terms of household money, there is a need to provide a service definition for this additional financial product.

Consequently, the generic financial service definition will need to be clearly specified to cover the two groups of financial products that are in the scope of the EU Ecolabel, namely:

i. The service of managing an investment product that has been packaged for retail investors in accordance with the requirements laid down in Regulation (EU) No 1286/2014 on eligible packaged retail and insurance-based investment products (PRIIPs). This shall include:
    - equity, bond and mixed investment funds, to include those referred to as Undertakings for the Collective Investment in Transferable Securities (UCITS) and, where applicable, Alternative Investment Funds (AIFs);
    - insurance-based products with an investment component, more precisely profit participation, unit-linked and Multi Option Product (MOP) life insurances.

and,

ii. The service of managing a fixed-term deposit or savings deposit product as referred to in Article 2(1) point 3 of Directive 2014/49/EU on deposit guarantee schemes in order to pay interest and derive environmental benefits from the projects and economic activities to which the deposited money is loaned. The service is provided by the credit institution on whose balance sheet appears the deposits held (liabilities) and the associated loans granted as credits (assets).

An eligibility condition for the EU Ecolabel is that for retail financial products, they shall be registered or authorised for marketing or distribution in a Member State of the European Union.

The EU Ecolabel criteria will be useful for retail investors who would like to express their investment preferences in relation to the environmental sustainability of the activities funded by their money.

For financial services provided and products offered in this context to retail investors, a number of existing Regulations and Directives need to be considered. For example, the Packaged Retail Investment and Insurance Products (PRIIPs) Regulation (EU) No 1286/2014 seeks to enable investors to better understand and compare the key features, risks, rewards and costs of different PRIIPs. The definition of the products within the scope and outside the scope of the PRIIPs Regulation is provided in the next section. Directive 2009/65/EC regulates and stipulates provisions on undertakings for the collective investment in transferable securities (UCITS) which are a popular product among retail investors. Directive 2011/61/EU (AIFMD) regulates the managers of alternative investment funds, such as hedge funds and private equity[5]. The non-financial and diversity information Directive 2014/95/EU is relevant in regards to the disclosure of information about environmental protection and social responsibility by certain large undertakings and groups.

2.4 Summary of the background analysis from the preliminary report

This section presents a summary of the preliminary market and technical analysis conducted in 2018 to enable the determination of the initial proposals for the product scope, identification of criteria areas as well as development of criteria proposals for the Ecolabel for this product group.

2.4.1 Product group name, scope and definitions

The First Technical Report was drawn up based on an analysis of information and data available on green financial products. This encompassed several sources including academic literature, industry or consumer association reports, results from the first stakeholder questionnaire survey, and consultation (in the form of bilateral interviews) with selected financial label and scheme operators. While the PR identified the need for an EU Ecolabel for financial products, the First Technical Report focused on the following main aspects:

- scope, definition and relevant EU legislation;
- market analysis;
- technical analysis of existing taxonomies and existing definitions of ‘green’ financial products.

The First Technical Report summarised the analysis conducted at the preliminary stage of the development of the criteria for the financial product group. This included identification of the product’s scope and definitions, analysis of the PRIIPs market, a technical analysis of the

[5] This Directive is only of relevance where Member States decided to allow marketing to retail investors on their territory.

existing taxonomies and the definitions of "green" financial products, as well as identification of the main criteria areas as the basis for a 1st criteria proposal.

2.4.2 Market analysis

The market analysis carried out in support of the scope and criteria proposals as presented in the First Technical Report focused on retail clients as investors. A retail client is one that is not a professional client, i.e. a client who does not possess the experience, knowledge and expertise to make its own investment decisions and properly assess the incurred risks.[6] Retail clients are mostly composed of households, being the major contributors to the net financial wealth (i.e. all financial assets minus all financial liabilities) of the Eurozone.

Statistics show that EU-28 households own about EUR 34 trillion of cumulated assets, and their financial liabilities are equal to 30% of their financial assets. Currency and deposits, pension funds, and (life and non-life) insurance products constitute around 30%, 20%, 18%, respectively, of the EU-28's household wealth. The share of equities in households' financial portfolios is also around 18%. Investment fund shares increased from 6% in 2012 to 8% in 2017. Turning to the least represented asset categories, less than 1% of households' wealth is invested in financial derivatives.

Many of the above-mentioned products are covered by the PRIIPs Regulation. PRIIPs are packaged retail and insurance-based investment products that for example banks, insurers and asset managers typically offer to retail clients. PRIIPs[7] include:

a) packaged retail investment products (PRIPs), i.e. investments, including instruments issued by special purpose vehicles, where the amount repayable to the retail investor is subject to market fluctuations;
b) Insurance-based investment products, i.e. insurance products whose maturity or surrender value is exposed to market fluctuations.

The following products are outside the scope of the PRIIPs Regulation[8]:

- non-life insurance products as listed in Annex I to Directive 2009/138/EC;
- life insurance contracts where the benefits under the contract are payable only on death or in respect of incapacity due to injury, sickness or infirmity;
- deposits other than structured deposits as defined in point (43) of Article 4(1) of Directive 2014/65/EU;
- securities as referred to in points (b) to (g), (i) and (j) of Article 1(2) of Directive 2003/71/EC;
- pension products which, under national law, are recognised as having the primary purpose of providing the investor with an income in retirement and which entitle the investor to certain benefits;
- officially recognised occupational pension schemes within the scope of Directive 2003/41/EC of the European Parliament and of the Council or Directive 2009/138/EC;
- Individual pension products for which a financial contribution from the employer is required by national law and where the employer or the employee has no choice as to the pension product or provider.

The scope of the PRIIPs Regulation is broad and intended to cover all financial products sold on the retail market that have exposure to underlying assets (stocks, bonds, etc.), provide a return over time and have an element of risk. PRIIPs cover a range of investment products which,

[6] See Regulation n. 1286/2014 of PRIIPs Regulation, Article 4(6) and Directive 2011/61/EU, Article (4)(1)(aj) for the definition of "retail investor". Moreover, see Directive 2014/65/EU, Article 4 (1), point (11) for the definition of "retail client" and Directive 2014/65/EU, Article 4(1), point (10) and Annex II for the definition of "professional client".
[7] See Regulation n. 1286/2014 of PRIIPs Regulation, Article 4(1)-(3) and the Discussion Paper "Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs)" n. JC/DP/2014/02.
[8] See Regulation n. 1286/2014 of PRIIPs Regulation, Article 2 (2).

taken together, made up a market in Europe worth up to EUR 20 trillion at the end of 2017. Investment funds, unit-linked life insurance products and unit-linked pension funds taken together account for a large part of the PRIIPs market.

Depending on the source there are between 60 000 and 80 000 investment funds domiciled in the EU (EFAMA Q1 2018 and Bloomberg, October 2018), with net assets amounting to around EUR 15 trillion[9]. Investment funds are invested predominately in equities (28%), bonds (23%), both (21%). EU legislation distinguishes between Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs). UCITS and AIFs funds reached an outstanding amount of about EUR 9 trillion and EUR 6 trillion, respectively, at the end March 2018. Some AIFs are sold to retail investors following regulation at the national level, although such funds are in principle designed for professional investors.

According to Bloomberg, 421 funds are currently marketed as green or sustainable[10]. These funds are further classified as clean energy, climate change, environmentally friendly and environmental, social and corporate governance (ESG) funds[11]. This represents about 0.01% of the total active funds corresponding to a similar share in terms of assets under management (Kahlenborn et al., 2017 on the very low market share of sustainability or environmentally themed products and green impact products).

As for other PRIIPs categories, the market for life insurance products offering non-guaranteed products linked to either investment funds (i.e. unit-linked contracts), or structured products (i.e. index-linked products) amounts to about EUR 3 trillion. Approximately 25% of households' financial assets are composed of stocks and debt securities. A particular category among bonds are "Green bonds", which finance or re-finance in part or in full new and/or existing eligible green projects This specific product has received attention both at EU level and from private initiatives. However, the European green bond market is still very small in size compared the market of conventional bonds, corresponding to approximately 2.5% of the total bonds market in 2018. It is worthy of note that about 36% of the global green bond issuance in 2017 is associated with EU issuers.

2.4.3 Technical analysis

Green investment is generally associated within the financing of investments that provide environmental benefits such as a reduction in GHG and air pollutant emissions, without reducing the production and consumption of non-energy goods. Financial products or investments are therefore green as a result of the uses to which the money is put in terms of the underlying assets or economic activities.

Initial evidence suggests that a range of strategies are employed in order to make investment portfolios more attractive to customers seeking green or environmentally sustainable financial products. An increasing proportion of assets are currently managed based on a number of sustainable investment strategies including:

- exclusionary screening,
- positive screening or best-in-class approach,
- norms based screening approach,
- environmental, social and governance (ESG) integration,
- sustainability themed investing or thematic investing,
- impact/community investing, and

[9] Source: EFAMA Q1 2018.

[10] The Bloomberg Fund Classification System provides a fund classification grouping and compares funds with similar investment objectives. Bloomberg classifies funds based on public documents including prospectuses, fund fact sheets, and annual/semi-annual reports to determine the intended investment objective of the fund manager. The characteristics of the objective relate to both asset class specific dimensions (e.g. strategy, type of investment) and non-asset class specific dimensions (e.g. industry focus, geographic focus, general attributes, etc.).

[11] One fund can be classified into more than a category, and approximately 35% of these funds are also classified as Socially Responsible Funds. For example, 49 funds belong in the category "Socially Responsible and ESG".

- corporate engagement and shareholder action.

Of these strategies, the prevailing and overlapping concepts of "green" used to date by investors have been developed around four main types of investment strategies: (1) socially responsible investing (SRI); (2) ESG integration / investing; (3) impact investing, and (4) thematic investing. Of these, impact investing and thematic investing focus on activities that deliver a specific and measurable social or environmental improvement. Green thematic investing will address specific environmental objectives or problems and can provide important information for the definition of green.

In the financial industry, an investment portfolio is a commonly applied term which encompasses assets such as stocks, bonds, cash, and real estate, amongst others. The most common asset classes in any portfolio are equities (stocks), fixed-income securities (bonds), real estate and cash equivalents. The share of each asset class in a portfolio is referred to as the asset allocation of that portfolio. These could be directly or indirectly invested in.

A number of labels and schemes are available in Europe to help investors assess and select from a range of financial products which are described as sustainable or green. These include the Greenfin (previously TEEC) Label[12], FNG Siegel[13], Nordic Swan[14], LuxFLAG Climate Finance Label[15] and the Austrian label[16] amongst others. Some of these labels and schemes define the "greenness" of an investment portfolio by setting either a requirement or threshold on:

- the minimum proportion (in percentage) of a portfolio's total assets under management mandated to be invested either in climate change mitigation and or climate change adaptation activities; or
- the percentage of revenues of the company(s) that can be attributed to "green" activities by assessing to what degree (quantified as a percentage) the company engages in sustainable economic activities which are defined in the taxonomy applied by the label or scheme.

The existing labels and schemes also make use of taxonomies to define green sectors or economic activities, in some cases with reference to screening criteria.

The different strategies, criteria and taxonomies employed by the prevailing labels and schemes, create uncertainties for investors as they are unable to compare different types of information for different financial products. It also represents an obstacle to the flow of capital towards more environmentally sustainable economic activities.

A Taxonomy is a classification system that defines 'green' economic activities. These economic activities could be projects or activities in specific economic sectors of any economy in areas such as renewable energy and green buildings. Regional and national labels as well as schemes available in Europe certify the "greenness" of financial products using any one of the following taxonomies:

- the Climate Bond Initiative (CBI) taxonomy;
- the Green Bond Principles (GBP) project categories; and
- the International Development Finance Club (IDFC) taxonomy.

These taxonomies differ in the manner in which they categorise different economic activities as environmentally sustainable. They also differ in their levels of granularity. This led to call for a harmonised taxonomy at the EU level. The framework established by the EU Taxonomy proposal will therefore be used as guidance in the development of the EU Ecolabel criteria, and the link with the EU Taxonomy will be established by taking a "look-through" approach.

[12] Energy and Ecological Transition for the Climate. Available at https://www.novethic.com/fileadmin/user_upload/divers/labels/1605-LabelTEEC_Referentiel-ENG.pdf

[13] FNG – Siegel. Available at https://www.fng-siegel.org/en/siegelkriterien-en.html

[14] Nordic Swan. Available at https://www.nordic-EU Ecolabel.org/

[15] LuxFLAG, https://www.luxflag.org/labels/climate-finance/

[16] The Austrian EU Ecolabel (January 2016). Eco-label Guideline UZ 49 for Sustainable Investment Products. Version 4.0. Available at: https://www.umweltzeichen.at/file/Guideline/UZ%2049/Long/Ec49_R4a_sustainable_Investment_products_2016.pdf

Therefore the EU Ecolabel defines criteria for determining whether the underlying assets of financial products offered to retail investors are sufficiently "green" (linked to environmentally sustainable economic activities) to be awarded the label. To achieve this, the following aspects were carefully considered:

- The scope of financial products to which the EU Ecolabel criteria is applicable.
- The potential for the product to deliver environmental benefits and to attract retail investors.
- Operational issues and product verification.
- Identification of optimal strategies to be considered in the EU Ecolabel criteria in order to promote environmentally sustainable investments based on definition of "greenness" provided by the criteria.
- How the EU Taxonomy will be used in the context of the EU Ecolabel.
- Options for compliance with the requirements of proposed EU Ecolabel criteria for the purpose of awarding the label, e.g. mandatory requirements, or optional requirements with a points-based scoring system.

3 PRODUCT GROUP NAME, SCOPE AND DEFINITIONS

3.1 Revised proposal

Previous (second) proposal for the product group name:
Retail financial products
Third proposal for the product group name:
Retail financial products
Previous (second) proposal for the product group scope:
The product group shall comprise the following products that are provided as a service to retail investors: • The service of managing an investment product that has been packaged for retail investors in accordance with the requirements laid down in Regulation (EU) No 1286/2014 on packaged retail and insurance-based investment products (PRIIPs). This shall include: - Equity, bond and mixed[17] investment funds, to include those referred to as Undertakings for the Collective Investment in Transferable Securities (UCITS) and, where applicable[18], Alternative Investment Funds (AIFs); - Insurance-based products with an investment component, more precisely unit-linked life insurances. • The service of managing a fixed-term deposit or savings deposit product as referred to in Article 2(1) point 3 of Directive 2014/49/EU on deposit guarantee schemes. The service shall be provided by the credit institution on whose balance sheet the deposits held (liabilities) and the associated loans granted as credits (assets) appear. The retail financial product shall be registered or authorised for marketing or distribution in a Member State of the European Union.
Third proposal for the product group scope:
The product group shall comprise the following products that are provided as a service to retail investors: • The service of managing an investment product that has been packaged for retail investors in accordance with the requirements laid down in Regulation (EU) No 1286/2014 on packaged retail and insurance-based investment products (PRIIPs). This shall include: - Equity, bond and mixed[19] investment funds, to include those referred to as Undertakings for the Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs) that are marketed to retail investors upon a national discretion (according to Article 43 of Directive 2011/61/EU[20]); - Insurance-based investment products (IBIPs), to include unit-linked, profit participation and multi-option life insurance products. • The service of managing a fixed-term deposit or savings deposit product as referred to in Article 2(1) point 3 of Directive 2014/49/EU on deposit guarantee schemes. The service shall be provided by the credit institution on whose balance sheet the deposits held (liabilities) and the associated loans granted as credits (assets) appear. Units or shares in European Long Term Infrastructure Investment Funds (ELTIFs) and real estate

[17] Mixed funds shall be considered as synonymous to hybrid funds
[18] AIFs may be marketed to retail investors upon a national discretion (art. 43 of AIFMD).
[19] Mixed funds shall be considered as synonymous to hybrid funds
[20] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

funds can be present in the underlying assets of a Retail AIF or insurance product applying for an EU Ecolabel.

The retail financial product shall be registered or authorised for marketing or distribution in a Member State of the European Union.

Previous (second) proposal for complementary definitions:

For the purposes of this Decision, the following definitions shall apply

1. 'packaged retail and insurance-based investment product' or 'PRIIP' means a product that is one or both of the following:

a) a packaged retail investment product (PRIP);

b) an insurance-based investment product;

2.'packaged retail investment product' or 'PRIP' means an investment, including instruments issued by special purpose vehicles as defined in point (26) of Article 13 of Directive 2009/138/EC or securitisation special purpose entities as defined in point (an) of Article 4(1) of the Directive 2011/61/EU of the European Parliament and of the Council (19), where, regardless of the legal form of the investment, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor;

3. 'insurance-based investment product' means an insurance product which offers a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations;

4. 'retail investor' means:

a) a retail client as defined in point (11) of Article 4(1) of Directive 2014/65/EU

b) a customer within the meaning of Directive 2002/92/EC, where that customer would not qualify as a professional client as defined in point (10) of Article 4(1) of Directive 2014/65/EU;

5. 'alternative investment funds' (AIFs) means collective investment undertakings, including investment compartment thereof, which:

a) rise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and

b) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC

6. 'undertaking collective investment transferable securities (UCITS)' means an undertaking for collective investment in transferable securities authorised in accordance with Article 5 of Directive 2009/65/EC

7. 'transferable securities' means;

a) shares in companies and other securities equivalent to shares in companies;

b) bonds and other forms of securitised debt (debt securities);

c) any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange;

8. 'share or stock' means a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings;

9. 'bond' means a fixed income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental);

10. 'investment fund' means a supply of capital belonging to numerous investors used to collectively purchase securities while each investor retains ownership and control of this own shares; types of investment funds include mutual funds, exchange-traded funds, money market funds and hedge funds;

11. 'portfolio' means a grouping of financial assets;

12. 'asset' means a resource with economic value that an individual, corporation or country owns or controls with the expectation that it will provide a future benefit;

13. ‘verification’ means a procedure to certify that a product complies with specified EU Ecolabel criteria;

14. ‘portfolio management’ means managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments;

15. ‘deposit’ means a credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution is required to repay under the legal and contractual conditions applicable, including a fixed-term deposit and a savings deposit;

16. ‘structured deposits’ means a deposit as defined in point (c) of Article 2(1) of Directive 2014/49/EU of the European Parliament and of the Council (1), which is fully repayable at maturity on terms under which interest or a premium will be paid or is at risk, according to a formula;

17. ‘unit-linked’ means that the financial benefits provided by an insurance contract are directly linked to the value of assets contained in an investment fund;

18. ‘revenue’ means this is the amount of money that is brought into a company by its business activities;

19. ‘turnover’ is also used as a synonym for investments; in the investment industry, turnover is defined as the percentage of a portfolio that is sold in a particular month or year;

20. 'Pension products' refers to non-public arrangements and investment vehicles which have an explicit objective of retirement provision (according to a national social and labour law or tax rules) irrespective whether they are of occupational or personal type.

Third proposal for complementary definitions:

For the purposes of this Decision, the following definitions shall apply:

‘alternative investment funds’ (AIFs) means collective investment undertakings, including investment compartment thereof, which:

a) rise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and

b) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC

‘asset’ means a resource with economic value that an individual, corporation or country owns or controls with the expectation that it will provide a future benefit;

‘bond’ means a fixed income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental);

‘CapEx’ means capital expenditure (investment) made along the life cycle of a project and assigned to the year when it is incurred. Included are investments in assets used for production, transformation and distribution; as well as for refurbishment, upgrades, new construction and the replacements of capital assets. Also included are investments made in Research & Development that are directed towards the development of new assets or production technologies;

‘deposit’ means a credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution is required to repay under the legal and contractual conditions applicable, including a fixed-term deposit and a savings deposit;

‘environmentally sustainable economic activity’ means an economic activity that qualifies with the criteria set out in Delegated Regulation (EU) xxxx/xxx supplementing Article 3 of Regulation (EU) 2020/852[21], including transitional activities as defined in Article 10(2) and enabling activities as defined in Article 16 of Regulation (EU) 2020/852;

‘green CapEx’ means capital expenditure made in environmentally sustainable economic activities;

‘green revenues’ means financial revenues derived from the ‘environmentally sustainable economic

[21] The exact wording of the legal reference to the EU Taxonomy and its Delegated Regulations is to be defined following consultation within the Commission Services.

activities' of a company;

'insurance-based investment product' means an insurance product which offers a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations;

'investment fund' means a supply of capital belonging to numerous investors used to collectively purchase securities while each investor retains ownership and control of this own shares; types of investment funds include mutual funds, exchange-traded funds, money market funds and hedge funds;

'packaged retail and insurance-based investment product' or 'PRIIP' means a product that is one or both of the following:

a) a packaged retail investment product (PRIP);

b) an insurance-based investment product;

'packaged retail investment product' or 'PRIP' means an investment, including instruments issued by special purpose vehicles as defined in point (26) of Article 13 of Directive 2009/138/EC or securitisation special purpose entities as defined in point (an) of Article 4(1) of the Directive 2011/61/EU of the European Parliament and of the Council (19), where, regardless of the legal form of the investment, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor;

'pension products' refers to non-public arrangements and investment vehicles which have an explicit objective of retirement provision (according to a national social and labour law or tax rules) irrespective whether they are of occupational or personal type;

'portfolio' means a grouping of financial assets;

'portfolio management' means managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments;

'retail investor' means:

a) a retail client as defined in point (11) of Article 4(1) of Directive 2014/65/EU

b) a customer within the meaning of Directive 2002/92/EC, where that customer would not qualify as a professional client as defined in point (10) of Article 4(1) of Directive 2014/65/EU;

'revenue' means this is the amount of money that is brought into a company by its business activities;

'share or stock' means a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings;

'sovereign bond' means a debt security issued by a national government;

'structured deposits' means a deposit as defined in point (c) of Article 2(1) of Directive 2014/49/EU of the European Parliament and of the Council (1), which is fully repayable at maturity on terms under which interest or a premium will be paid or is at risk, according to a formula;

'sub-sovereign bond' means a debt security issued by a regional, city or local government entity, as well as government agencies;

'transferable securities' means:

a) shares in companies and other securities equivalent to shares in companies;

b) bonds and other forms of securitised debt (debt securities);

c) any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange;

'turnover' is also used as a synonym for investments; in the investment industry, turnover is defined as the percentage of a portfolio that is sold in a particular month or year;

'undertaking collective investment transferable securities (UCITS)' means an undertaking for collective investment in transferable securities authorised in accordance with Article 5 of Directive 2009/65/EC;

'unit-linked' means that the financial benefits provided by an insurance contract are directly linked to the value of assets contained in an investment fund;

'verification' means a procedure to certify that a product complies with specified EU Ecolabel criteria.

3.2 Rationale of the proposed name, scope and definitions

The main focus of the product group for the 1st set of criteria for retail financial products is on the PRIIPs products and specifically UCITS and retail AIFs. Following on from requests by stakeholders and investigation by the JRC, the scope proposal has been extended to include:

- (from the 2nd criteria proposal) Fixed-term deposit and savings deposit accounts of the kind offered by high street banks. These are mainstream products that are the depository for the majority of household savings as well as playing an important role in the economy as a source of loan finance and liquidity for investment by businesses.
- (in this 3rd criteria proposal) A number of further PRIIPs – namely the insurance-based investment products (IBIPs) referred to as Profit Participation and Multi-Option Product (MOP) life insurance. These products may be offered to retail investors as alternatives to other UCITS and retail AIF products, so are important comparable products in the retail segment of the investment and savings market.

The first proposed scope of the EU Ecolabel criteria is understood from earlier market analysis done by JRC to cover the majority of the market for investment fund and savings products that may be offered to retail investors across the EU.

Following requests from stakeholders, the potential to make two further additions to the scope has been analysed – namely pension funds and professional AIFs – with the outcome reported in TR2.0. It is not considered possible to include pension funds (also referred to as institutional investors) at present because the market share of products in which retail investors can choose their fund is very limited, particularly for Pillar 1 and 2 products. Moreover, their diversified underlying assets are likely to require further attention in order to develop criteria. In regard to AIFs addressed to professional investors, these are business to business products and the result of an internal consultation within the Commission's Services is that they cannot presently be included.

It is therefore proposed that in the 1st revision of the criteria – anticipated for 2022/23 – a review is undertaken of the potential for a further extension of the scope to include pension products where the retail investor has a choice of the fund(s), European Long Term Infrastructure Funds (ELTIFs) and real estate funds. The revision will need to include a focus on the legal aspects of their inclusion and the identification of verification needs in order to cover the possible diversity of underlying assets.

3.3 Outcomes of the 1st AHWG meeting and main changes in TR2

Feedback received on TR1.0 and further research conducted by JRC can be found in the previous version of the report (TR2.0).

The main change to the scope proposal in T2.0 was the addition of fixed-term deposit or savings deposit products.

3.4 Outcomes of the 2nd AHWG meeting and stakeholder consultation

This section summarises stakeholders' comments received after the 2nd AHWG meeting. The JRC received in total 43 comments on engagement from 22 stakeholders. The major comments have been clustered and are summarised below. Based on these comments, the JRC identified the needs for further research.

The inclusion of pension funds

Pension schemes represent high volumes of investments and are accessible to a vast majority of households. In particular, Personal Pensions Products (PEPPs) could be a good starting point (whether EU PEPPs or national products that fall under the definition of Pillar 3). Many of the individual pension products could be labelled already, as they are often investment funds.

It was stated that there are examples of Pillar 2 pension funds, where the pension beneficiaries are eligible to choose the fund they invest in. There are examples of fund selection being at the discretion of the retail investor, so applying a blanket view that pension funds in which in general the retail investor has no choice of product is considered not to fully reflect the real situation in the market. A preferable option would be to allow for wherever it's possible to select the underlying fund. Examples were cited such as the FCPE, which is a French pensions saving-scheme in which final holders are retail investors who can choose the fund they will invest in.

The inclusion of all AIFs

The importance in the market of AIFs addressed to professional investors was again emphasised. They are the most likely fund structures to be used to mobilise investments in renewable energy projects, and as such if they were to be included in the scope, would create the potential to support the role of AIFs in investing in taxonomy compliant activities.

Several stakeholders considered there to be issues with the argument that Business 2 Business products could not be awarded the ecolabel. Several examples were cited from the textile group of consumers products that are not available to both professional and retail investors being awarded the ecolabel. These include:

- the Austrian textile company LENZING AG, an important licensee of the EU ecolabel for textiles has its fibres awarded - but these are only available for other companies as a retail client cannot buy such fibres.
- FULGAR Spa and Camira Ltd, that mainly (albeit exclusively) sell ecolabelled fabrics to other businesses as clothing brands. In that case, the customer can buy indirectly the textile by buying fabric as part of an end product.

Some ecolabelled consumers product groups only target professional users e.g. "Industrial and Institutional Dishwashing detergents" and "Industrial and Institutional Laundry detergents". The consumers product group lubricants has a scope that clearly goes far beyond retail consumers needs, such as concrete-release agents.

Inclusion of real estate funds and European Long Term Infrastructure Funds (ELTIFs)

The inclusion of real estate funds was requested. Retail funds investing in real estate are considered to be important investment vehicles certain Member States. France was cited as an example, with SCPI and OPCI referred to.

Germany is the largest national retail market in the EU where the assets under management of retail real estate funds are quoted as having reached an all-time high of EUR 109 billion by the end of 2019. Last year, they also quoted as accounting 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 underline the importance of real estate funds as vehicles for retail investments in Germany.

It was also highlighted that the EU Taxonomy includes within its scope the acquisition and holding of property assets and that the criteria create the potential to assess the sustainability of assets. It would be important that any criteria for real estate funds are carefully calibrated. A transition period would be useful for the already existing real estate funds.

Inclusion of European Long Term Infrastructure Funds (ELTIFs)

The inclusion of European Long Term Infrastructure Funds (ELTIFS) established under the auspices of Regulation (EU) 2015/760 [22] was requested. It was noted that some of them were created to facilitate retail investors' investment in non-listed assets:

> *'...while providing less liquidity than investments in transferable securities, ELTIFs can provide a steady income stream for individual investors that rely on the regular cash flow that an ELTIF can produce.'*

Infrastructure investors are considered to favour long-termism and were among the earliest and most proactive fund products to pave the way to sustainable financing. It was pointed out that about half of the funds having received the stringent French Greenfin label are accounted for by infrastructure funds.

In both these cases it was considered that it would send a strong message to the market if a revision clause was to provide for the inclusion of illiquid assets (e.g. by end of 2022).

Clarifications on the inclusion of insurance products

Clarity was requested on the scope of the insurance products that are included within the scope. In particular how the criteria can be applied to so-called Profit Participation products, in which there is a collective pool of assets associated with products (a general fund), and also hybrid products, where there may be a combination of a general fund and unit-linked fund shares.

Future scope extensions

It was requested by a number of stakeholders that the Commission make a clear statement of intention, or a roadmap, in relation to possible extensions to the product scope at the 1st revision of the criteria. This should address the potential to include:

- Retail ELTIF funds
- Retail AIFs investing primarily in real estate;
- Personal Pension Products, as well as first and second Pillar products that allow for choice of product and/or assets;

3.5 Further research and main changes in the third proposal

Based on the themes that emerged from discussions at the AHWG2 and in comments provided to the public consultation (via BATIS JRC tool), further research by the JRC has focussed on the following topics:

[22] Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds

- The potential for inclusion of real estate and infrastructure funds,
- The potential for inclusion of structured products,
- The potential for inclusion of pension funds and institutional investors, and
- An evaluation of the feasibility of extending the scope of Insurance–based investment products.

Inclusion of real estate and infrastructure funds

Whilst real estate assets, both new and renovated buildings, will fall within the scope of the economic activities which have criteria within the EU Taxonomy, the setting of a green investment threshold for real estate funds themselves would require more data on the potential performance of portfolios. Also, whilst data provided by stakeholders shows that they are of market significance in some Member States and are possible to market to retail investors, this is not the case across the whole EU.

Given that the intention with this first criteria development process has been to focus initially on the feasibility of PRIIPS products and simpler savings products, it is therefore proposed that the potential to include real estate funds is analysed as part of the 1st revision of the criteria set.

As to ELTIFs, their eligibility will depend on whether they are sold to a professional or are sold directly to retail consumers, as well as whether they can comply with the Ecolabel criteria. It is proposed that their broad inclusion is analysed as part of the 1st revision of the criteria set. Their inclusion would imply the establishment of explicit criteria regarding infrastructure projects.

Moreover, given that both real estate and infrastructure investments may be present as underlying assets in retail AIF and life insurance products, it is proposed as a first step to clarify in the criteria that units or shares in ELTIFs can be present in the underlying assets of an ecolabelled product. In this way infrastructure that falls within the scope of the EU Taxonomy can contribute towards the green revenue threshold of criterion 1 without having at this stage to set thresholds for an individual real estate or infrastructure fund product.

Inclusion of structured products

In general, if a product is a PRIIPS product largely investing in equities and/or bonds as underlying assets, then it is possible to include them within the current proposed products' scope and according to criterion 1, as this does not require the development of further new criteria for some of the underlying assets. Structured deposits were looked at in the 1st Technical Report on the Ecolabel for financial products and found to be of limited market relevance at present. Moreover, structured products are complex and it is not possible to determine a level of greenness for the derivatives or money market instruments used, which may account for a significant proportion of the underlying assets.

Alternative Investment Funds (AIFs)

The market significance of professional investors was acknowledged in the 2nd Technical Report. However, as was reported, an internal consultation within the Commission Services suggested that there are difficulties in professional AIFs within the scope of what is a consumer labelling scheme. It was also clarified that AIFs are made available to retail investors in some countries if national laws foresees this and that professional funds that form part of the underlying assets of another product that is authorised for sale to retail investors are within the proposed scope.

Pension funds and institutional investors

The market significance and the size of the assets managed by pension funds was acknowledged in the 2nd Technical Report. However, as was reported, internal consultation within the Commission Services suggested that there are difficulties in including them within the scope of what is a consumer labelling scheme because most Pillar 1 and 2 products do not provide a choice of fund products to the retail investor (see the 2nd Technical report). It is proposed that

the possibility to include some initial pension products within the scope be reviewed at the time of the 1st criteria revision.

Evaluating the feasibility of extending the scope of Insurance–based investment products

Following requests from the insurance industry and the regulatory body EIOPA the JRC and DG FISMA have evaluated the potential to extend the scope to the two life insurance products which are briefly described below, together with some clarifications relating to the verification and underlying assets of the third product, which was already within the proposed scope:

1. Profit participation products: A typical life insurer offering profit participation products will have underlying investment 'general fund'. which is similar to a mixed fund, composed indicatively of around 75% of bonds (50:50 government and corporate bonds), 10% equities, 5% real estate and the remaining portion (about 10%) in loans and other assets.
2. Multi Option Products (MOPs): These products may have a number of hybrid configurations; they may have unit-linked products as underlyings and/or may consist of a general fund, the composition of which would be similar to that of a Profit Participation product, together with a range of sub-options that are then the choice of the retail investor. The choice of sub-options can be extensive and clients can also switch option during the contract period.
3. Unit-linked products: These products generally consist of a series of underlying shares in investment funds, the configuration of which is largely determined by the life insurer, although there may be some limited element of choice. These underlying funds can include asset allocation funds that invest in illiquid assets such as real estate.

The first two products have been taken in turn and have been evaluated according to the following key considerations for their potential inclusion in the 1st group of products covered by the Ecolabel:

- Market significance: Their significance as an investment choice for retail investors across the EU and in specific regions or Member States.
- The potential to verify the underlying assets: That the "*greenness*" of their underlying assets can be verified by the Competent Body, in a realistic way;
- Whether new criteria are required: That including these products does not at this stage require the development of further new criteria which entails setting specific thresholds for the underlying assets.
- Traceability of capital allocations: That the allocation of investments is clearly traceable , which means that the Competent Body needs to be able to verify the link between client's money invested in these products and the "*green*" underlying assets, that is the money of the clients is invested/allocated to corresponding "*green*" assets.
- Underlying products/options of the insurance product that will require an EU ecolabel are retail products: Where a product allows the client to choose investments in several funds and to switch between the funds (in particular in the case of MOPs products), any underlying funds will need to be retail products (i.e. a UCITS or an AIF authorised for sale to retail investors). This is because the main product will likely not be possible to label in advance.

Taking these conditions into account, discussions have been held with EIOPA before further discussions are held with Commission services on the extension of the EU Ecolabel scope for the 1st product group.

Product 1: Profit Participation (with profits) products

Profit participation products offer investments by the insurance undertaking in asset classes part of fund and distribute a portion of the insurance undertakings profits to policyholders. These products fall under PRIIPs Category 4.

Most profit participation ('with-profits') products are based on the insurer's own investments in the general fund (sometimes also referred to as a general account), but the insurer may also decide to set up sub-funds or segregated funds for particular products.

Market significance

Solvency II market data indicates that in 2019, and based on Gross Written Premiums, Profit Participation products accounted for approximately 53.5% of the aggregated EU life insurance business. *Figure 1* shows details per country of the proportion of Unit-Linked and Profit Participation premiums.

It is important to note that hybrid MOP products have been allocated in these data to their constituent profit participation or unit-linked products. That means that for France in particular, as well as Luxembourg, Italy, Austria, Germany, Hungary and the Netherlands these data includes significant contribution from hybrid products[23].

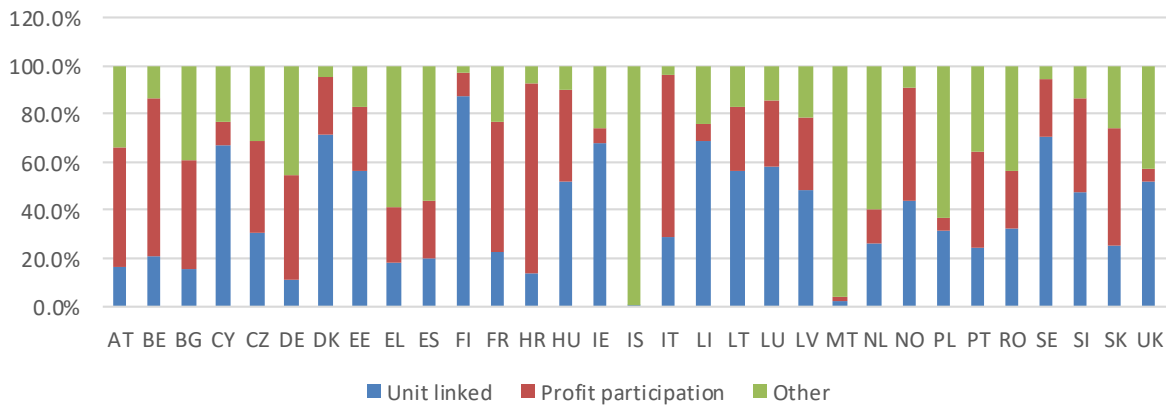


Figure 1 - Proportion of Unit-Linked and Profit Participation premiums, based on 2019 Solvency II data
Source: EIOPA (2020)

The potential to verify the underlying assets

The underlying assets in the general fund of a typical life insurer offering profit participation products are understood to be composed of about 75% bonds (split 50:50 between government bonds and corporate bonds), 10% equities, 5% real estate and the remaining proportion (about 10%) may be invested in loans and other assets.

In regards to the reporting of capital allocations, there is at the moment no legal obligation for insurance undertakings to disclose this to supervisory authorities. Moreover, the reporting for liabilities under current financial regulations (referred to as Solvency II), either annually or quarterly, is not at the level of the product, but by 'lines of business'. In the future 'green' products will, however, under Article 8 or 9 of the Sustainable Finance Disclosure Regulation (SFDR), have to disclose the planned asset allocation of the product in the pre-contractual disclosure documents. All IBIPs are in the scope of the SFDR, including profit-participation products.

[23] That means that for these countries, both the profit participation and unit-linked bars are covering also hybrid products. See section on "Market Significance" for further reference.

Whether new criteria are required

The general fund is understood to work in a similar way to that of a UCITS mixed fund. As a result, verification could be on the same basis as for mixed funds as described under the proposals for criterion 1 of the ecolabel. Real estate assets could be included as, given that there are proposed to be EU Taxonomy criteria for both new and renovated buildings, they could contribute on an asset by asset basis towards the greenness of the overall product. So, there would not appear to be the need for new criteria.

Traceability of capital allocations

Given that in some cases only a proportion of the funds held in the general fund would be earmarked towards the EU Ecolabel license, there would be the need for some form of accounting practice used that:

- Demonstrates a clear traceability to the Competent Body between the money invested and the underlying "green" assets, and
- Protects these assets by ensuring they cannot be transferred and used for other ends than for the "ecolabelled" insurance product.

The terminology 'ring-fencing' or the 'segregation' of assets is used to refer to the non-transferability of assets between different portfolios within the company balance sheet for prudential reasons. It is understood, however, that in some Member States using this same terminology for the EU Ecolabel would discourage or even disadvantage potential license holders, although the meaning of these terms would refer, in the case of the Ecolabel, to the traceability of capital allocation, so a suitable reference shall be decided on.

Outcome as to whether to include the product

Following discussions with EIOPA and some Member State representatives, it appears to be possible to both require the insurer to create a separate (segregated) "sub-fund" to the general fund only investing in 'green' assets for those insurance products applying for the ecolabel. Or, in case the insurer does not create this separate (segregated) account, a specific report would be need to be submitted to the Competent Body in charge of verifying compliance with the Ecolabel criteria addressing the traceability of "green" underlying assets. As a result, it is considered possible to include profit participation products and apply the criteria now set for UCITS mixed funds, with some adaptation to the two situations just described, to be included in the criterion.

Product 2: Multi-option products (MOPs) with client choice of unit-linked or hybrid products configurations

Multi-option products (MOPs) offer a choice of different underlying 'options'. As can be seen in *Figure 2*, these options predominantly comprise a choice of unit-linked funds (#1) or a hybrid (#2), which is a mix of unit-linked and profit participation options. The latter (#2) typically offers one profit participation option and a wide variety of unit-linked options to be chosen on top of the profit participation fund.

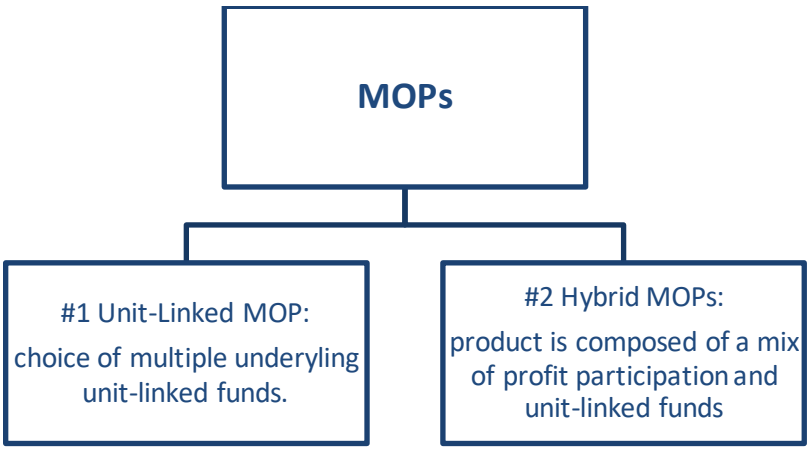


Figure 2 - Representation of Multi Option Product (MOP) options
Source: EIOPA (2020)

Market significance

In the summer of 2020 EIOPA, conducted a survey on hybrid products amongst its Members in order to assess the size of the EU hybrid markets. The results showed that the main hybrid markets are France, Luxembourg, and Italy. In France, in 2019, more than 90% of all life insurance sold are hybrid products. They are understood to be composed of the following liabilities:

- 72% in profit participation funds - in French they are called euro funds, which are a general fund for which the invested life insurance savings are fully guaranteed at all times, and
- 28% is in unit-linked funds - funds for which the savings invested can be partially guaranteed insofar they can provide greater returns.

About 97% of contracts are multi-option products, with a larger profit participation component (fond euro) and a small part in unit-linked. The duration of the product is 12 years in average.

Another type of product sold in France is the "euro-croissance" which is a "euro fund" (profit participation) or a mix between the euro fund (profit participation fund) and the unit-linked funds. These type of product offer guaranteed savings only at maturity, not at all times as in the case of the classic "fonds euro" sold in a Multi-Option Product. The hybrid "euro-croissance" type of product was created in 2014 in France. Investments in these types of product are still at a low level at the moment.

Luxembourg and Italy each have a significant amount of hybrid marketed (between 30% and 40%). They are followed by Austria, Germany, Hungary and the Netherlands where hybrids represents around 20% of all products sold. Finally, Bulgaria, Cyprus, Croatia, Portugal, Romania and Slovenia have no or almost no presence of hybrids in their market.

The potential to verify the underlying assets

For MOPs that offer purely Unit-Linked funds as options, the asset allocation is illustrated in the analysis on unit-linked assets of insurers in a later section of this chapter. For Hybrid MOPs, the premium is largely invested in the profit participation (general fund) element, rather than in the unit-linked part, and hence the product is composed primarily of corporate and sovereign bonds, followed by equities and diversified "asset allocation" (AIF) funds.

Whether new criteria are required

The various MOP configurations are understood to be composed of a general fund and/or various combinations of unit-linked UCITS or AIF fund shares. It therefore appears that the

underlying assets can be verified using a combination of sub-criteria from the proposed criterion 1.

Traceability of capital allocations

MOP products raise more issues in relation to traceability of assets. It is understand that with these products, the client is offered different sub-options and that they can chose some of these sub-options and also move from one option to the other over time. These characteristics may make it more difficult for the MOP itself to be ecolabelled. This is largely because without restricting a retail investors choices only to the underlying options already ecolabelled, a MOP product configuration as a whole would be difficult to label in advance of these choices being made. Moreover, product permutations could not be labelled on an ad hoc basis as and when they are chosen, unless the underlying funds or assets are already labelled.

If we take a hypothetical example of a MOP with 101 underlying options. 50 of these options are unit-linked EU ecolabelled funds, 50 are AIF funds, and the other is the profit participation option. The clients can choose the options they prefer and if they have green preferences, they might chose the ecolabelled sub-options. But if they only chose some ecolabelled options, then the MOP as a whole would contain funds that had not been verified to meet any EU Ecolabel criteria.

For a MOP with unit-linked options, it would not therefore be possible to label the MOP product in the example because the choice of underlying funds is open to clients. As a result, the overall portfolio greenness would not be possible to calculate for the overall MOP product in the example. Instead, the individual units shares would all have to be in EU ecolabelled funds, which as a consequence would all need to be retail products.

Outcome as to whether to include the product

For hybrid MOPs, which it is understood to largely consist of assets within a general fund, the fact that retail investors are offered a choice of unit funds suggests that, in addition to the general fund, all the chosen unit-linked funds would have to be EU ecolabelled. The EU Ecolabel is awarded to a specific product configuration and before they are sold. As a consequence, multiple product configurations are only permissible if each configuration on its own meets the ecolabel criteria. This also suggests therefore, that for the hybrid MOP itself to be ecolabelled, the clients choice would have to be restricted to, using the hypothetical case in the example above, the 50 ecolabelled funds.

Since it is understood that in practice, it is not feasible to restrict client's choice, but on the contrary, the choice of the client is open and can even be switched among options during the contract period, the only solution for a MOP to be ecolabelled is to have all underlying options ecolabelled. This would also solve the issue that the number of underlying unit-linked components and/or profit participation of a product vary significantly from one country to another and therefore setting a minimum threshold would have a different relevance depending on the national market.

Product 3: Unit-linked products

Given that this product had already been proposed as being included in the scope, further considerations have mainly focused on the gathering of further information on their market significance and what type of underlying assets such products may include.

Market significance

Solvency II market data indicates that in 2019, and based on Gross Written Premiums, unit-linked products accounted for approximately 36% of the aggregated EU life insurance business.

Figure 3 below show the underlying asset allocation of insurers' unit-linked business, based on a large sample of Solvency II data. This figure is likely to include allocations from hybrid unit-linked products. As can be seen, these total assets are mostly composed of equity funds,

followed by debt funds (loans and bonds) and asset allocation funds. Asset allocation funds are understood to mainly have holdings in illiquid assets such as real estate.

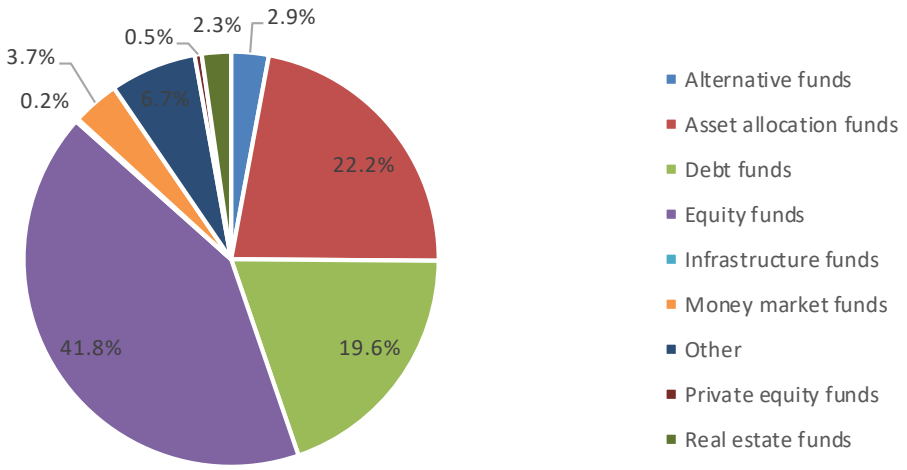


Figure 3 - Unit-linked and index linked portfolio value by fund composition and category
Source: Financial Stability Report, July 2020 EIOPA

The potential to verify the underlying assets

The issue has been raised by stakeholders as to the types of underlying assets that can contribute towards the greenness of a product. The current criterion proposal foresees that unit-linked life insurance products would be verified by looking at the underlying funds (UCITS and/or AIF) and according to the underlying funds' assets. The market data compiled by EIOPA shows that a significant proportion of underlying units shares may be in 'asset allocation funds', which are understood to include funds holding illiquid assets such as real estate. This type of fund is not currently proposed as being included in the EU Ecolabel scope as a separate fund product in its own right; however, the EU Taxonomy is proposed as including criteria for the construction of new and renovated buildings. This means that it will be possible in practice to calculate the contribution of taxonomy compliant green revenue from these assets on a building-by-building basis.

Outcome and implications for verification

The implications for the composition and verification of unit-linked funds are as follow:

- Most of the underlying assets would be held by sub-funds that are either UCITS or AIFs. However, the availability of underlying AIF funds that have the potential to be ecolabelled (i.e. they are authorised for sale to retail investors) is not possible to identify from the data compiled to date.
- The EU Ecolabel would need to be awarded to the unit-linked product, not the underlying fund(s), so even if unit shares are held in a professional real estate AIF, it is not the AIF that would get the label but the unit-linked product. However, this would not be the case if the unit-linked product also gives investors the option to choose a fund at the beginning of the contract or to switch choices during a contract, with the result that each unit would need to be ecolabelled.
- Real estate assets could be covered as they would contribute towards the greenness of the overall product, but only if the compliance with EU Ecolabel criteria is calculated at the level of the overall fund, rather than each individual unit fund being already labelled. This is because it is not proposed at this stage to develop specific criteria and thresholds for individual real estate funds.

4 STRUCTURE AND RATIONALE FOR THE CRITERIA AND CRITERIA AREAS

This section provides an overview of how the criteria set could be configured. This includes the identification of the areas that should be covered by the criteria. The broad criteria areas are described, then the details of each specific criterion are developed further in subsequent sections. Annex 2 presents a table comparing the first and second draft proposal for criteria, across the different criteria areas.

4.1 Proposed structure of the criteria

The following criteria areas were identified with a view to enhancing the environmental benefits of investments:

1. Investment in environmentally sustainable economic activities.
2. Investment in companies investing in transition and green growth
3. Exclusions based on environmental aspects
4. Exclusions based on social aspects and corporate governance practices,
5. Engagement
6. Measure taken to enhance investor impact
7. Information for retail investors
8. Information appearing on the EU Ecolabel

To facilitate the identification of 'environmentally sustainable economic activities' in a harmonised and consistent manner, the definition proposed for 'environmentally sustainable activities' refers to the EU Taxonomy. In this sense, "green" will mean economic activities that qualify as 'environmentally sustainable' under the EU Taxonomy. In a first stage, the EU Taxonomy will focus on identifying the economic activities that significantly contribute to climate change mitigation and climate change adaptation while not harming any of the other objectives. In the future, the EU Taxonomy will identify economic activities that significantly contributes to the achievement of any of the six EU Taxonomy objectives. Annex I provides further details on the EU Taxonomy, its timeline, and the link with the EU Ecolabel.

In addition to the identification of environmentally sustainable economic activities through reference to the EU Taxonomy, the use of exclusions which limit the flow of investments into economic activities which are considered environmentally harmful will ensure that the EU Ecolabel is awarded to the best environmental performing products.

Another aspect to take into account when linking the EU Ecolabel criteria to the EU Taxonomy is that the EU Taxonomy will cover minimum social safeguards, while the EU Ecolabel requires taking into account "where appropriate, social aspects". The aspects that were identified (through the stakeholder survey and reviews of the existing schemes and labels) as being important issues for investors, have been further reviewed and proposed as criteria (in particular social and environmental exclusion criteria) for the EU Ecolabel.

The **portfolio composition in terms of environmentally sustainable economic activities** adopts an overall green threshold for each product, complemented in the case of UCITS equity funds by the potential to include a weighted contribution for companies investing in transition or green growth. This allows for a distinction to be made between company revenue derived principally from environmentally sustainable activities, capex and projected growth in green revenue to enable investment in transition activities or growth in the market share of green activities; as well as diversification for risk management purposes.

This approach is complemented by **technical eligibility criteria for companies investing in transition and green growth**, which may be used for the purposes of calculating the portfolio threshold, as a reference point for transition from certain excluded economic activities and also as a target for engagement to achieve change and growth.

These changes reflect the need for the EU Ecolabel to provide asset/fund managers with the flexibility necessary to invest in transition activities and also to diversify their portfolio.

Exclusions based on environmental aspects focus on the potentially harmful environmental effects of activities financed. The need to adopt criteria that exclude a list of economic activities was identified. The criteria represent a cut-off for economic activities deemed to be detrimental or opposed to EU and international environmental policy aims. The proposed 5% threshold applies at a company level and is linked to revenues. Summarily, the criterion prevents EU Ecolabel funds from investing in activities which could harm the environment significantly (brown activities).

A **social exclusions** criterion aims to address social concerns potentially associated with investments. Changes have been introduced at both a company and sovereign state level in the criterion. In addition to the proposed changes, at the company level, exclusions apply to both transnational and other business enterprises, regardless of their size, sector, location, ownership and structure. Corporate policies on social aspects shall be established and put into practice. A due-diligence procedure in the form of a management system is also required to monitor and manage adverse impacts or potential risks. At the sovereign state level, additional human rights treaties shall be ratified, and the corruption perception index threshold is amended. The criterion, in its current form, envisages addressing stakeholder's concerns on social matters and mitigating adverse social effects of investments. In addition, exclusions based **on corporate governance practices** followed by the companies that the financial products invest in, have been considered.

The **engagement** criterion aims to make use of mechanisms through which investors can seek reforms that improve the quality of company activities and/or grow shareholder value. The establishment of a clear engagement policy which seeks to further the environmental objectives of the EU Taxonomy is established as the starting point. The strategy then provides the context for requiring more effective and focussed use of voting rights as well as bilateral or collective shareholder dialogue with companies to request or campaign for changes in how they are managed and investment strategies.

The **reporting on measures taken to enhance investor impact** is intended to encourage fund and asset managers to identify and actively manage opportunities to enhance the investor impact of the service they provide to retail investors. It requires fund managers to report on which mechanisms for enhancing investor impact they have addressed as a result of investment decisions, as well as identification of which of the measures they are taking to actively manage their investor impact. In this way fund managers will be introduced to the concept of investor impact whilst retail investors can also be provided with information about which measures they can expect from a product.

Finally, **information for the consumer and information about the EU Ecolabel** stipulates the information to be communicated to consumers. Two levels of information are required. The first level aims at communicating the singular aspects of the fund to the consumer throughout simple statements on the various criterion, i.e. portfolio composition in terms of environmentally sustainable economic activities, environmental and social exclusions, engagement aspects, etc. The second level of information requires a full annual report that shall be available to the consumers electronically and where they can find the details of the methodologies used for estimating the portfolio composition in terms of environmentally sustainable economic activities, environmental and social exclusions, engagement aspects, etc.

4.2 Rationale of the proposed general text on assessment and verification

The assessment and verification text refers to the different types of evidence that are considered relevant as proof of compliance for each criterion. The general text is presented in the box below. A separate assessment and verification text is then provided for each criterion proposal

in Section 5. The frequency with which updated information is to be provided to Competent Bodies is currently proposed as 12 months, in line with other labels and industry practice.

The EU Ecolabel Regulation indicates that competent bodies shall preferentially recognise verifications performed by bodies which are accredited under EN 45011. However, this standard has been substituted by ISO/IEC 17065:2012: *Conformity assessment - Requirements for bodies certifying products, processes and services*. For this reason, certification bodies are no longer accredited in accordance with these requirements. Therefore, a statement has been included in the text making reference to Regulation (EC) 765/2008 of the European Parliament and of the Council.

Assessment and verification
The specific assessment and verification requirements are indicated within each criterion. Where the applicant is required to provide declarations, documentation, analyses, or other evidence to show compliance with the criteria, these may come from the applicant and/or their supplier(s) and/or their subcontractor(s). As a prerequisite, the 'financial product' shall meet all legal requirements related to the place of product manufacture, registration and authorisation. Competent bodies shall give preference to attestations that are issued by bodies that are accredited under the relevant harmonised standard for bodies certifying products, processes and services. Accreditation shall be carried out in line with Regulation (EC) No 765/2008 of the European Parliament and of the Council[24]. Competent bodies may require supporting documentation and may carry out independent checks. After being awarded the EU Ecolabel licence, the applicant is required to inform the relevant competent body of any changes pertaining to their licensed product(s). The applicant is required to provide updated information on their licensed product(s) every 6 months. Such information related to any changes or deviations should include all the evidence of proof of compliance to the proposed EU Ecolabel criteria. The competent body may perform follow-up assessments of the applicant's financial product up to once a year during the award period.

[24] Regulation (EC) No 765/2008 of the European Parliament and of the Council of 9 July 2008 setting out the requirements for accreditation and market surveillance relating to the marketing of products and repealing Regulation (EEC) No 339/93. Available at: http://data.europa.eu/eli/reg/2008/765/oj

5 CRITERIA PROPOSALS

5.1 CRITERION 1 (and 2): Investment in environmentally sustainable economic activities (and Companies investing in transition and green growth)

Previous (second) proposal for Criterion 1: investment in green economic activities

Definition: green economic activity

A 'green economic activity' is an environmentally sustainable economic activity as defined by the Taxonomy Regulation, i.e. an economic activity that complies with the relevant technical screening criteria adopted under the Taxonomy Regulation.

1.1 Investment funds

A. Equity funds

At least 60% of the total portfolio value in terms of assets under management (AuM) shall be invested in companies whose economic activities comply with the following threshold:

i. At least 20% of AuM shall be invested in companies deriving at least 50% of their revenue from green economic activities.

ii. The remaining proportion of AuM (0-40%) shall be invested in companies deriving between 20% and 49% of their revenue from green economic activities.

The remaining proportion of the total portfolio shall consist of

- companies deriving less than 20% of their revenue from green economic activities and not excluded by criteria 2 or 3, or
- other assets or cash.

B. Bond funds

At least 70% of the total portfolio asset value shall be invested in bonds that comply with the EU GBS.

If the bond fund comprises sovereign and sub-sovereign bonds, these shall not be excluded by criteria 2.2.

C. Mixed funds

For mixed funds, the equity part shall comply with the requirement for equity funds in (A), and the bond part shall comply with the requirement for bond funds in (B).

D. Funds of funds (FoFs) For funds of funds (FoFs), at least 90% of the AuM shall be invested in funds that have been awarded the EU Ecolabel.

E. Feeder funds

Feeder funds shall have a master fund that has been awarded the EU Ecolabel[25].

[25] The feeder fund shall comply with the same requirements as other funds (stand-alone funds).

Derivatives

A UCITS or Retail AIF may invest in derivatives according to its investment objectives. The use of derivatives shall be in line with the funds environmental investment policy. The use of derivatives shall be restricted to the following situations:

- *Hedging:* Derivatives may be used for hedging purposes with regard to currency risk, duration risk, market risk or/and sensitivity to changes in interest rate structures.
- *Exposure:* The use of derivatives to increase exposure to the underlying assets shall be temporary and respond to significant subscriptions. The management company shall explain in the fund's periodical reports how it proceeds and, in particular, to illustrate the temporary nature of the use of derivatives for exposure purposes.

The underlying assets shall comply with EU Ecolabel criteria, including on environmental and social exclusions as well as consumer information.

Derivatives shall not be used for the short selling of securities.

Other assets

Other assets[26] shall be counted in the total portfolio, when assessing compliance with the portfolio threshold in terms of AuM.

Assessment and verification

A. Equity funds

The applicant shall provide:

i. documentation showing that the monthly averages for the 12 months preceding the application for the EU Ecolabel comply with the portfolio composition requirements for equity funds or pre-contractual information and portfolio statement and prospectus including:

- complete listing of the portfolio assets, and
- evidence that the fund complies with the respective minimum percentages for the equity fund and bond funds as specified in A and B.

ii. An audit report on the latest annual financial statement.

B. Bonds funds

The applicant shall provide the following:

- documentation showing that at least 70% of the total portfolio asset value complies with the EU GBS, based on the monthly averages for the 12 months preceding the application for the EU Ecolabel and,
- the EU GBS certificates for the bond funds as proof of projects financing in green economic activities

C. Mixed funds

The applicant shall provide documentation showing that the fund complies with the respective minimum percentages for the equity and bond shares as specified in A and B of this section, based on monthly averages for the 12 months preceding the application for the EU Ecolabel.

D. Fund of funds (FoFs)

26 Other assets may include as an example, derivatives or money held as cash.

The applicant shall provide the portfolio statement and prospectus indicating that:

- at least 90% of FoFs have been invested in funds already awarded the EU Ecolabel.

E. Feeder funds

The applicant shall provide the portfolio statement and prospectus indicating the following:

- portfolio's composition showing that the underlying fund has been awarded the EU Ecolabel

Derivatives

The applicant shall provide the following documentation on the derivatives included in the funds:

- The investment or management policy governing the use of derivatives and outlining clearly how the derivatives are to be applied including information about the counterparty.
- A statement on the strategy applied addressing how the use of derivatives is in line with the fund environmental policy and how the derivatives comply with the EU Ecolabel criteria, including on environmental and social exclusions.
- -A listing of the types of derivatives and other assets used during the last 12 months preceding the application for the EU Ecolabel, including their nature, average total amount invested (i.e. share of the portfolio) and their average duration/frequency of use shall be demonstrated.
- For OTC derivatives, compliance with the EU Ecolabel criteria on environmental and social exclusions, and consumer information on all of the counterparties used over the last 12 months preceding the application for the EU Ecolabel.

1.2 Unit-linked insurance products

Unit-linked insurance products consisting of a UCITS or Retail AIF shall, on a look-through basis, comply with the requirements set out in sub-criterion 1.1 for investment funds for equities in A. for the equity share, and for bonds in B. for the bond part, as well as for derivatives and other assets.

Where the unit-linked insurance product consists of several UCITS and/or Retail AIFs, the requirements for equities and bonds shall apply at the level of the sum total, over all relevant UCITS and/or Retail AIFs, of the values of the equity shares and bond parts, respectively.

Assessment and verification

The applicant shall provide documentation showing that the monthly averages for the 12 months preceding the application for the EU Ecolabel request comply with the respective minimum percentages for the equity and bond shares as specified in A and B assets, as well as for derivatives and other assets, in sub-criterion 1.1.

1.3. Green fixed-term and savings deposit accounts

Requirement 1. Green loan to deposit ratio

At least 70% of the value of the total deposits shall be used to make green loans and/or to invest in green bonds.

The value of both the loans and the deposits shall be calculated based on the annual average for the time that the product has been on the market. For new products the target ratio shall be stated and after a minimum of one year on the market. The licence-holder shall declare the ratio achieved to the Competent Body.

Requirement 2. Green loans made using the deposited money

Loans contributing to the green loan to deposit ratio shall only be granted to green economic activities. The applicant shall provide annual updates on the implementation status of the funded

projects or activity.

The list of projects and green economic activities funded shall be disclosed in a dedicated EU Ecolabel report to be provided to the retail customer and/or a dedicated web-based portal to which retail customers will be provided access.

Requirement 3. Internal ring fencing of the deposited money

The money held in deposit and granted as loans shall be strictly ring fenced within the accounts of the Credit Institution. The structural solution and/or internal procedures used shall allow for the traceability of the each retail customer's deposited money and their contribution to the total value of the green loans granted.

Assessment and verification

The applicant shall provide on an annual basis an itemised list of the green loans approved for projects and activities. The value and type of projects and/or green economic activities funded shall be identified for each loan. This listing shall be provided and/or updated year on year. The applicant shall provide a declaration that the green loans list is in compliance with the EU Taxonomy requirements for green economic activities. Competent Bodies reserve the right to select projects at random from a loans list for verification purposes.

The applicant shall provide a set of declarations and supporting information to verify the declared loan to deposit ratio and to ensure that is traceable and transparent. They shall comprise the following:

i. The total value of the deposits derived from individual values marked and entered into the Single Customer View (SCV) for the specific product.

ii. The value of each green loans and bonds granted using the deposited money. This shall be recorded and declared together with the total value of the green loans and bonds for each year.

iii. The internal procedures and/or structures used to ring fence the funds and how they allow for the traceability of the deposited money shall be described. This could be supported by an auditors' qualification of the effectiveness of the procedure which may be included in the annual report of the credit institution.

iv. The value of the deposits and green loans related to the product shall be reported annually in a dedicated EU Ecolabel report to be provided to the retail customer, to also be reflected as itemised entries on the balance sheet in the annual report of the Credit Institution, with each entry to be clearly marked as EU Ecolabel-verified deposited money.

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

The minimum proportion indicated below of the assets under management of the retail financial product are invested or loaned to environmentally sustainable economic activities. This requirement shall apply to the different retail financial products in the scope as follows:

- Investment funds and Profit Participation insurance funds: the total portfolio value or portion of the general fund invested in environmentally sustainable economic activities.
- Unit-linked funds: the investment in unit shares meeting the individual requirements to the total portfolio value invested in environmentally sustainable economic activities or the investment in EU Ecolabel investment funds.
- Multi option and hybrid insurance funds: the total portfolio value in a general fund invested in environmentally sustainable economic activities and/or the investment in unit share choices that meet the relevant total portfolio value thresholds.
- Fixed term and savings deposit accounts: the value of deposited funds loaned to environmentally sustainable economic activities.

Sub-criteria also apply to:

- the proportion of the total portfolio value invested in 'companies investing in transition' and

'companies investing in green growth', for which requirements are defined in criterion 2,

- the economic activities of the issuers of corporate bonds that form part of the assets under management (AuM), which are defined in sub-criterion 1.1.C
- The international commitments of the issuers of sovereign bonds that form part of the assets under management (AuM), which are defined in sub-criterion 3.2
- Other assets[27] that shall be counted in the total portfolio, when assessing compliance with the portfolio threshold, as defined in sub-criterion 1.1.I

All underlying assets that can comply with the criteria established in the Delegated Regulation (EU) xxxx/xxx supplementing Article 3 of Regulation (EU) 2020/852 [21] ('the EU Taxonomy') may be counted towards the total portfolio greenness, including, where applicable, real estate and infrastructure investments made by underlying funds in which unit shares are held.

1.1 Investment funds and Profit Participation insurance funds

A. Retail AIF funds

At least 70% of the total portfolio value in terms of assets under management (AuM) shall be invested in environmentally sustainable economic activities. The equity component shall be calculated according to the requirements of criterion 1.1.B and for the bonds to contribute they shall meet the requirements of criterion 1.1.C.

B. UCITS equity funds

At least 40% of the total portfolio value of the assets under management (AuM) shall be invested in environmentally sustainable economic activities, which may include a contribution from companies investing in transition or green growth, according to the formula below.

$$G = \begin{cases} \sum_{i=1}^{n} \left(PCi * (0.6 * GRi + 0.4 * GCi)\right), if\ GCi > GGRi \\ \sum_{i=1}^{n} (PCi * (0.6 * GRi + 0.4 * GRGi), if\ GCi < GGRi \end{cases}$$

Where:

G = % of total portfolio value invested in environmentally sustainable economic activity

i = an individual company in which portfolio equities are held

n = total number of companies in the portfolio

PCi = % Portfolio contribution of company i

GRi = % Green Revenue of company i

GCi = cumulative % Green Capex of company i over 5 years

GRGi = cumulative % projected Green Revenue Growth i over 5 years

Each company's percentage contribution shall be calculated as the weighted average of their % green revenue (GRi) and their % Green Capex (GCi) or % projected Green Revenue Growth (GRGi). The company contribution to the total portfolio value is then weighted based on the % of holdings in the total portfolio value (PCi). The sum of the weighted company contributions gives the % of total portfolio value invested in environmentally sustainable economic activity.

The eligibility requirements for green CapEx (GCi) and growth in green revenue (GRGi) are stipulated in criterion 2.

27 Other assets may include as an example, derivatives or money held as cash.

The remaining proportion of the total portfolio may include:

- companies deriving less than 5% of their revenue from environmentally sustainable economic activities and that are not excluded by criteria 3 and 4, and/or
- other assets or cash

Holdings in derivatives shall meet the requirements of sub-criterion I.

C. UCITS bond funds

At least 50% of the total portfolio value of the assets under management (AuM) shall be invested in green bonds. For corporate and sovereign bonds to contribute towards the portfolio greenness threshold, and be considered to be 'green bonds', they shall meet the following requirements:

- The green projects to be financed using the bond's proceeds shall be identified and shall be verified as environmentally sustainable economic activities.
- for corporate bonds, the issuer shall either meet the requirements of criterion 2.1 for companies investing in transition or show that their percentage of green revenue is more than 50%.
- The allocation of finance to the green projects or portfolios of projects shall be separated, tracked and reported on a 12 monthly basis following issuance.
- The value of refinanced projects within a green bond issue may only contribute to portfolio greenness if the issuer can demonstrate that the refinancing supports the creation of asset-backed securities or the recycling of funds for lending to new green projects.

Bonds verified as meeting the criteria of the EU Green Bond Standard shall be accepted as green bonds.

General purpose corporate bonds that are not green bonds may also contribute to the portfolio greenness. To contribute towards the portfolio greenness threshold, the issuer shall meet the requirements of criterion 2.1 for companies investing in transition or show that their percentage of green revenue is more than 50%. The percentage of green revenue of the issuer shall be applied as the percentage value of the bonds that contributes to portfolio greenness.

D. UCITS mixed funds

At least 50% of the total portfolio value of the assets under management (AuM) comprising bonds and equities shall be invested in environmentally sustainable economic activities. The equity component shall be calculated according to the requirements of criterion 1.1.B and for the bonds to contribute they shall meet the requirements of criterion 1.1.C.

The remaining proportion of the total portfolio may include:

- companies deriving less than 5% of their revenue from environmentally sustainable economic activities and that are not excluded by criteria 3 and 4, and/or
- other assets or cash

Holdings in derivatives that meet the requirements of sub-criterion I.

E. Fund of funds (FoFs)

At least 90% of FoFs have been invested in funds already awarded the EU Ecolabel.

The remaining proportion of the total portfolio may include:

- other assets or cash
- holdings in derivatives that meet the requirements of sub-criterion I

F. Unit-linked insurance products

All the underlying unit funds in which shares are held shall comply with the requirements in Criterion 1, as relevant to the type of fund and its composition. Alternatively all underlying unit funds shall hold the EU Ecolabel.

G. Profit participation insurance products

The portfolio holdings of the general fund and any associated underlying funds shall each comply with the requirements of Criterion 1, as relevant to the type of fund and its composition.

Where the general fund of the product is shared with other products, then the assets held in relation to the ecolabelled product shall be separated on the balance sheet of the license holder in such a way as to restrict transferability and to ensure that the assets underlying the EU ecolabelled products are traceable and correspond with money invested by the customers.

H. Multi option and hybrid insurance products

The portfolio holdings of the general fund and any associated underlying funds in which unit shares are held shall each comply with the requirements of Criterion 1, as relevant to the type of fund and its composition.

Where the general fund of the product is shared with other products, then the assets held in relation to the EU Ecolabel product shall be separated on the balance sheet of the license holder in such a way as to restrict transferability and to ensure that the assets underlying the EU Ecolabelled products are traceable and correspond with money invested by the customers.

All the underlying unit funds in which shares are held, shall comply with the requirements in Criterion 1, as relevant to the type of fund and the composition. Alternatively, all underlying unit funds shall hold the EU Ecolabel.

I. Other assets

Derivatives

A fund may invest in derivatives according to its investment objectives. The use of derivatives shall be in line with the funds environmental investment policy. The use of derivatives shall be restricted to the following situations:

- *Hedging:* Derivatives may be used for hedging purposes with regard to currency risk, duration risk, market risk or/and sensitivity to changes in interest rate structures.
- *Exposure:* The use of derivatives to increase exposure to the underlying assets shall be temporary and respond to significant subscriptions. The management company shall explain in the fund's periodical reports how it proceeds and, in particular, to illustrate the temporary nature of the use of derivatives for exposure purposes.

Derivatives shall not be used for the short selling of securities.

Assessment and verification

A. Retail AIFs

The applicant shall provide the following:

i. documentation showing that the monthly averages for the 12 months preceding the application for the EU Ecolabel request, comply with the portfolio composition requirements or pre-contractual information and a portfolio statement and prospectus including:

- complete listing of the portfolio assets, including where relevant equity, bonds, real estate and infrastructure, and
- evidence that the fund complies with the respective minimum percentage at the time of application or in the year preceding it.

ii. An audit report on the latest annual financial statement.

iii. For products put on the market less than 12 months prior to the application, the fund manager shall provide a prospectus which details the fund strategy, the initial composition and how the greenness threshold will be met

iv. For all products new and existing, an update on continuous compliance shall be provided every 12 months.

B. UCITS equity funds

The applicant shall provide the following:

i. Documentation showing that the monthly averages for the 12 months preceding the application for the EU Ecolabel request comply with the portfolio composition requirements for equity funds or pre-contractual information and a portfolio statement and prospectus including:

- complete listing of the portfolio assets, and
- evidence that the fund complies with the respective minimum percentages for the equity fund.

ii. The documentation required to demonstrate that selected companies within the portfolio that contribute towards green CapEx or green revenue growth qualify with criterion 2.

iii. For products put on the market less than 12 months prior to the application, the fund manager shall provide a prospectus which details the fund strategy, the initial composition and how the greenness threshold will be met

iv. For all products new and existing, an update on continuous compliance shall be provided every 12 months.

C. UCITS bond funds

The applicant shall provide the following:

i. Documentation showing that the monthly averages for the 12 months preceding the application for the EU Ecolabel request comply with the portfolio composition requirements for bond funds,

ii. the external verification for green bonds as proof of the allocation of financing to green economic activities.

iii. For general purpose corporate bonds, documentation that verifies the percentage green revenue of the issuer.

iv. For products put on the market less than 12 months prior to the application, the fund manager shall provide a prospectus which details the fund strategy, the initial composition and how the greenness threshold will be met.

v. For all products new and existing, an update on continuous compliance shall be provided every 12 months.

D. UCITS mixed funds

The applicant shall provide documentation as specified in B and C of this section.

E. Fund of funds (FoFs)

The applicant shall provide licence number of the EU Ecolabel licences held by each of the underlying funds

F. Unit-linked insurance products

The applicant shall provide documentation as specified in B, C and D of this section.

Where an underlying fund has the EU Ecolabel, the license number shall be provided. The prospectus and information about the management service provided to retail investors shall demonstrate the pre-selection of EU Ecolabel unit funds.

G. Profit participation insurance products

The applicant shall provide documentation as specified in B, C and D of this section, as applicable to the general fund. Where relevant, information shall be provided about the accounting practice used to separate the underlying assets of the fund that comply with the EU Ecolabel criteria, together with annual audit financial accounts that show the assets separated on the balance sheet.

Where an underlying fund has the EU Ecolabel, the license number shall be provided. The prospectus and information about the management service provided to retail investors shall demonstrate the pre-selection of EU Ecolabel unit funds.

H. Multi option and hybrid insurance products

The applicant shall provide documentation as specified in B, C and D of this section, as applicable to the general fund. Where relevant, information shall be provided about the accounting practice used to separate the underlying assets of the fund that comply with the EU Ecolabel criteria, together with annual audit financial accounts that show the assets separated on the balance sheet.

Where an underlying fund has the EU Ecolabel, the license number shall be provided. The prospectus and information about the management service provided to retail investors shall demonstrate the pre-selection of EU Ecolabel unit funds.

I. Other assets

The applicant shall provide the following documentation on the derivatives included in the funds:

- the investment or management policy governing the use of derivatives and outlining clearly how the derivatives are to be applied including information about the counterparty
- A statement on the strategy applied addressing how the use of derivatives is in line with the fund environmental policy.
- A listing of the types of derivatives and other assets used during the last 12 months preceding the application for the EU Ecolabel [where applicable], including their nature, average total amount invested (in proportion of the portfolio) and their average duration/frequency of use shall be demonstrated.
- For OTC derivatives, consumer information on all of the counterparties used over the last 12 months preceding the application for the EU Ecolabel [where applicable].

1.2. Green fixed term and savings deposit accounts

A. Green asset to deposit ratio

At least 70% of the value of the total deposits shall be used to make green loans and/or to invest in green bonds.

The value of both the assets (limited, for the purpose of criterion 1.2, to green loans and bonds) and the deposits shall be calculated based on the annual average for the time that the product has been on the market. For new products the target green asset to deposit ratio shall be stated and after a minimum of one year on the market. The license holder shall declare the ratio achieve to the Competent Body.

B. Green loans made using the deposited money

Green loans contributing to the green asset to deposit ratio shall only be granted to environmentally sustainable economic activities. The green loans may be made by partner credit institutions, provided there is traceability back to the deposited funds.

The applicant shall provide annual updates on the implementation status of the funded projects, which may be aggregated by economic activity.

C. Green bonds purchased using the deposited money

Bonds that contribute to the green asset to deposit ratio shall be green bonds or general purpose corporate bonds meeting the requirements of 1.1.C.

D. Separation of the deposited money

The money held in deposit and then granted as loans and/or used to buy bonds shall be separated within the accounts of the Credit Institution in such a way as to restrict transferability and to ensure that the funds loaned are traceable to the money deposited by the customers. The structural solution and/or internal accounting procedures used shall allow for the traceability of the each retail customers' deposited money and their contribution to the total value of the green loans granted.

Assessment and verification

A. Green asset to deposit ratio

The applicant shall provide a set of declarations and supporting information to verify the declared asset to deposit ratio and to ensure that it is traceable and transparent. The information related to green loans shall comprise:

iii. the total value of the deposits derived from individual values marked and entered into the Single Customer View (SCV) for the specific product;

iv. the value of each green loan issued and bonds purchased using the deposited money. This shall be recorded and declared together with the total value of the green loans and bonds for each year.

v. The value of the deposits and green loans related to the product shall be reported annually in a dedicated EU Ecolabel report to be provided to the retail customer, to also be reflected as itemised entries on the balance sheet in the annual report of the Credit Institution, with each entry to be clearly marked as EU Ecolabel verified deposited money and green loans.

B. Green loans made using the deposited money

The applicant shall document on an annual basis the value of green loans approved by types of projects and economic activities. The value of green loans made by associated credit institutions shall be reported on.

The applicant shall provide a declaration that the green loans approved meet the criteria for being environmentally sustainable economic activities. The Competent Body reserves the right to select projects at random from a list of the economic activities funded for verification purposes.

C. Green bonds purchased using the deposited money

The applicant shall document on an annual basis the

i. the external verification for green bonds as proof of the allocation of financing to green economic activities.

ii. For general purpose corporate bonds, documentation that verifies the percentage green revenue of the issuer.

D. Separation of the deposited money

The internal accounting procedures and/or structures used to separate the funds, limit transferability and how they allow for the traceability of the deposited money shall be described. This could be supported by an auditors' qualification of the effectiveness of the procedure that may be included in the annual report of the credit institution.

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

The equities or bonds of a company may be eligible for inclusion as a company investing in transition or green growth within an EU Ecolabel product, if they meet either criteria 2.1 or 2.2.

2.1 Companies investing in transition [28]

A company is considered as investing in transition if:

- It obtains >95% of its revenue from economic activities in the energy, mobility, manufacturing and/or waste management sectors, and
- It currently generates between 5 and 50% of its total revenue from environmentally sustainable economic activities, and
- A formal commitment has been made to close down capital assets that would otherwise be excluded under criterion 3.1.

In addition, the following shall be demonstrated by the company's strategic investment plan:

- How the company is investing to increase its's green revenue base on a projected path to achieve >20% within a minimum of 5 year forward looking period, and
- A commitment to an average green capex over a minimum of 5 years of greater than 20%, based on a two year look back period and a minimum of 3 years forward looking period, and
- The means of raising capital shall be identified, to include own balance sheet resources, loans and bonds.

2.2 Companies investing in green growth

A company is considered as investing in green growth if:

- It obtains >95% of its revenue from economic activities in the energy, mobility, manufacturing and/or waste management sectors, and
- It currently generates more than 50% of its revenue from environmentally sustainable economic activities.

In addition the following shall be demonstrated by the company's strategic investment plan:

- How the company is investing to increase its's green revenue base within a minimum of a 5 year forward looking period, and
- How the company is investing to increase its's market share in key segments and by how much within a minimum 5 year period, and
- A commitment to total green capex over a minimum of 5 years of greater than 50%, based on a two year look back period and a minimum of 3 years forward looking, and
- The means of raising capital shall be identified, to include own balance sheet resources, loans

[28] The differs from the definition of a 'transitional' activity in the EU Taxonomy, which relates to specific activities (not companies) that are not inherently low carbon, whereas in this criterion the reference is to companies whose revenue may be generated by transitional and enabling activities.

and bonds.

Assessment and verification

For each qualifying company the strategic investment plan and prospectus shall be provided. The plan shall provide background information and market data to support the green revenue and/or market share projections. The allocation of capital expenditure plans, both looking back and forward looking shall also be detailed, including specific investments in projects and sites. Each plan shall be accompanied by an auditors' opinion.

5.1.1 Rationale of the proposed criterion text

Given that the scope of retail financial products has been expanded to encompass a number of more complex insurance products, criterion 1 has been updated accordingly. Therefore, specific rules are provided that are tailored to the structures and underlying assets of the newly included insurance products. As a result, the criterion now addresses Profit Participation and Multi Option and hybrid insurance products.

The greenness threshold for retail AIFs has been raised to 70%, based on feedback that the ability to put together a compliant portfolio is easier. Indeed, the investable universe of retail AIFs is larger than the one of a UCITS fund, as it comprises both listed and unlisted equities, which can include 'pure player' green companies, as well as illiquid assets, which can include renewable energy projects, real estate and infrastructure projects. Although in some Member States only AIFs following UCITS-like strategies based on listed equities are authorised, in others AIFs composed of unlisted equities or illiquid assets may be sold to retail investors, and it is these products that have the potential to achieve a high level of ambition under criterion 1. Illiquid assets can be verified by the relevant EU Taxonomy criteria and where the activities are included within the scope (e.g. wind farms, office buildings, rail infrastructure).

The threshold for UCITS equity funds has been raised to 40%, based on feedback that the investible universe for equities can be expanded by making the following changes to the criteria:

- Remove the pocket approach as it restricts asset managers and portfolio managers ability to put together compliant and suitably diversified portfolios, particularly in the case of large capitalisation companies;
- That the CapEx and/or projected growth in green revenue of 1) companies that are investing in transition (5-50% green revenue) and 2) companies investing in green growth (>50% green revenue) may contribute on weighted basis towards calculating the portfolio compliance.

This proposal for UCITS equity funds would ensure a forward looking approach, offering retail investors a portfolio that both invests in current green economic activities and that commits to future growth in green revenue, contributing to the transition towards a low carbon economy. Feedback from the sub-group is that in the current market the balance in an EU Ecolabel portfolio between current and future growth is likely to reach a maximum of 60:40, i.e. 30% current green revenue and 20% future growth commitments. This is because access to equities with sufficient green revenue is currently constrained by the limited size of the green economy.

Capex has been introduced as a metric for investment in green economic activities, at the request of the majority of the sub-group members on criterion 1[29]. However, there was also a consensus that it cannot be used in isolation and that instead it should be seen in the context of a forward looking investment plan that will ultimately result in growth in green revenue.

[29] More details on the subgroup can be found in Section 5.1.4.1

Whilst there is consensus amongst the stakeholders that CapEx is a forward looking metric, there are concerns about consistency of reporting and current data availability. Analysis of company data also suggests that the % of green CapEx is in general not greater than 20-30%, which would limit the benefit of a "Green revenue: green CapEx" weighting. It is therefore proposed to allow for either CapEx or projected % green revenue growth to be used, whichever is greater. This would reflect a hybrid of the two final criterion options (5A and 5B) presented to the criterion 1 sub-group.

A new criterion 2 is proposed which complements the requirements for UCITS equities and defines the qualifying criteria for both 'companies investing in transition' and 'companies investing in green growth'. The criteria were developed based on a consensus within the criterion 1 sub-group and with reference to literature and the recommendations of other initiatives. Companies shall provide evidence of the projected growth in their green revenue base in the form of an investment plan. The plan may be supported by commitments to CapEx and growth in green revenue over a 7-year time frame, consisting of a 2 year look back and 5 years forward looking investment and growth.

The threshold for bond and mixed funds have both been set at 50%. It is understood from the feedback of asset managers that for both these products the ability to purchase green bonds enables the constraint of access to green equities to be overcome. Bonds also support a more diversified portfolio.

It is proposed that during the 1st validity period for the ecolabel criteria green bonds shall be accepted that meet the main underlying criteria of the EU Green Bond Standard, which define the framework for how a use of proceeds green bond shall be issued. Based on a comparison made between existing green bond schemes (such as CBI) a simplified set of common underlying criteria has been defined.

For bond funds the threshold has been reduced (50%) because although it is proposed to accept green bonds that meet the main underlying criteria of the EU Green Bond Standard, a comparison with existing green bond schemes (such as CBI) suggests that the criteria are stricter. Therefore, it is anticipated that access to EU Ecolabel-compliant green bonds may still be constrained.

Responding to stakeholder requests, it has been clarified that both sovereign and corporate general purpose bonds may contribute to portfolio greenness.

In the case of corporate general purpose bonds, i.e. those where no conditions on the allocation of proceeds are required, it is proposed that their greenness is determined by the green revenue of the issuing company.

In all cases the issuers of corporate bonds shall demonstrate that they do not have excluded activities and that they qualify as 'companies investing in transition' or companies investing in green growth'. This is to prevent any potential allocation of proceeds to harmful economic activities, safeguard against the potential harm of EU Ecolabel credibility, act against retail investors mislead and to ensure that the finance raised is verified as contributing to a change in the companies' economic activities.

Refinancing from bonds may only contribute to portfolio greenness where it can be shown that it expands access to capital. This is based on the findings and recommendations of stakeholders that have identified this mechanism as having significant potential impact.

The assessment and verification section has been carefully revised to make it more comprehensive and straightforward

The criteria proposed for deposit accounts are largely unchanged, except for the reference to ring fencing, which has been replaced by a requirement to report on accounting practices used to ensure 'separation' and to limit transferability of the funds for other purposes. The requirement for itemised reporting of each loan for verification purposes and in a report provided to retail customer has been modified to refer instead to reporting on loans at a more general level of detail.

5.1.2 Summary of the main changes introduced to criterion 1 in TR2.0

Feedback received on TR1.0 and further research conducted by the JRC can be found in the previous version of the technical report (TR2.0).

This section provides an overview of the evidence-based suggestions made by the JRC in terms of criterion 1 improvement. A summary of the issues addressed in the TR2.0 are summarised as follows:

- JRC has concluded that adopting a temporary framework for economic activities not yet featured in the EU Taxonomy and its technical criteria would not serve to improve the transparency of the financial sector, and might be perceived as an endorsement by the European Commission of one specific taxonomy over others. Hence, the EU Ecolabel sticks to the most updated version of the EU Taxonomy. Nevertheless, it will monitor work on the development of the EU Taxonomy and align with it to reflect any potential changes through amending decisions.

- Regarding the way other investment funds are treated in criterion 1, the TR2.0 considers Article 50 (2) (a) of the UCITS Directive and limits the proportion of these funds to 10% of the fund's portfolio. This threshold is considered pragmatic and efficient to set requirements in the EU Ecolabel that are aligned to the Directive.

- In terms of real estate inclusion in the portfolio, JRC suggested that to include listed real estate as a specific asset class within the portfolio could not been carried forward. That is due to the different requirements of relevant energy performance across Member States, the limited presence of real estate in PRIIPs portfolios, the varying criteria in the available real estate-related standards and labels, and the limited volume of investment opportunities.

- Another topic that is addressed in the TR2.0 was as to whether assets, such as derivatives and cash, should be included in the portfolio, although, no greenness verification is required due to these products challenging assessment. Based on that and considering the importance of theses underlying assets for diversifications purposes, it is suggested that such types of underlying assets are excluded as an eligible green asset class. Still, they are included in the calculation of total portfolio value.

- The TR2.0 also concludes on whether assessment and verification require any specific parts to be tailored to individual products within the scope. Stakeholders have confirmed that tailoring aspects of the assessment and verification to individual products would increase the costs and complexity of assessment and verification and thus have a potential negative impact on the EU Ecolabel uptake. Therefore, only one type of assessment and verification would apply to all.

- The assessment and verification requirement has been further reviewed to clarify as much as possible the relevant documentation required as proof of compliance. Currently, it is envisaged that the EU Ecolabel will not evaluate documentation/materials provided by the applicants as proof of compliance based on the source but rather on compliance with the requirement.

- Considering the comments received on the TR1.0, an extensive part of the follow up research has been focusing on the strictness of the greenness threshold. Since the outcomes of this research and the updated formulation of criterion 1 are explicitly described in the TR2.0, JRC recommends consulting the previous paragraph in this document and the TR2.0 to gain more detailed insights to this subject matter.

- It was found to be feasible to add savings and deposit accounts to the initial scope of the product group. These are a mainstream financial product that could ensure high visibility for the EU Ecolabel and diversify the current scope of financial instruments beyond equities and bonds to also include loans, which play an important role in supporting economic activity as well.

- The basis for the new criteria for fixed-term deposit account and a savings deposit accounts is the verification of the balance sheet of a bank and identifying and reconciling deposit value with loan value. This relationship can be expressed as a 'green loan to deposit' threshold percentage. The basis for verifying the greenness of the product shall the issuing of green loans using the deposited funds. Green loan lending criteria would then to be applied by a bank's credit committee at the point of making decisions on the granting of loans, with activities defined as green and therefore suitable for lending if they are compliant with the EU Taxonomy. This decision-making process and the compliance of the projects or economic activities with the green loan criteria would also need to be verified. Moreover,
- The criteria proposed for deposit accounts are largely unchanged in their structure and ambition level, except for:
    - the reference to ring fencing, which has been replaced by a requirement to report on accounting practices used to ensure 'separation' and to limit transferability of the funds for other purposes.
    - the requirement for itemised reporting of each green loan for verification purposes and in a report provided to retail customer has been modified to refer instead to reporting on green loans at a more general level of type of project and economic activity.
    - a reference to the sub-criterion 1.1.C on green bonds and general purpose corporate bonds has been introduced in order to clarify how products comprising bonds shall verify that they have complied with the threshold. To reflect this mix of potential assets, overall reference is now made to a 'green asset to deposit ratio' instead of a 'green loan to deposit ratio'.
    - The ability to pool loan assets that are drawn down from funds in the deposit account but which are allocated by credit institutions working in association with the license holder has been added. This is introduced subject to consultation within the Commission services.

5.1.3 Outcomes of the 2nd AHWG meeting and stakeholder consultation

Comments received from stakeholders during and after the 2st AHWG meeting were directed at various aspects of criterion 1, including the ambition level of equity thresholds and the structure of the requirements on bonds. The EU Taxonomy alignment is also commented along with assessment and verification issues and on how Capex could be included in the greenness criterion. It is also commented on the need for adequate disclosures, mostly at a corporate level, so that the criterion could work out pragmatically. A few comments were received on more specific parts of the TR2.0, such as derivatives and unit-linked insurance products. The comments are presented in an aggregated format in the clusters below.

1) *Thresholds ambition level*

Stakeholders suggested increasing the threshold for the equities' greenness up to 50% at the portfolio level. They argued that only in doing so, greenwashing could be avoided. The current ambition level, 18% of total revenues from environmentally sustainable and thus EU Taxonomy aligned activities, could compromise the credibility of the EU Ecolabel and would also be outdated in the case the market evolves rapidly. It is also suggested the 'pocket approach' to be dropped.

On the opposite, other stakeholders mentioned that at the date of the EU Ecolabel implementation, it should be ensured that a significant number of investment funds would be

eligible. This should be done not to jeopardize the viability of the EU Ecolabel. They also argued that due to the suggested pass/fail criteria and the limitations in data provision, the eligible universe would be quite limited. In that sense, it was asked whether a forecast study in terms of EU Ecolabel market uptake could be carried out for the next three years following the criteria implementation.

The same stakeholders proposed to examine the appropriateness of the proposed thresholds via tests and reflect on the market maturity before proposing a stringency level. At the current stage, the argued that only 2% of all companies in the MSCI World index could potentially qualify for the first pocket threshold (at least 50% of turnover derived from taxonomy compliant activities) and less than 10% for the transition pocket (20%-49% turnover derived from taxonomy compliant activities). Some few supported a minimum threshold for the transition pocket at 5% of green revenues.

There were opinions in favour of a dynamic threshold that will consider market development and maturity along with the EC climate protection targets. They highlighted that the advantage of this approach is that it incentivises investments while thresholds can be tightened over time.

Stakeholders have also advocated that retail financial products need to be sufficiently diversified to comply with the UCITS Directive and thus to protect investors. Therefore, it is argued that establishing a sizable eligible investment universe shall be a key priority to comply with sectoral EU rules.

In terms of fund of funds (FoFs), they advocated that all underlying funds should be EU Ecolabel compliant, and not only 90%. It was proposed that in the current criterion, the remaining 10% of not Ecolabel funds to be subject of environmental and social exclusions. Differently, it was suggested to decrease the ambition level for ecolabel funds by 70% while considering other national green labels since the market is still not mature and therefore it cannot support the creation of EU Ecolabel FoFs.

2) *Structure and strictness of the greenness criterion on bonds*

Stakeholders suggested increasing the bonds threshold at 75% while others supported to go up to 100%. It is also proposed to reformulate the requirements on bonds and to structure them in a similar way to equities. Subsequently, corporate bonds could be considered to comply based on revenues from environmentally sustainable activities of companies issuing the bonds. For instance, bonds issued by green companies (>50% green revenues) will be accepted as environmentally sustainable.

Some stakeholders suggested not to have any requirements on the issuer side. That practically means that companies indicating less than 20% of revenues from environmentally sustainable activities will be allowed to issue green bonds. Nevertheless, environmental and social exclusions shall still apply. It was also proposed to drop the requirement for EU GBS and replace it temporarily by green use-of-proceeds bonds of other recognised schemes. That is proposed since the market cannot currently provide with EU GBS in an amount sufficient to build up EU Ecolabel portfolios.

At the sovereign level, it is argued that the JRC needs to improve and shorten the list of requirements for eligible bonds. It is commented that currently, the criterion 1 fails to identify whether bonds proceeds are invested in environmentally sustainable projects or elsewhere or if they are only used for refinancing debt.

3) *EU Taxonomy alignment*

At the current state, there is insufficient availability of data that are necessary for screening against EU Taxonomy eligible activities, making it challenging to check compliance which is crucial for the EU Ecolabel approach. Therefore, some stakeholders suggested putting on hold the EU Ecolabel criteria development until data sufficiency is reached. Moreover, they have

proposed freezing the process up till the EU Taxonomy delegated acts, which define technical screening criteria, are finalised, adopted and implemented.

It is suggested the greenness criterion shall include enabling activities as defined in the EU Taxonomy since these activities are crucial in supporting the transition. It was also argued that at least 70% compliance with the EU Taxonomy at a portfolio level is necessary so that the credibility of the EU Ecolabel is not compromised.

4) *Capex inclusion in the greenness criterion*

Stakeholder highlighted the need to include Capex as a metric of transition and of figuring out the stock greenness requirements. They supported Capex inclusion as it is a forward-looking indicator largely determining how far a company is willing to green its future business models. That would also be in alignment with the EU Taxonomy since it points out capital and operational expenditures as metrics for a green transition. However, some stakeholder questioned the availability of Capex relevant data.

5) *Sufficiency in disclosing relevant data*

Stakeholders argued that the efficiency of criterion 1 depends closely on a sufficient level of relevant corporate disclosures. Therefore, it is suggested to incentivise companies to become early adopters of disclosing requirements. Between others, stakeholders found that disclosures on Capex and the percentage of EU Taxonomy aligned activities are of crucial importance and should be made mandatory. It is mentioned that the NFRD Directive[30] will be in force in 2022 for climate change mitigation and adaptation and in 2023 for the other EU Taxonomy objectives so there is an issue in terms of disclosing non-financial data before those dates, which might influence the functionality of criterion 1. It is also pinpointed that the NFRD directive affects companies in the EEA area only and cannot be imposed on those operating elsewhere.

6) *Assessment and verification*

To support an effective assessment in terms of a fund's underlying assets conformity, stakeholders argued that criterion 1 requirements should be kept simple and straight-forward. To increase confidence, it is suggested that only third parties should carry out the assessment. In doing so, relevant EU-wide standards for independent assessment need to be developed. Moreover, third party institutions other than the national Competent Bodies should assess EU Taxonomy compliance. It was also questioned whether a potential corporate revenues breakdown should be certified independently as required for EU Green Bonds. Additionally, the frequency of the assessment was highlighted, and it is advocated that it shall be done annually.

Further on, regarding the assessment procedure, it is argued that EU Taxonomy-related corporate data, subject to the NFRD Directive and the disclosures requirements of the EU Taxonomy, shall only be based on company-disclosed data, and not on estimates

The need for a record should be dropped, at least for new funds. The requirement to provide evidence of the monthly averages for the 12 months preceding the application may substantially delay the application submission and would not allow for new and innovative products to be eligible, such as those including, e.g. derivatives, which have very short lifetimes. Moreover, the EU Ecolabel could adopt a more forward-looking approach. In doing so, it needs to establish procedures which ensure that the fund will be managed during the validity period of the license as documented when the license is granted. It is also commented that at the current stage, it is

[30] Non Financial Reporting Directive available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095

not clear whether the assessment is performed by fund managers, competent bodies or independent evaluators.

Verification requirements need to be homogenous across the EU to facilitate dissemination of the EU Ecolabel funds. Additionally, no national labels should be asked for accessing local markets, but funds can do so if they comply with the EU Ecolabel criteria. The opposite could increase costs and harm the EU Ecolabel uptake.

Stakeholders pointed out that data for assessment of compliance will be mostly purchased from ESG data providers. That could increase the costs of obtaining the EU Ecolabel significantly. The quality of the received information and the methodology behind could also influence the assessment outcomes.

7) *Derivatives*

Derivatives can be used for hedging risk purposes, and therefore they are quite crucial in making up funds' portfolios. A potential restriction on the use of derivatives in EU Ecolabel could also raise technical issues, e.g. bond futures, and therefore should be avoided. Stakeholders pinpointed that any reference on the alignment of derivatives with the environmental investment policy could create expectations as to the green performance of this asset. Hence, it shall be emphasised that risk hedging is their only purpose. It was suggested to adjust the criterion considering ESMA guidelines.

8) *Unit-linked insurance products*

Insurers do not always have detailed information about the underlying investments of each unit-linked account of the product. Considering this, stakeholders suggested a similar approach to funds of funds for life insurance products. 100% of unit-linked funds shall comply with the criteria of the EU Ecolabel for retail financial products as no liquidity buffer is needed in this case (compared to funds of funds). In terms of a look-through approach for unit-linked insurance products, insurers mentioned that its application would be challenging.

9) *Savings and deposit accounts*

Development of products and market implementation of the criteria

It was considered by one stakeholder that it will take some time before green funds/savings accounts will emerge as a market reality due to the initial lack of qualified green assets. It was considered by another stakeholder that there would need to be testing in the market of the concept of traceability and how this functions in practice. A transitionary period was proposed in this regard, with the initial green loan to deposit ratio in the 1st year of the criteria validity set at 50%, with the potential to subsequently raise this to 70%.

The scope of underlying loans and bonds

Reference was made to the bonds held in relation to a fixed term account. The return offered to customers from deposit accounts often derives from investments made on government and corporate bonds. Here it was noted that the criterion meeting the threshold should not be limited to just the loans granted by the bank.

It was also noted by some stakeholders that it would be inappropriate to limit the underlying assets to only the credit institution's (green) loans. It should therefore be possible for a bank to build an underlying pool of qualified/compliant green assets from different lenders/issuers.

The ability to earmark, connect and trace credits to deposits

The difficulty to earmark certain types of credits and make the link to deposited funds was raised as an issue. It was also noted that in the case of revolving facilities or short-term loans,

the funds can move quickly between projects that receive loans, adding complexity to possible reporting. A green asset ratio was proposed by one stakeholder and supported by some others.

The reference to 'ring fencing' raised a number of concerns about the regulatory implications. The first is that it relates to prudential requirements that banks must adhere to following the 2008 financial crisis and as introduced in subsequent banking structural reforms. Reference was made to inclusion of deposits in calculating the LCR – the Liquidity Coverage Ratio – and the NSFR – the Net Stable Funding Ratio of banks. It was considered that a 'tagging' of the assets loaned to should enable traceability to be achieved without a formal ring fencing.

Reporting for each loan and credit

Concern was raised relating to disclosure on a loan by loan basis and the ability to report on an annual basis. Instead it was proposed to be able to 'map' the pool of green assets and report per sector or activity or according to environmental objective. The disclosure would need to be confidential as client consent would be needed to reveal the clients.

5.1.4 Further research and main changes in the third proposal

In order to address the comments received from stakeholders, additional research was conducted. These are presented below.

5.1.4.1 Ambition level of the greenness criterion for equities

Apart from further literature review, JRC has called on the creation of a sub-group to support the development of the greenness criterion 1. The main objective of the subgroup discussions was to address how in criterion 1 (and in particular the thresholds for equities) can be shaped in order to keep a reasonable level of market uptake while having a high level of ambition in terms of environmental excellence. This included discussions on companies in transition and the requirements for bonds.

The sub-group included 18 members:

- Existing label operators: FNG label, ADEME, VKI, Nordic Swan
- NGOs: FairFin, Better Finance, BEUC/EEB, Transport & Environment, WWF Europe
- Asset Manager: Amundi, BlackRock, BNP Paribas, FIDEAS, Triodos, Mirova
- Data analysits: Climate and Company, MSCI, Sustainalytics
- Other: French Ministry of Ecological and Inclusive Transition

Two stakeholder meetings took place, the first one on 28th July 2020 and the second one on 9th Sep 2020. The minutes of the meetings can be found on the website[31].

Five analyses were reviewed by the JRC, differing in terms of scope, methodology, and data. Four of the analyses (A1 to A4) assessed the EU Ecolabel criterion 1 specifically, investigating the size of the investment universe eligible for the EU Ecolabel under the TR2 version of criterion 1. The five analyses are detailed below:

A1: The study '*Testing Draft EU Ecolabel Criteria on existing UCITS equity funds*[32]' performed by the Climate & Company and the Frankfurt School's UNEP Collaborating Centre and commissioned by DG FISMA;

[31] https://susproc.jrc.ec.europa.eu/product-bureau//product-groups/432/documents
[32] https://susproc.jrc.ec.europa.eu/Financial_products/documents.html

A2: The EU Taxonomy analysis performed by MSCI on the compliance of companies with the EU Ecolabel criteria;

A3: The equity analysis performed by FIDEAS on the compliance of equity funds with the EU Ecolabel criteria;

A4: An analysis provided by Sustainalytics based on their experience regarding the eligible assets universe and the ambition level of criterion 1.

A5: The PRI study on the alignment of the financial market with the EU Taxonomy criteria of climate change mitigation and adaptation. Different analysts were involved and the results are presented on the PRI web-page (https://www.unpri.org/policy/eu-sustainable-finance-taxonomy/eu-taxonomy-alignment-case-studies)

The scope and outcomes of these independently performed analyses are summarised below and represent a starting point for discussing and reviewing the ambition level.

A1: Supporting DG FISMA financed study '*Testing draft EU Ecolabel criteria on existing UCITS equity funds*'

The objective of this study was to test the application of criterion 1 (TR2 version) to a sample of 101 "green" UCITS equity funds domiciled in the EU27. Focused on the EU environmental objective "climate change mitigation", the study analyses the share of EU Taxonomy aligned revenues of these funds' constituents and hence provide insights into the potential qualification of the equity funds under the current proposal for criterion 1.

Study outcomes

- More than 50% of the revenue-weighted activities are not covered by the EU Taxonomy's climate change mitigation criteria;
- Only 3 out of 101 (3%) funds would qualify for criterion 1, having a sufficiently large share of EU Taxonomy aligned and green (i.e. falling into the "green" or "transition" pocket) activities; This number remains unchanged even if it is assumed that 11% (i.e. the average "green" share in the sample) of the "non-verifiable" share per company was green as per EU Taxonomy;
- Two further sensitivity analyses with a less strict application of the EU Taxonomy. The results suggest that in total a maximum of 6 out of 101 funds are complying with criterion 1. Reasonable assumptions and proxies were considered to broaden the evaluation;
- The results also show that currently due to data constraints (in particular limited reporting) and the limited coverage of the EU Taxonomy, the evaluation of funds against criterion 1 is constrained. This may pose a challenge for verifying products until the market has responded to the new disclosure requirements;
- It is difficult to evaluate fund greenness comprehensively, based on available data from the major ESG data providers. The lack of disaggregated company data, such as (but not limited to) product-specific data on energy efficiency equipment, limits a comprehensive evaluation;
- The relevance of non-EU companies poses an issue as mandatory disclosures will apply to EU companies only;
- The manufacturing and energy sector is of particular importance within the underlying assets of the funds analysed.

Limitations

- Only UCITS equity funds were investigated, although the EU Ecolabel targets a wider scope of retail financial products;

- Data availability placed a constraint on the verification of the compliance with the EU Taxonomy (and mapping of companies' economic activities to the EU Taxonomy);
- Only climate change mitigation was considered in this study;
- DNSH criteria, social safeguards and other provisions of the draft Ecolabel proposal and the underlying, corresponding EU Taxonomy proposal were not addressed (outside the scope of this study).

A2: MSCI analysis

An analysis made by MSCI took a different approach to A1 by seeking to determine which part of the screened securities universe could currently be available to portfolio managers as a selection universe for active management or as the basis of an indexed solution. The sample contains 9000 companies, which have been checked against proxy EU Ecolabel criterion 1 requirements (as drafted in the TR.2), as well as the exclusionary criteria 2 and 3. The analysis for criterion 1 was based on a climate change proxy addressing all six EU Taxonomy environmental objectives

Study outcomes

- Eligible companies, based on the climate change mitigation and adaptation objectives, would represent between **3.9%** and **5.7%** of the market, depending on whether large+mid cap or small cap companies are considered, as detailed in *Table 1* and *Table 2*, respectively. The outcomes can therefore be used to examine how the investment universe is affected by how the thresholds are configured.
- Applying the environmental and social exclusions could further reduce the investment universe by almost 40% (large+mid-caps). However, applying these exclusions require a large number of assumptions and proxies to currently be applied.
- An evolutionary approach to thresholds (whether % of AUM or % of revenue) may be required because of the dynamic situation in the market. Thresholds would be adjusted year-on-year to reach the ideal threshold. This approach might encourage companies to transition to a greener economy, and/or increase their green economic activities. Based on a sensitivity analysis the eligible pool of companies increases by a factor of two (small caps) to almost three times (large+mid caps).
- A differentiated approach to thresholds may be required because of the difference in eligible stocks by capitalisation. Given that most pure-play green companies are smaller, differentiating thresholds could credit large companies with smaller % from green economic activities but that derive more in absolute revenue. Based on a sensitivity analysis the eligible pool of companies increases by a factor of nine (*large caps*), whereas the eligible pool for small and mid-cap companies is not affected.

Table 1 - MSCI analysis:Eligible universe based on EU Ecolabel criterion 1 on equities (large and mid-cap companies)

		0%	<20%	20%-50%	>=50%
Climate change	Weight	69%	27%	3.2%	0.7%
	After exclusions		15%	1.8%	0.6%

Table 2 - MSCI analysis: Eligible universe based on EU Ecolabel criterion 1 on equities (small cap companies)

		0%	<20%	20%-50%	>=50%
Climate change	Weight	76%	17%	3.1%	2.6%
	After exclusions		14%	2.7%	2.3%

Limitations

The study adopted screening proxies, which can be applied in a scalable way – since detailed and relevant corporate disclosures may not appear until 2022 for climate mitigation and adaptation and 2023 for the other four objectives within the EU, and it will be even harder to obtain for companies domiciled elsewhere.

A3: Fideas Asset Management analysis

An analysis was made by fund manager and analysts FIDEAS of both potential uptake by funds and the underlying investable universe of equities. They examined a sample of 3707 EU equity funds and 300 stocks (large, mid and small capitalisation) for eligibility with the EU Ecolabel criterion 1 (as drafted in the TR.2), using Morningstar and Trucost data. A number of ecolabelled portfolios were designed and their performance and characteristics modelled and analysed in comparison to a benchmark fund.

Study outcomes

- Only 57 funds were compliant with EU Ecolabel criterion 1 requirements, meaning that only **1.54%** (Nr. of funds) or **1.25%** (AuM) could qualify;
- UCITS funds represent 74% of the fund sample;
- Assigning the companies into different pockets according to their green revenues [33] gave the results in *Table 3*. The table suggests that more than 50% of the companies have less than 20% green revenues, and therefore would not qualify for the green and transition pocket;
- The main constraint identified was the size of the investable universe of green activities – the green economy at this point in time;
- The active risk of an ecolabelled fund although greater is deemed 'acceptable' compared to a benchmark fund (+23%). At higher levels of compliance (80% and 100%) based on the 2nd proposed criterion 1 design, the active risk becomes significantly higher – +43% and +63% on average.
- The tracking error for the ecolabelled portfolios that were modelled was relatively small (1.28 – 2.91%), which is relatively small compared to the corresponding risks.
- In order to compose an ecolabelled fund an overweighting compared to benchmark is required in the sectors of automobiles & components, capital goods, materials, real estate, utilities and telecommunication services. Care needs to be taken not to overweigh sectors with only a marginal impact on climate change or to underweight key sectors that need to make a transition.
- The relative importance of sales volumes, for example of electric vehicles, versus revenues was highlighted.

Table 3 – FIDEAS analysis: Allocation of companies, based on their green revenues, in three pockets

		Exclusions	<20%	20%-50%	>=50%
Aggregate green	With exclusions	11.7%	52.4%	6.6%	29.6%
	Without exclusions		62.1%	6.9%	31%

[33] Green revenues were computed using Trucost data; activities are defined as green using EU Taxonomy eligibility only

Limitations

- Only EU based equity funds have been included in the sample;
- There is uncertainty relating to the fund analysis since it is based on Morningstar categories or using the name of the fund itself. Therefore, it does not map directly on the proposed EU Ecolabel criteria;
- The pool of stocks used to put together portfolios was relatively small.

A4: Sustainalytics screen

Sustainalytics carried out a proxy screen of the Ecolabel criteria (TR.2 version) on their global universe (12000 companies) and on a portfolio of some 600 of the largest European stocks. The proxy screen does not ideally match with the Ecolabel criteria, but the order of magnitude of the outcomes may still be representative of the current reality.

Screening outcomes

- The results of the proxy screen on the 12000 companies revealed that approximately **6.5%** of these companies would meet the exclusionary screens and have at least some revenue from EU Taxonomy aligned activities. However, if a revenue threshold of >20% is applied, then less than 4% meet the criterion;
- The results of the proxy screen on the 600 European stocks revealed that approximately 65 would meet the exclusionary screen and have at least some positive revenue from EU Taxonomy aligned activities;
- In a real-world setting, there is a significant risk that the limited number of companies that meet the criteria may create an asset bubble in the market;
- While the exclusion rules reduce the eligible universe, the proposed requirement with respect to greenness act as a far stricter filter. The reason being that there are very few companies that meet the proposed EU Taxonomy aligned revenue thresholds;
- Several factors will influence any increase of the investable universe in the foreseeable future, including how fast the outstanding EU Taxonomy objectives will be developed and adopted and corporate disclosures with respect to EU Taxonomy alignment not only in Europe but globally. Likely most important is however the speed at which economies will transition and companies generate more revenues from EU Taxonomy aligned activities.

Limitations

The screening is made up of a green proxy using Sustainalytics Sustainable Products Research, and a set of exclusionary screens on nuclear, oil & gas, tobacco, weapons, adult entertainment, and Global Compact Compliance.

A5: the PRI studies

This report[34] shares insights from the first comprehensive set of case studies around how to use the EU taxonomy. Starting in late 2019, over 40 investment managers and asset owners worked to implement the taxonomy on a voluntary basis in anticipation of upcoming European regulation.

34 PRI study about the potential use of the EU Taxonomy available at: https://www.unpri.org/policy/eu-sustainable-finance-taxonomy/eu-taxonomy-alignment-case-studies

The investors assessed EU Taxonomy alignment before many details of the final regulation are in place, and before widespread corporate reporting against the EU Taxonomy is available. Many challenges remain, not least the availability of data and potential changes to the detailed EU Taxonomy criteria. The case studies demonstrate that the EU Taxonomy framework can be operationalised, and offer important insights for investors beginning their taxonomy preparation.

This report also summarises recommendations from the group to policymakers and supervisors who will oversee the implementation and development of the EU Taxonomy.

Report outcomes

- The report identifies how and to what extent existing activities are aligned with the requirements set in the EU Taxonomy. To do so, it adopts metrics such as Capex and highlights challenges to assess this indicator and thus evaluate compliance. The most common method of calculating alignment for listed equity was quantifying the proportion of turnover aligned with the Taxonomy. In the case of Green Bonds (GBs), investors relied on use-of-proceeds to calculate the assessment.
- In a next step the report assesses the recommendations of group members to other financial market participants implementing the EU Taxonomy. It summarises them into a four-step process: Establish a framework, develop a process, identify challenges and find solutions There is no single correct way to approach the EU Taxonomy but following these steps may help investors initiating their taxonomy assessment.
- Group members identified the key challenges they faced in implementing the taxonomy, and the solutions they found. The challenges can be broadly defined as problems around sourcing data, matching data to the taxonomy, adapting to the granular taxonomy approach and creating new processes to address the taxonomy. Various solutions were proposed – but not all will be suitable for every investor. There were also specific challenges for those dealing with Green Bonds.
- The report summarises main challenges for the application of the EU Taxonomy in the areas of sourcing and matching of data, obstacles in the adaptation of the EU Taxonomy. The report also identifies key constraints relating to the green bonds, such as e.g. the limitations on breaking down use-of-proceeds, bonds that might be invested to environmentally sustainable activities others than climate change mitigation and adaptation etc.
- The Report makes policy recommendations. Recommendations are provided for three key themes: data, guidance and supervisory expectations, and the further EU Taxonomy development.

<u>*Summary of the analyses findings and further options for criterion 1*</u>

The results of all the above analyses suggest that the eligible universe under the current criteria proposal would not currently be sufficient to compile EU Ecolabel eligible funds that correspond to the 10-20% of the best performers in the market, although one shall bear in mind that:

- The studies only assess climate change mitigation compliance – the eligible pool might increase once the criteria for all EU Taxonomy environmental objectives will be defined and adopted, although there may be some overlap as companies seek to fulfil multiple objectives;
- The adoption of the EU Taxonomy is expected to improve the granularity and quality of data disclosed by European companies, but this will have a lag time as the market familiarises itself with the final criteria and data is compiled and disclosed;

- The analysed sample only contains equities. It is expected that the inclusion of green bonds will enhance the greenness of the portfolio.

Based on the analyses, three key factors may need to be taken into account when seeking to revise the criterion:

- *Capitalisation*: The eligible universe varies depending on the capitalisation of the companies, and the pure players tend to fall into the small-cap category. The majority of the underlying assets of UCITS are composed of large and mid-cap companies;
- *Revenue*: The percentage of green revenues alone may not be a good indicator for the scale of impact. For example, 10% green revenue for a large-cap company may have a greater effect than a 50% green revenue from a small-cap company;
- *Companies in transition*: Although not directly identified by the analysis, an option suggested by stakeholders for expanding the eligible universe could be to explore the provision in the EU Taxonomy to support companies in transition.

Four options for a revised version of criterion 1 were formulated by JRC, considering the outcomes of the analyses and the stakeholders' views on the subject matter. These options are provided below, and open up to some overall questions that need to be addressed (see box below)[35]. These options and questions were discussed at the 1st sub-group meeting. As a result of this meeting the JRC have developed a fifth hybrid option for discussion at the 2nd sub-group meeting.

Outcomes of the 1st sub-group meeting

At the first subgroup meeting, a quite large consensus was found around option 2. The main conclusions of the 1st subgroup meeting and JRC considerations/need for further research are detailed below:

- UCITS greenness threshold: A target ambition of an overall greenness target in the range of 40-51%.

  For consideration: The final threshold will need to provide sufficient flexibility to put together UCITS products that have a high proportion of large capitalisation companies and sufficient risk diversification.

- Retail AIF greenness threshold: The target ambition may be higher than 51% as there is more flexibility to put together portfolios as they can contain both unlisted (SME) pure players and illiquid assets, thereby allowing for a larger investible universe.

  For consideration: The final threshold is to be determined.

- Assets under management: Option 2 is based only on an average of the green revenue for the companies for which equities are held. An additional weighting needs to be added that takes account of the proportion of the investment allocated to each company.

  For consideration: Option 2 proposes a simple weighted average. The proportion of other assets such as EU Taxonomy neutral equities, cash, currency and derivatives shall also be taken into account, in order to provide a transparent overall view of the portfolio's performance for retail investors.

[35] A more detailed description of the four alternative options is available at: https://susproc.jrc.ec.europa.eu/product-bureau//sites/default/files/2020-08/1st%20subgroup%20meeting%20-%20JRC%20discussion%20paper%20on%20the%20level%20of%20ambition%20of%20criterion%201.pdf

Proposed options for criterion 1 – Equities greenness
Alternative option 1: *Thresholds geared to market capitalisation and the investable universe* This option treats different types of equity funds as distinct sub-categories/sub-products and tailors the thresholds according to the individual characteristics of the funds. Hence, it proposes different weighting factors for green revenues and Capex to make up the portfolio contribution depending on whether it refers to large-cap, mid and small cap companies or private equity AIFs. Alternative option 2: *A combination of Green revenues and Capex as a metric* Option 2 refers to equity funds and entails a combination of green Capex and green revenues as an indicator for greenness. This version of criterion 1 does not contain the three pockets approach anymore. Instead, there is a requirement for the weighted average of green Capex and green revenues to be more than 50%. Additionally, companies with green revenues below 5% shall be excluded. Alternative option 3: *Dynamic thresholds for green revenues* The third option elaborates a green revenues dynamic criterion. It establishes a 5 years' period for improving green revenues and sets different requirements for large/mid and small-cap companies. The option contains indicative minimum thresholds for green revenues, differentiated for large/mid-cap and small-cap companies, while adopting a forward-looking approach. The dynamic rate of change of green revenues can be modified to be pragmatic. The weighting of the large and mid capitalisation companies in the fund is for the moment assumed to be equal. The same applies for the importance of green revenues sourced from pure green companies and companies in transition. Alternative option 4: *Threshold for applying flexibility to companies in transition* This option elaborates further on the previous ones. The main feature of this option is the linking of a threshold for identifying companies investing in transition to requirements on engagement, a commitment to Capex and planned changes in green revenue.

- Supporting risk diversification: Whilst there was a consensus in the subgroup to move away from the three-pocket approach (TR2.0 version of criterion 1), for diversification purposes the criterion will still need to be shaped to allow portfolios to contain a certain proportion of:
  - taxonomy neutral assets, i.e. for which there are no current criteria or they are not within the implied scope of economic activities
  - cash and money market instruments such as currency and derivatives.

  For consideration: It may not be necessary to define a pocket % as such; the value of these assets could be included in the greenness calculation. This raised the question as to what is the maximum greenness threshold that can still permit a workable % of these assets.

- Supporting companies investing in transition: Whilst there was a consensus to move away from the pocket approach of TR2.0, the criterion should provide flexibility under certain conditions for companies making investments in order to increase their green revenue. This flexibility may be expressed in the form of a weighting factor for green Capex. There was however concern that the EU Ecolabel should not be a 'transition label', so provision for flexibility should be somehow restricted.

For consideration: A number of options have been identified to restrict the use of the Capex weighting factor:

- Focus on strategic economic activities that require substantial Capex in order to increase green revenue e.g. power generation, real estate
- Apply a cut-off of <50% or <20% green revenue
- Limit the number of companies or % of assets under management to which the Capex weighting factor can be applied.
- Apply a more favourable weighting for companies with lower % green revenues, in particular in the case of large capitalisation companies. For example, 50:50 at <20% and 60:40 at 20-40%.

- Further requirement for companies investing in transition: Capex in isolation cannot provide a full picture as to whether a company is on a path to transition. An investment plan should be made, demonstrating the commitment to make strategic Capex in order to increase their green revenues. This Capex may be defined in terms of assets and/or research and development (R&D), recognising that for some EU Taxonomy enabling activities (e.g. computer server manufacturing to supply data centres) companies tend not to invest directly in manufacturing but rather in product design for contract manufacturing. For the purpose of credibility of the label, companies shall have already demonstrated that they are on a path to transition.

  For consideration: A number of rules are required in order to allow an asset managed to compute the Capex weighting factor:

  - Look back period: The company shall have commenced capital investment during the previous 2 years.
  - Look forward period: The company shall provide a strategic plan showing how Capex commitments and other supporting activities will, over a minimum period of 5 years (including the look back period) translate into an increase in green revenues that will take the company above the xy% threshold.
  - Board level engagement: The asset manager of the fund shall engage with the companies in transition in order to support their transition pathways. Linking criterion 1 to the engagement criterion, this engagement shall begin with the development and adoption of the strategic plan and then continue into implementation /monitoring. The cut-off threshold for companies eligible for the Capex weighting will enable the prioritisation of engagement activities.
  - Link between capex and green revenues: There seem to be limited research evidence linking Capex and green revenues in a way that justifies the proposed weighting approach. Moreover, the diverse situations of each company of which equities may be held mean that such an approach may only reflect a limited number of real-life situations and therefore not take into account the transition path of all companies. Many factors come into play, which means that it cannot be reduced to a simple relationship.

- Impact enhancement: This could be rewarded with points according to how many enhancement steps had been fulfilled. Evidence already suggests that capital allocation alone cannot deliver investor impact. It is rather the case that the position and signaling of the fund can lead to potentially enhanced investor impact

  For considerations: reporting on two areas of enhanced impact could be rewarded:

  – where a fund actively supports companies investing in transition, up to the threshold set (if any), and

– where a fund is in some way contributing to expansion of access to new capital for unlisted and small cap companies in particular. This shall include the identification of opportunities arising from equity raising, including IPOs.

As a result of this meeting the JRC have developed a fifth hybrid option for discussion at the 2nd sub-group meeting. Based on the points above, two new alternative options (options 5a and 5b) were formulated by the JRC, and discussed at the 2nd sub-group meeting. Options 5a and 5b both build up on option 2, integrating into it further research based on the points for considerations listed above. It is important to stress that Options 5a and 5b are essentially the same requirement, but differ in the way such requirement is achieved and reported.

The two options 5a and 5b are described in the next paragraphs and are compared and contrasted in *Table 4*.

Table 4 - Comparison between options 2, 5a and 5b for equity funds

Design aspects	Option 2	Option 5A	Option 5B
Portfolio threshold	51% (Green revenue and Capex)	40% (Green revenue and Capex)	40% (Green revenue + transition revenue)
Weighting for assets under management	No weighting	Weighted sum of company green revenue and Capex%	Weighted sum of company green revenue %
Minimum company green revenue threshold	<5% is not included	<5% is included but does not contribute	<5% is included but does not contribute
How companies investing in transition are addressed	Weighted average of green revenue and Capex is used	Weighted average of green revenue and Capex is used	Projected change in green revenue over minimum 3 years is used
Cut-off for transition contribution to portfolio greenness - Company greenness threshold - Contribution to meeting the portfolio threshold	No cut-off	No cut-off (Capex must > green revenue) 15%	<20% (green growth also reported) 15%
Requirements for green revenue and Capex from 'companies investing in transition' to qualify	No requirements specified	Requirements are set relating to: - Capex look back and future commitments - Strategic plan to increase green revenues - Engagement to support change	Requirements are set relating to: - Capex look back and future commitments - Strategic plan to increase green revenues - Means of raising the capital shall be identified - Engagement to support change
How risk diversification is addressed	No specific reference – flexible portfolio composition	Supported – cash, currency and derivatives with >95 definition for EU Taxonomy 'neutral' companies	Supported – cash, currency and derivatives with >95 definition for EU Taxonomy 'neutral' companies
Transparency in reporting	No specific reference	No specific reference	Separate reporting of transition and green growth

Alternative option 5a: Weighting of green capex for companies investing in transition

Option 5a is developed based on proposal 2. The overall portfolio green threshold was proposed at 40%; green revenue and green Capex contribute to the achievement of such threshold. In addition to the weighted average of green revenues and total green Capex, option 5a also considers the stocks contribution in the fund portfolio. The total green Capex stand for the total of investments in green assets and those in green R&D activities.

Option 5a proposes that the weighted average is only applied to companies whose the % total green Capex (see *Table 5*) is higher than the % green revenues. In this case, a weighting green revenues:total green Capex applies, with a weighting factor that could potentially be between 50:50 and 80:20. If the % total green Capex is lower than the % green revenues, only the % green revenues contributes to the overall portfolio green threshold. According to available information, total green Capex is generally higher than 20% for light green companies, decreasing considerably for dark green companies. Therefore, accounting for green Capex would enable the inclusion of companies investing in transition in the EU Ecolabel portfolio.

The fund portfolio is assumed to allow for a portion of diversification asset, which can include cash, derivatives and EU Taxonomy neutral companies. The share of this portion is deliberately left free, i.e. it is the task of the asset manager to decide on the size of the diversification pocket, provided that the overall portfolio green threshold is met. Therefore, the size of the diversification pocket will be regulated by the fact that EU Taxonomy neutral companies are included in the calculation of the overall greenness of the fund, but contribute as a 0% (no contribution). Environmental and social exclusions apply to this pocket. For the purpose of the modelling (*Table 5*), the diversification pocket is indicatively set at 20%.

The overall greenness of the portfolio is calculated as the sum of the individual stocks greenness, and not as an average as it was proposed in Option 2.

Option 5a is shown in the next *Table 5*. In the Table, different weighting factors are shown.

Table 5 - Example of calculation of the overall portfolio greenness according to option 5a

	Portfolio contribution	Green Revenues %	Green Capex %	Green R&D Capex %	Total green Capex =green Capex + green R&D Capex	Average with weight Green revenues 50%/R Capex 50%	Average with weight Green revenues 80%/R Capex 20%	Greenness = weighted average (50/50)* portfolio contibution	Greenness = weighted average (80/20) * portfolio contibution	Greeness = porfolio contribuit on* green revenues
Risk diversification	20%	<5%	Excluded	Excluded	Excluded	Excluded	Excluded	0%	0%	0%
Company A	8%	10%	30%	18%	48%	29%	18%	2.3%	1.4%	1%
Company B	13%	20%	22%	15%	37%	29%	23%	3.7%	3.0%	3%
Company C	10%	44%	20%	12%	32%	44%	44%	4.4%	4.4%	4%
Company D	15%	52%	15%	11%	26%	52%	52%	7.8%	7.8%	8%
Company E	14%	55%	10%	10%	20%	55%	55%	7.7%	7.7%	8%
Company F	20%	75%	10%	9%	19%	75%	75%	15.0%	15.0%	15%
Overall greenness at fund level								**40.9%**	**39.4%**	**38.3%**

Assumptions

1. Diversification part can contain cash, derivatives and EU Taxonomy neutral companies
2. If Green Revenues % > Total green Capex %, then the model only considers Green Revenues % and the respective portfolio contribution to compute the stock greenness.
3. If Green Revenues % < Total green Capex % then the model takes into account Green Revenues, Relevant Capex and portfolio contribution.

The inclusion of green capex contribution in option 5a aims at including companies investing in transition, thereby enlarging the investment universe and supporting companies on a demonstrable path towards a low carbon economy. This inclusion is proposed to be somehow restricted, in order to avoid the creation of a portfolio fully focused on companies in transition. For this purpose, the maximum % contribution of weighted total green Capex was proposed to be limited at 15%. This means that for example, if the fund has a 60% greenness of the portfolio, only 15% can come from weighted total green capex contribution. This restriction is supported with a number of requirements to be fulfilled by companies investing in transition. These requirements will be discussed in details in later sections.

Alternative option 5b: Transparent reporting of portfolio greenness and contribution to a transition

As in option 5a, option 5b also sets an overall portfolio green threshold of 40%. In option 5b the overall portfolio greenness considers the stock green revenues and the expected increase of green revenue as a result of corporate strategic plan to incentivise an increase of green revenues. This strategic plan can include, among others, investments in green assets (green Capex) and green product R&D, as well as other measures towards increased greenness, such as e.g. engagement activities. The inclusion of the expected increase of green revenue aims at supporting the inclusion of companies investing in transition (i.e. companies that are not green now, but that are on a demonstrable path to become it). Additionally, the increase in green revenue of companies that are already green would also contribute to the overall greenness of the portfolio.

As in option 5a, the overall greenness of the portfolio is calculated as the sum of the individual stocks greenness. The difference between 5a and 5b is that the latter would report separately the potential increase in green revenue, making it more transparent for retail consumers and avoiding any concerns relating to green washing. To be effective, the potential increase in green revenue should be documented and monitored and should require the written confirmation of the company.

The potential contribution of expected increases of portfolio greenness is accepted only for companies in transition. Moreover, this contribution is to be kept at a level that restricts its ability to be used to meet the overall threshold. *Table 6* illustrates option 5b.

Table 6 - Example of calculation of the overall portfolio greenness according to option 5b

	Portfolio contribution	Present day Green Revenues %	Increase of Green Revenues %	Present day Portfolio greenness	Expected increase of portfolio greeness	Portfolio future greenness
Risk diversification	20%	Excluded	Excluded	0%	0%	0%
Company A	8%	10%	5%	0.8%	0.4%	1.2%
Company B	13%	20%	6%	2.6%	0.8%	3.4%
Company C	10%	44%	6%	4.4%	0.6%	5.0%
Company D	15%	52%	2%	7.8%	0.3%	8.1%
Company E	14%	55%	2%	7.7%	0.3%	8.0%
Company F	20%	75%	1%	15.0%	0.2%	15.2%
Overall average at fund level				38.3%	2.6%	40.9%

As mentioned above, the inclusion of the expected increase in green revenue in option 5b aims mainly at including companies investing in transition, thereby enlarging the investment universe and supporting companies on a demonstrable path towards a low carbon economy. Companies already green expecting to increase their green revenues can also make use of this indicator. However. The contribution of the expected increase in green revenue is proposed to be somehow restricted, in order to avoid the creation of a portfolio accounting for equities that do not exist yet, as well as to avoid an extensive focus on companies in transition. For this

purpose, the maximum accepted contribution of expected green revenue to the fund was proposed to be limited at 15%. This restriction is supported with a number of requirements to be fulfilled by companies investing in transition and companies investing in green growth. These requirements will be discussed in details in later sections.

Conclusions of the 2nd meeting and key feedback from sub-group members

During the 2nd subgroup meeting, the majority of the sub-group members expressed their clear preference for option 5a; few of them mentioned that option 5b could also serve a basis for the criterion. Some stakeholders expressed their preference for a pocket approach (similar to the TR2 version), pointing to the difficulty of obtaining data at a high level of granularity.

After the 2nd sub-group meeting, written feedback was received, addressing the key points for further research and mainly focusing on the appropriateness of options 5a and 5b with respect to:

- The level of ambition of the criterion (in terms of the necessary flexibility for asset managers and the feasibility to manufacture an EU Ecolabel-compliant UCITS portfolio);
- The inclusion of capex;
- The relevance of the requirement on risk diversification.

The sub-group members' feedback is summarised below.

Level of ambition

The level of the criterion ambition on equities is further discussed, based on existing analyses (citations), in the 1st sub-group meeting. It is evidence based that it will be challenging setting up an ambition level threshold that would increase uptake and in the same time refer to portfolio greenness higher than the one in the TR2.0. The rationale behind refers to the unclear picture of the EU Taxonomy eligible universe and the pace the market share of eligible activities will evolve in the next years. On top on the analyses of the EU Taxonomy applicability, it is pinpointed that the second EU Taxonomy delegated acts (DA), which refers to the remaining four objectives of the EU Taxonomy, will be adopted by the end of 2021. Moreover, reporting and relevant disclosures are still scarce and that proxies need to be used to boost disclosure of relevant information. Proxies might not be agreed and may differ across board, which could compromise the quality of relevant data.

Therefore, setting up the most appropriate level of ambition remains challenging and shall be a matter of consensus and of the following EU Ecolabel criteria revision. For the time being, it seems more important to define the structure of the criterion instead of focusing on the right ambition level.

However, the TR3.0 acknowledges that setting a greenness threshold for equities is crucial. A way forward could be a dynamic threshold that considers market evolution and the possibility to boost reorientation of capital flows in environmentally sustainable investment. Thereafter, the trajectory of a dynamic threshold could be revised in a 3 years period.

Considering all the above, and the clear preference of the sub-group for option 5a, the third proposal of the criterion is to set the overall green threshold of the (equity) fund at 40%. This would represent an intermediate level of ambition, based on discussions in the sub-group. It is based on the most ambitious UCITS fund performance from the market (up to 30% green) then anticipating a contribution from green capex and/or green revenue growth projections that would bring the aggregate fund performance up to 40%.

The greenness of the portfolio is calculated by summing the individual contributions of each asset. In some cases, and subject to limitations, the company contribution towards greenness can include the % of total green capex, averaged with green revenues with a weighting factor total green revenues:total green capex of 60:40. In this way, Capex would potentially increase the

greenness of the stocks for companies investing in transition and in green growth, and thus increase the portfolio greenness. This option does not consider a dynamic evolution of the threshold at stock and portfolio level, since no data exist as to what rate of change could be deemed pragmatic and achievable over the criteria validity period.

Capex inclusion

Despite potential obstacles in its use, Capex inclusion in the structure of equities' greenness criterion was strongly supported by the majority of the sub-group members. Although this parameter alone might not allow for a complete analysis of a company's transition efforts, such a simplification may be necessary to establish a clear and simple reference framework. It is argued that Capex inclusion will allow to track those companies that invest mainly in EU Taxonomy-compliant projects, and therefore could stand for a simple and straightforward indicator for corporate transition.

Since available analyses on Capex show its cyclical nature, averaging it over some kind of timeframe will be necessary in order to include it in the criterion's requirements. A 5-year future timeframe was suggested, since big capitalization companies, particularly in the energy/utilities sector, may need long periods to transform. Moreover, to better assess transition, it is important to adopt a combination of backward and forward looking approach (past, present, future) since past and current investments will partially cause future GHG emissions.

The technical difficulties of using and reporting on Capex were highlighted by the sub-group members, as listed below.

Capex might act misleading in some cases, e.g. a company could show high green Capex as percentage of the total Capex, yet the value of the investment could remain low, and thus without any significant effect on transforming business activities.

It was also stressed that it is quite challenging to establish a clear relationship between green Capex and its direct effects on the green revenue growth, since Capex can also be used for maintenance instead of growth purposes. The inclusion of Capex would cut-off the financial sector, which accounts for 13% of the MSCI World and it is a key enabler of the energy transition.

An additional obstacle in adopting the Capex approach is related to relevant disclosures. Indeed, data availability may not be sufficient at the moment to comply with the EU Ecolabel criterion. However, disclosure (also on Capex) is a requirement of the NFRD directive, and there are strong expectations in terms of their disclosure in the EU and elsewhere. EU companies will be required to report their green revenues, and the green as % of total Capex in 2023; yet, companies elsewhere won't be obliged to do so. There is also a potential data gap between implementation of EU Ecolabel criteria and obligation for disclosures in the EU area.

Finally, it was highlighted that analysts and investors could apply diverse definitions of Capex/green Capex, and that could lead to misleading interpretations in terms of threshold compliance. However, the EU Taxonomy is expected to increase the clarity on its definition, by setting precise requirements on it.

Given the large consensus on the use of capex at the sub-group meeting, the third proposal for criterion 1 is to allow the use of Capex as an indicator for companies investing in transition and for companies investing in green growth. Because current market data has revealed a current limitation as to the % contribution of Capex to calculation of a company's contribution to the portfolio threshold, it is proposed to also allow the projected change in green revenue to also be used, with whichever is greatest (up to a limit of 100%) contributing to the portfolio threshold.

A 7-year time frame is proposed for the CapEx commitments, consisting of a 2 year look back and 5 years forward looking investment and growth. In order to deal with potential diversions from company's expectations on their 7-year planned capital investments, and in order to avoid any risk of greenwashing, specific conditions apply to include capex in the calculation of the overall greenness of the portfolio. These requirements are detailed in Section 5.1.4.4.

Diversification threshold

While the "pocket" for diversification purposes is left free in this third proposal of criterion 1, it is crucial to verify the appropriateness of the criterion with respect to risk diversification.

Some stakeholders mentioned that risk diversification should not be a problem and, in general, the 20% used in the model (see Tables 7 and 8) was considered sufficient. For thematic funds, the risk diversification pocket can easily be lower than 20%, according to the sub-group, as this kind of funds typically have a significant proportion (>90%) of their holdings invested in the theme.

Nevertheless, stakeholders mentioned that it may be difficult to identify compliant products in specific sectors where there are a lot of companies involved in EU Taxonomy-neutral activities, thereby implicitly incurring a higher portion of diversification activities. Investments in emerging markets or High Yield products could be financial products where risk diversification could be a problem.

Stakeholders also suggested that the criterion could also consider to adopt a phased approach, although it might be challenging to define phases that will correctly reflecting the evolvement of the market.

It was also pinpointed that clarity is needed as to whether the 20% is on a look through basis for derivatives and whether compliant derivatives are included (e.g. single derivative on a compliant company for example). The sub-group members also highlighted the importance that the portfolio share, which is not EU Taxonomy compliant shall meet the exclusionary criteria.

5.1.4.2 Structure and strictness of the greenness criterion on bonds

A small number of key issues have been raised by stakeholders in relation to bonds. These issues mainly relate to the scope of bonds covered and the certification of green bonds against the background of the EU Green Bond Standard development. However, some more fundamental issues have also been raised in relation to exposure of bond holders to the activities of the issuer and to the investor impact of holding specific types of bonds.

Based directly on the discussions in the AHWG2 and the associated written feedback, the following issues have therefore been addressed by the JRC in its follow-up research:

- The strictness of the bond fund threshold, which in the TR2.0 was proposed as being 70% of the value of assets under management;
- The possibility for the EU Ecolabel to accept, during a transitional period certified green bonds other than those of the proposed EU Green Bond Standard;
- The need for clarity on the inclusion of sovereign and corporate (general purpose) bonds in the scope of criterion 1;
- The potential for the exposure of investors to the economic activities of bond issuers, with particular reference to Use of Proceeds green bonds; and,
- The investor impact of holding green bonds, in terms of both the potential for additionality and the potential to contribute to the expansion of capital markets for climate aligned/EU Taxonomy aligned investment.

Threshold for green bonds in a portfolio and acceptance of existing certified green bonds

The 2nd criterion proposed a threshold of 70% for the value of the bonds held that should be verified as green bonds complying with the EU Green Bond Standard. In both the AHWG2 and follow-up discussions, stakeholders have generally been supportive of this threshold, because the market for green bonds is growing relatively rapidly and there is an increasing diversity of

bond issuers. This can be seen in the growth of green bonds issuance since 2012/13 to 2015/2016 displayed in *Figure 4*, although to put this growth in context, in 2015/16 green bonds still only accounted for around 0.13% of the value of the bond market.

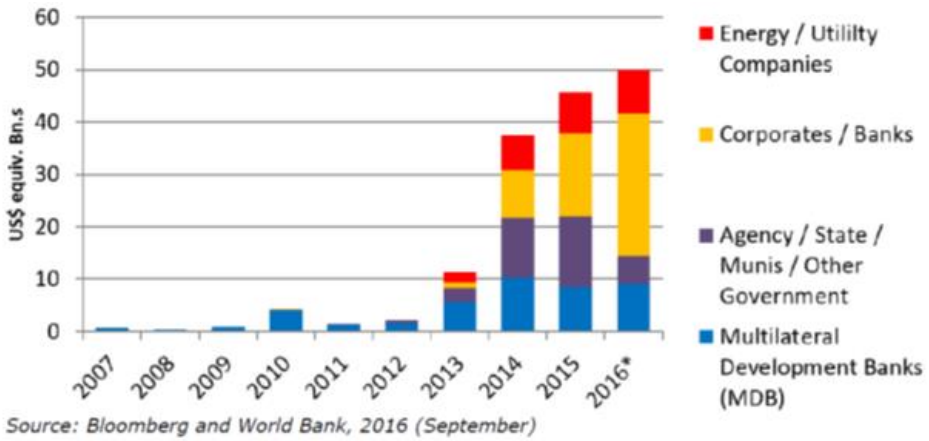


Figure 4 - Growth in annual green bond issuance by issuer type
Source: European Commission (2016)

A concern was, however, raised from the asset management side as to the feasibility of obtaining sufficient green bonds in the case that only EU GBS certified bonds can be accepted for the EU Ecolabel. This is because, to date, a large proportion of the market consists of unlabelled green or climate bonds[36], as well as green bonds issued and/or certified by four main bodies – the Climate Bonds Initiative (CBI), the International Capital Market Association (ICMA), the International Finance Corporation (IFC) and the European Investment Bank (EIB). A breakdown of the form of assurance for the green bonds issued in 2019 can be seen in *Figure 5*, where SPO stands for 'Second Party Opinion' and means that an issuers pays for an external audit[37].

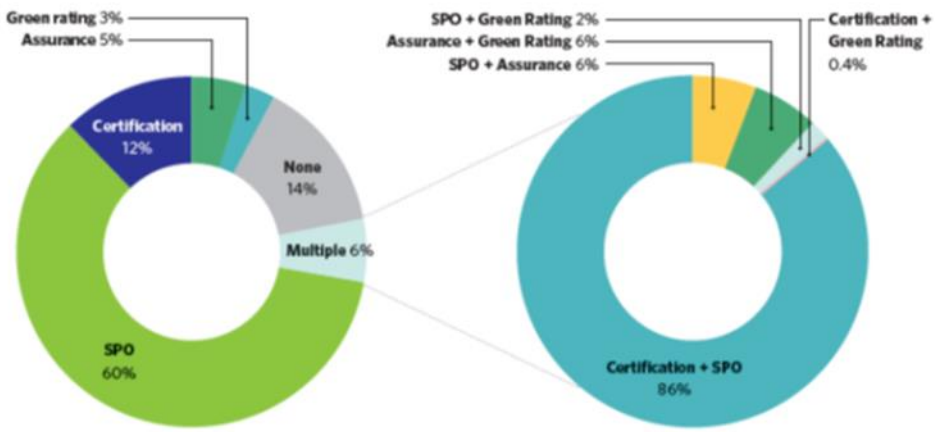


Figure 5 - breakdown of the form of assurance for the green bonds issued in 2019
Source: Climate Bonds Initiative (2020)

[36] European Union, *Study on the potential of green bond finance for resource-efficient investments*, Luxemburg, November 2016
[37] See Climate Bonds Initiative, *External review – pre-issuance reviews*, https://www.climatebonds.net/market/second-opinion

Considering a potential scarcity in green bonds in the market, it was suggested to adapt the ambition level to 50%. In doing so, the specific thresholds for bond and equities will be aligned and the criterion will have similar structure for different asset classes and will be simple and straight forward.

The sub-group has also suggested that the green bonds, as defined in the criterion, shall allocate the use of proceeds in EU Taxonomy aligned activities and comply with the exclusion criteria. In terms of general-purpose corporate bonds, it was suggested to contribute to the greenness as well, yet their contribution cannot be higher than the percentage of the corporate green revenues.

The JRC was also asked to explore whether green bonds that are not verified according to the EU Green Bond Standard (GBS) could be accepted during a transitionary period, whilst not undermining the establishment of the EU GBS scheme. Given that the exact legal form that the scheme and its requirements will take is still under discussion and consultation by Commission Services, this period would likely extend from the entry into force of EU Ecolabel criteria to a point after which the TEG recommendations have been translated into the final EU GBS. The earliest current estimate is late 2022.

Following discussions, it has been agreed within the Commission that the criterion could refer to the underlying criteria of the EU GBS without requiring EU GBS certified bonds as such. The extent to which existing green bonds would be able to fully comply with these criteria and whether this would therefore work as an interim step has also been checked. A comparison of the underlying criteria of the green bond scheme of the leading certification body, CBI, and also the green bond principles of ICMA has been made and is presented in *Table 7* as well as in Table 1 in the Appendix. The most significant differences appear to relate to:

- The underlying taxonomies form the basis for accrediting whether activities to be financed are 'green',
- The introduction of additional requirements, such as company compliance with the core ILO conventions as a safety net, and
- How the use of proceeds is monitored and disclosed, before being included within an impact report.

The first point could create the most significant barrier to finding equivalence for existing green bonds because it relies on the existing schemes adopting a new underlying taxonomy. The last of the points is important in order to assure retail investors that there is causality between the bond issue and investment in projects.

The scope of bonds covered by criterion 1

Following the second round of consultation, it shall be clarified that the sub-criteria on bonds and mixed funds shall specifically address use of proceeds bonds, as well as general corporate, sovereign and sub-sovereign bonds. Between them, general purpose corporate and sovereign bonds account for the majority of the bond markets[38]. **Error! Reference source not found.** illustrates the broad range of issuers of green bonds. This clarification will therefore support diversification of assets within EU Ecolabel portfolios.

[38] Check reference source

Table 7 - Comparison of the underlying green bond criteria of the EU GBS, CBI and ICMA

Indicative design aspects	EU GBS	ICMA	CBI
Green projects definition	EU Taxonomy	Investment in specific economic categories	CBI Taxonomy
Project evaluation and selection	As described in the green bond framework. Alignment with the EU Taxonomy	Alignment with the ICMA green project categories External review encouraged	Alignment with CBI Taxonomy
Methodology description	As described in the green bond framework	Description of methodology and assumptions	Description of methodology and assumptions
Metrics documentation	Impact metrics	Quantitative performance metrics and indicators	Quantitative performance metrics and indicators
Use of proceeds	Tracking Documentation of allocation	Separation of proceeds Tracking Documentation of allocation Monitoring Auditor for documentation	Separation of proceeds Tracking Documentation of allocation
Reporting	Impact report Allocation report	Impact report Allocation report Project impact shall be evaluated by the issuer	Impact report Allocation report Project impact shall be evaluated by the issuer
Reporting granularity	Project and portfolio	Project and portfolio	Project and portfolio
Documentation of compliance with objectives	Environmental objectives	Environmental sustainability objectives	Environmental objectives
Documentation of refinancing	As described in the green bond framework	Description of proceeds allocation for refinancing purposes	Description of proceeds allocation for refinancing purposes
Verification	Issuer appoints external verifier Compliance with green bond framework Allocation of proceeds	Third party verification of proceeds allocation	Third party verification of proceeds allocation

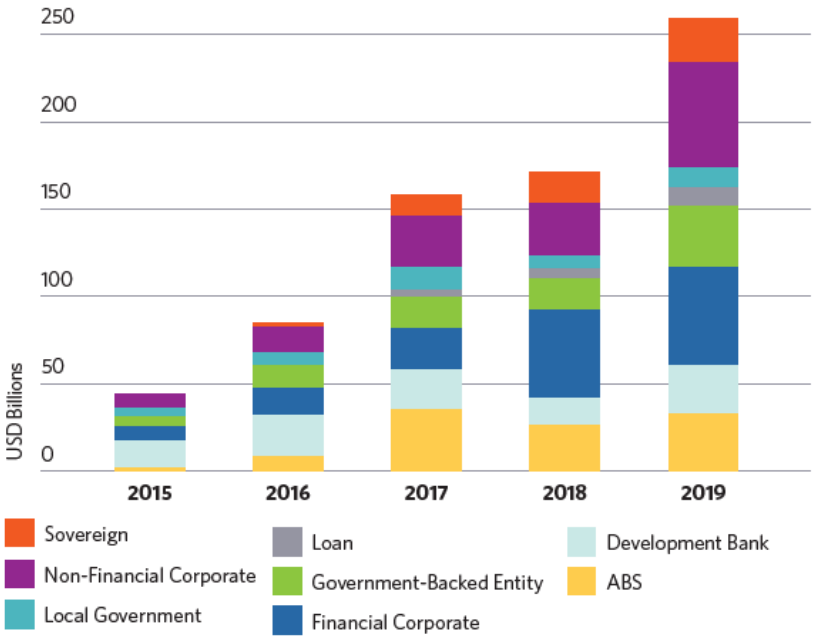


Figure 6 - Green bonds issuers in 2019.
Source: Climate Bonds Initiative (2020)

The approach proposed for the EU GBS is suitable in those cases where the bond is structured to identify the use of proceeds, which in turn forms the basis for verification and monitoring. However, if the bond is issued in order to raise general finance for the public or private issuer, then EU Ecolabel verification would need to be solely based on the issuer. A mechanism is therefore needed to determine the portfolio greenness contribution of corporate general purpose bonds.

It is also important to note that other forms of bond issuance have also been identified, particularly in relation to the role of bonds in expanding access to capital and being able to enhance/verify an investor's impact. These include, notably:

- Project-based bonds,
- Bonds that perform the function of asset backed securities, and/or
- Bonds issued by banks.

The first type of bond only currently plays a minor role in the bond market, as they entail exposure to greater risk and reward, as well as not always being well suited to this form of financing.

The second type of bond has been identified as having significant potential to expand access to capital, particularly for investment in small scale renewables and household-scale investments across the EU[39]. There are understood to only be a small number of specialist issuers, such as Obvion in the Netherlands, as well as large public entities in the USA, such as Fannie Mae, which is a government-backed provider of mortgages. The European Investment Bank's structuring of bonds to provide loans is an example of a variant on this type of bond, having the potential to recycle funds.

[39] Centre for Climate Change Economics and Policy, *Public sector agenda for stimulating private market development in green securitisation in Europe*, February 2017

Exposure to the bond issuer's balance sheet

Significant concerns were raised by several stakeholders about exposure of the portfolio to the balance sheet of companies, in particular for companies that may operate significant holdings in excluded economic activities. From an investment perspective, this is technically correct and may be particularly the case in the energy sector where, as can be seen in *Figure 7*, the majority of green bonds are issued (non-financial corporate issuers). Buildings are also a significant target for the allocation of use of proceeds and where there could be potential for exposure to real estate funds with poor performing assets.

On the other hand, green bonds may provide issuers with a verified route to invest in a low carbon transition, so some stakeholders have argued that this route should not be precluded. This raises issues in relation to whether there is additionally, because generally in order to issue green bonds a company must have sufficient financial resources and a credit rating that will permit them to issue investment grade corporate bonds.

In order to address the concerns related to exposure of retail investors it could therefore be possible in the case of corporate bonds to apply criteria to the issuer, but attention would need to be paid to whether this form of verification is readily available and whether it would constrain the number of bonds available from which portfolios could be constructed.

A number of existing labelling schemes already adopt this approach, focusing on exclusions related to company activities. However, if the aim is to provide retail investors with an opportunity to make forward looking investments, as suggested by market research on expectations, then it could be possible instead to focus on how the green bonds issued will contribute to either a progressive increase in verified green revenue or investment to maintain a carbon reduction trajectory.

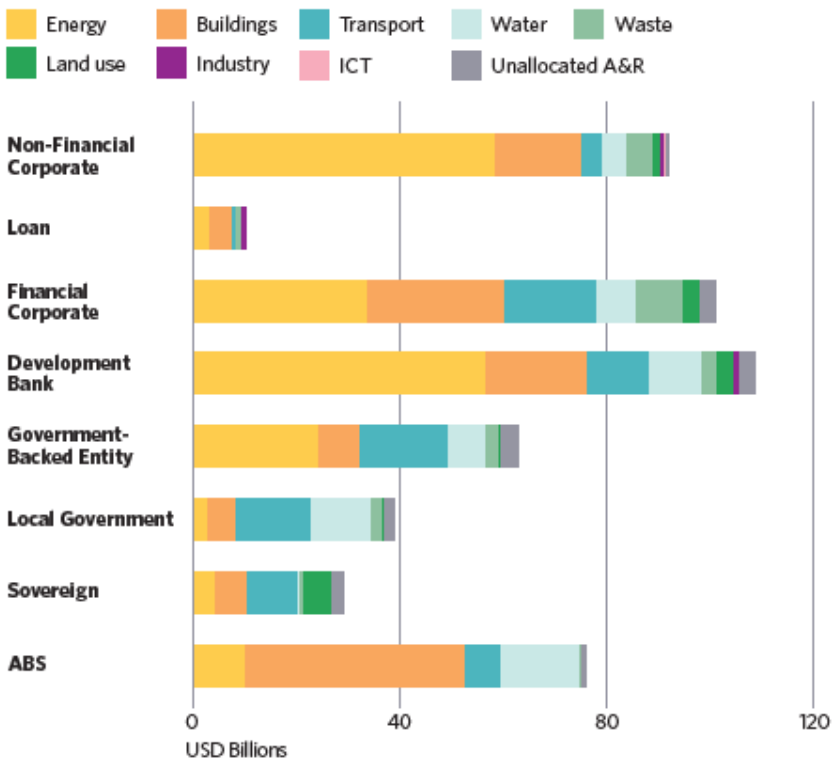


Figure 7 - Use of proceeds by issuer type in 2019.
Source: Climate Bonds Initiative (2020)

The impact of use of proceeds bonds

Analysis by the 2Degree Investing Initiative has identified a number of potential weaknesses in the use of proceeds bond model, as well as opportunities to enhance the model and where to focus attention in order to use bond issuance to expand access to capital[40]. They have identified two main obstacles to use of proceeds green bonds achieving their stated goal:

- Bonds are primarily refinancing instruments.
- Green bonds issuers are not constrained in their investment practices and do not necessarily invest in a greener way overall.

The first point highlights one of the main functions of bonds in the capital markets, which is to allow for the recycling of funds for loan finance by financial institutions. Whilst disclosure of the financing of new or existing projects forms part of the existing bonds schemes, 2DII have identified opportunities to specifically support vehicles such as Asset Backed Securities. ABS vehicles have traditionally been used to package many small loans, such as mortgages, and so could play a future role in the recycling of capital for domestic green loans. A recent study of green bonds by the JRC suggest that the majority of issuance (84%) is allocated for new investment[41], although in the broader bond market the picture is different.

The second point questions the value of the green bond in driving a change in investment strategies. It is claimed that '*there is no accompanying requirement to track actual changes in issuers' investment plans, nor the alignment of these investment plans with climate goals'*. In this respect the investor, as highlighted earlier in this section, is exposed to the wider activities of the issuer. This is further illustrated in *Figure 8* where it can be seen that use of proceeds green bonds may only initially result in the segregation or ring fencing of green projects that may anyhow have received investment. The counter argument made by leading proponents of green bonds is that they continue to play an important role in raising awareness of the potential for investments in environmentally sustainable economic activities and in driving for greater transparency on the investment strategies of large multinational companies.

As noted in the previous section on exposure to the issuers, it could be possible to focus on how the green bonds issued will contribute to either a progressive increase in verified green revenue or investment to maintain a carbon reduction trajectory. 2DII propose a form of enhanced green bond, which would in practice entail:

- The issuers being required to confirm (where external analysis exist) or perform scenario analysis on their assets and investment plans, and
- focus attention on 'real assets-linked' bonds (ABS, project bonds) and climate-aligned issuers for general-purpose bonds.

The market potential for this enhanced approach is illustrated in the *Figure 9*.

[40] 2 Degrees Investing Initiative, *Shooting for the moon in a hot air balloon – measuring how green bonds contribute to scaling up investments in green projects*, discussion paper, May 2018

[41] Fatica, S & Panzica, R, *Corporate green bonds as a tool against climate change*, JRC Technical Report, European Commission, 2020

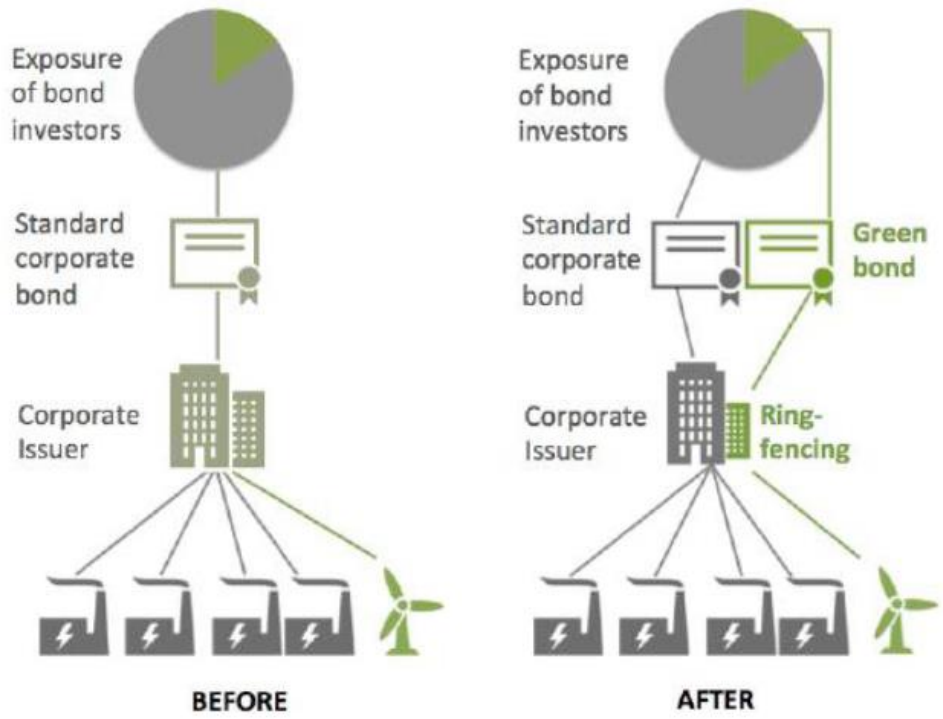


Figure 8 - Relationship of green bond issuance to investment plans and investor exposure. Source: 2Degrees Investing Initiative (2018)

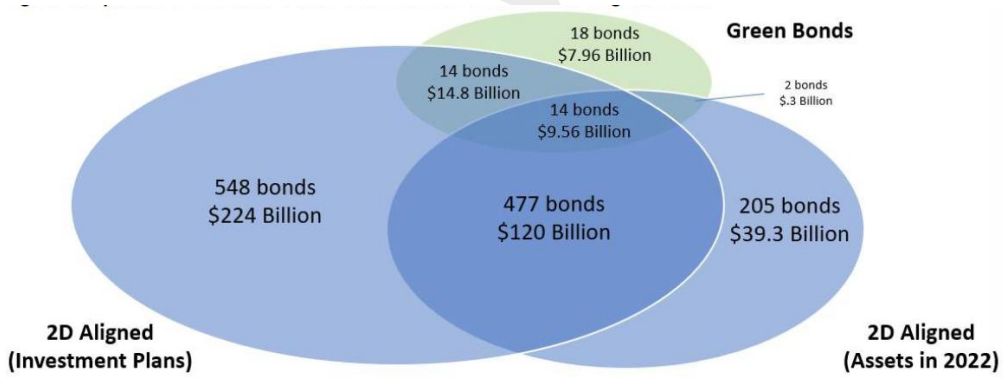


Figure 9 - Comparison of the power sector green bonds market with 2 degree aligned bonds. Source: 2 Degrees Investing Initiative (2018)

Based on discussions with stakeholders, as well as a review of literature and analysis relating to investor impact, the following further actions could also be considered within the criteria in order to enhance the investor impact achieved from the bonds acquired:

- Disclosure of how the proceeds will be used: Whether the proceeds will finance new or existing assets and on what basis refinancing could contribute towards portfolio greenness. The latter could be directed towards forms of reinvestment that facilitate the recycling of loan finance.
- Verification of proceeds allocation: The EU GBS scheme is proposed as requiring an impact report with ex post verification of the allocation of the proceeds. Equivalent requirements should therefore apply for green bonds that are accepted having been

issued by other schemes (in case the transitionary period for non-EU GBS bonds is implemented).

Greenness of the issuer

It was strongly suggested to consider the greenness of the issuer while issuing corporate green bonds. That was also a requirement reflected in the criterion part for equities. Considering this as well as the current criterion for equities, JRC proposes including green bonds issued by companies investing in transition or companies investing in green growth and can provide with the respective amount of green revenues. It was also suggested that the issuer does not have excluded activities.

Frequency of reporting in terms of tracking and monitoring

This specific question was not debated extensively. Therefore, JRC suggests frequency of reporting in terms of tracking and monitoring to 12 months. This could facilitate provision of data and not increase costs and is aligned with other labels in the market.

5.1.4.3 Assessment and Verification

JRC has reflected on the comments received next to the 2nd AHWG meeting and based on that has developed a more solid assessment and verification procedure, which is now specific for the different assets under management and also simple and straightforward. It is suggested the fund applying for the EU Ecolabel is not subject to the national label's rules, as this could increase the cost significantly. The TR3.0 also proposes the verification procedures are similar across the EU member states. Yet, the quality of the provided data, the methodology used to obtain them, including the use of proxies and estimates, and the possibility to third parties to assess compliance, need to be further clarified. There are still challenges in the assessment and verification process that are linked to the disclosure requirements for corporates, such as the granularity of green revenues and Capex. Therefore the JRC intends to open a further discussion on how to better deal with data gaps, provided methodologies and proxies and to enhance verification credibility relating to green capex in the next EUEB meeting that will take place in November 2020 and incorporate the outcomes in the report.

5.1.4.4 Criterion 2 – Companies investing in transition and in green growth

The 2nd criteria proposal for the EU Ecolabel introduced under criterion 2 the concept of transition. This refers to the potential to verify companies that are investing in a transition towards a higher proportion of green revenues on their balance sheet. The concept can have two potential benefits for the EU Ecolabel:

1. **Investor impact:** It would recognise and support the investment being made, particularly by large capitalisation companies, to contribute towards meeting EU Taxonomy environmental objectives. It therefore contrasts with capital allocation to support SMEs with a high proportion of environmentally sustainable economic activities, where the objective would be growth rather than transition.
2. **Investable universe**: It could expand the investable universe because current analyses (see Section A) suggest that currently the size of the environmentally sustainable economy may constitute a major constraint on putting together an EU Ecolabel compliant portfolio. Moreover, although substantial investment is being made by mid to large capitalisation companies, particularly in the utility sector, their

green revenue share tends still to be low. The recent analysis carried out for DG FISMA by Climate Company and the Frankfurt School of Finance and Management, as well as findings presented by MSCI (see sections A.1 and A.2), suggests that the manufacturing sector in particular would merit attention, being the most significant economic activity within UCITS equity holdings.

This overall concept was discussed at the 2nd Ad-Hoc Working Group meeting and the JRC explored how this could be applied in practice and to what extent it should be incorporated into the EU Ecolabel criterion proposal. It also forms part of proposals received by stakeholders for the configuration of the equity fund component of criterion 1.

Transition under the EU Taxonomy Regulation

The EU Taxonomy Regulation was adopted on the 1st April 2020. It includes provision for what are referred to as 'transitional activities' that can make a substantial contribution towards the environmental objectives, and defines these activities under Article 10, clause 2 as:

> *'....an economic activity for which there is no technologically and economically feasible low-carbon alternative shall qualify as contributing substantially to climate change mitigation where it supports the transition to a climate-neutral economy consistent with a pathway to limit the temperature increase to 1,5 ⁰ C above pre-industrial levels, including by phasing out greenhouse gas emissions, in particular emissions from solid fossil fuels, and where that activity:*
>
> *(a) has greenhouse gas emission levels that correspond to the best performance in the sector or industry;*
>
> *(b) does not hamper the development and deployment of low-carbon alternatives; and*
>
> *(c) does not lead to a lock-in of carbon-intensive assets, considering the economic lifetime of those assets.'*

Both transitional activities and low carbon activities may constitute environmentally sustainable economic activities that can be verified in order to contribute towards compliance of a product with the thresholds under the proposed criterion 1 *(Figure 10)*.

In this respect, the EU Taxonomy also allows companies as a whole to invest in a 'transition' pathway by defining environmentally sustainable economic activities rather than environmentally sustainable companies. Companies can therefore transition by gradually increasing their share of environmentally sustainable economic activities (*Figure 11*). Whilst this example refers to factories, it could also apply to energy plant or any other site that contributes towards green revenues generation. Note, however, that the example in *Figure 11* would not allow for achievement of intermediate thresholds for performance based on the unit of measurement in the EU Taxonomy technical screening criteria – it is based on the binary performance of each site or factory.

Moreover, the EU Taxonomy Regulation refers to the disclosure of Capital Expenditures (Capex) related to EU Taxonomy compliant activities. This has the potential to be used as a metric for reporting on the investment being made in transitional activities.

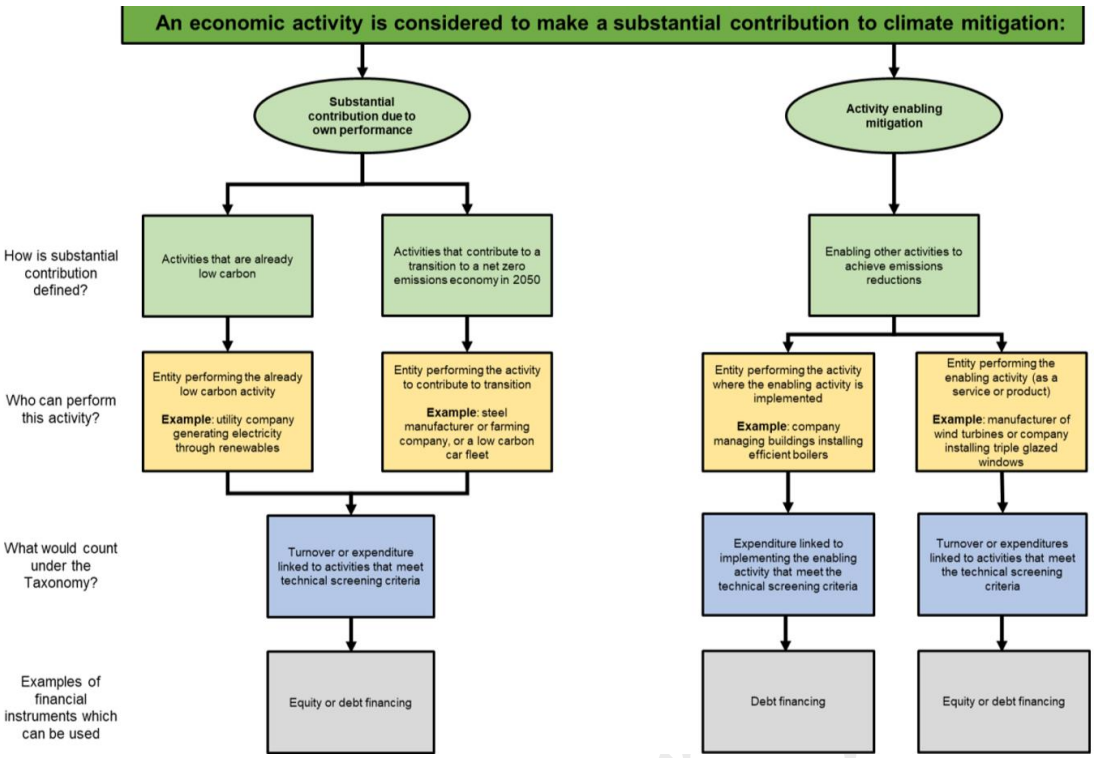


Figure 10 - How the EU Taxonomy distinguishes different types of economic activities as making substantial contribution to climate change mitigation.

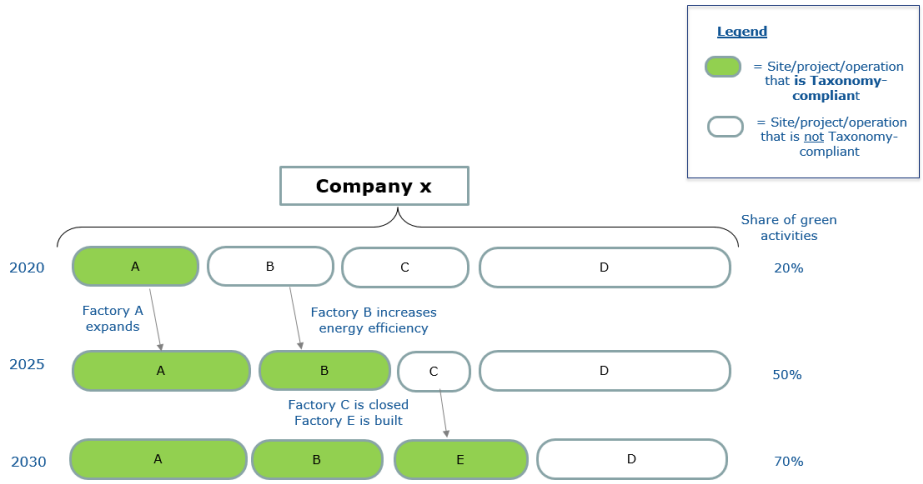


Figure 11 - How the EU Taxonomy enables companies to transition.

Estimates of EU Taxonomy compliance for utilities with power generating assets by MSCI illustrate the potential need for a transitional approach. *Figure 12* presents the result of an analysis of electric utilities with at least 50% of the revenue from power generation. Of the 37 power producers that report emissions data tied to generation, the majority do not currently meet either the TEG recommended threshold (100 g CO_2eq/kwh) nor an IEA recommended threshold (220 g CO_2eq/kwh).

Utilities are understood to be an important asset within UCITS funds and whilst such an approach requires further development, in principle it would serve the dual purpose of supporting risk diversification whilst reducing the environmental impacts of one of the major contributors towards EU and international greenhouse gas emissions that has been prioritised for inclusion in the EU Taxonomy.

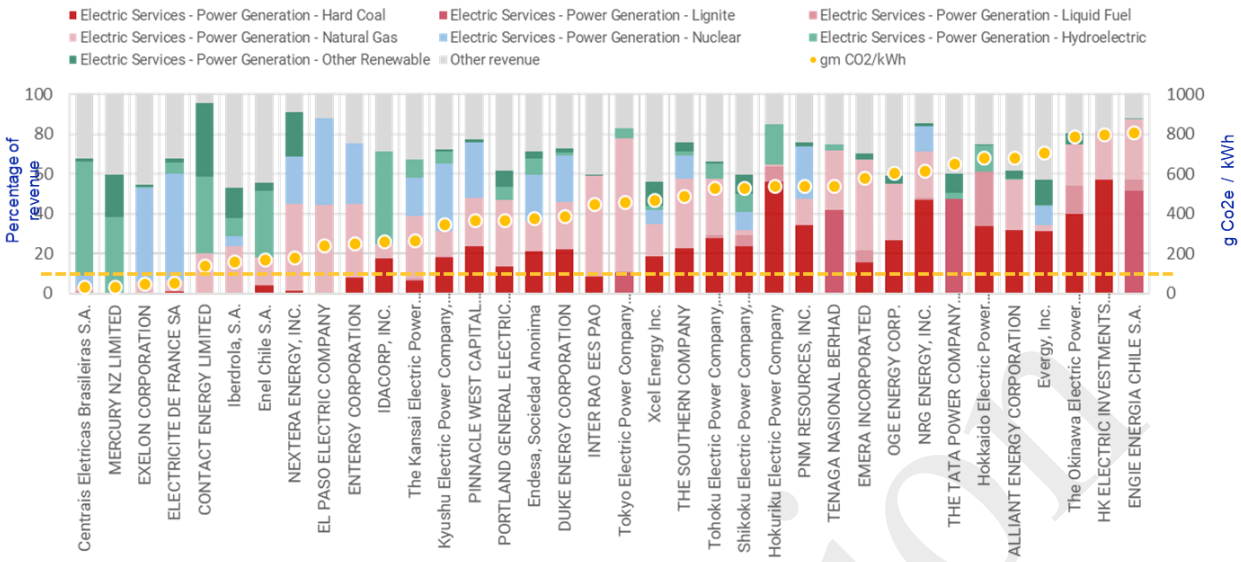


Figure 12 - CO_2 emissions and power generating assets for a sample of major international utilities
Source: MSCI (2020). Notes: TEG recommended threshold for utility: < 100 gCO2e/kWh; Based on the set of Electric Utilities with >50% of revenue from power generation.

Precedents and existing examples of criterion on companies in transition

Some initial precedents for this type of criteria were explored in the TR2.0, published in December 2019. These included a criterion from the Belgian Febelfin label linked to power station CO_2 emissions and exemption criteria set by the Nordic Swan for fossil fuel related activities (see the box below). The latter were cited as an example in the 2nd AHWG. Feedback suggested that it may be difficult to communicate to retail investors the concept of derogations or exemptions from exclusions. Please note that the Nordic Swan label is awarded on a point-basis, whereas the EU Ecolabel is a pass-or-fail label.

Nordic Swan

Investment funds criteria, v1.0.

Exclusion criteria, 5. Extracting and refining fossil fuels

The fund may not invest in companies which themselves or through entities they control derive 5% or more of their revenue from extracting coal (all sorts of thermal coal, e.g. lignite or anthracite), natural gas, crude oil or uranium, and/or from refining coal, natural gas, crude oil or uranium for fuel. Companies that fulfil all of the following criteria are exempt and may be included in the fund.

- At least 75% of the company's energy sector investments on average for the last three consecutive years are in the renewable energy sector.
- Revenue from renewable energy comprises at least 50% of the company's total revenue. This ratio may be calculated on average over the course of 1, 2 or 3 of the last financial years.
- The company has less than 0.1% revenue from tar sand, shale oil or shale gas, or other fracking activities and/or mining of oil shale.

The JRC has also identified increasing evidence of the verification and issuing of so-called 'transition bonds' which could provide some transferable concepts for application to equities. Axa provides an example of the guidance and expectations for companies investing in transition, which could offer a further precedent for the EU Ecolabel (see the box below). Data providers such as Sustainalytics are also starting to provide Second-Party Opinions for transition bonds, including assessment on:

- the alignment of the issuer's transition strategy and commitments with internationally established decarbonisation pathways,
- the alignment of the use of proceeds with decarbonisation pathways.

Axa investment managers

'Transition bond' definition and guidelines 42

Transition bonds are intended for companies:

- in greenhouse gas-intensive industries such as materials, extractives, chemicals and transportation
- in industries which currently do not (and for the foreseeable future may not) have sufficient green assets to finance but do have financing needs to reduce their greenhouse gas footprint of their business activities, as well as their products and services

Transition bond issuers should clearly communicate what climate transition means in the context of their current business model and their future strategic direction. Senior management and board directors should make a commitment to align their business with meeting the COP21 Paris Agreement goals.

The issuer's transition strategies should be intentional, material to the business and measurable. The Transition Bond must fit into a broader transition strategy. This should be defined by quantified short and long-term environmental objectives. Transition Bonds should be a tool to principally finance a share of the issuer's spending necessary to achieve targets.

Bond issuers are increasingly announcing environmental targets for 2030 or even as far in the future as 2050. While long-term objectives are welcomed, we ask for quantified shorter targets to assess the issuer's progress against its own transition pathway. We also encourage issuers to explain their board and senior management's strategic decision-making process and the Capex needed to meet these targets. Issuers should ensure that their broader sustainability practices, such as policies and programmes, are capable of helping achieve the objectives.

Options and considerations for setting transitional criteria

As it has been illustrated above, a number of options exist that could provide a basis for such a criterion. Each option has its strengths and weaknesses, which were proposed to be evaluated by the sub-group members. The options listed below are all relevant for discussion:

- **Capital expenditure:** As a metric to disclose the investment priorities of a company. The specific challenges to this metric were addressed in previous sections.
- **Share of Taxonomy compliant 'green' revenue:** As a metric to disclose how the revenue base for the company is changing, or is planned to change.

[42] Axa, Financing brown to green: Guidelines for Transition Bonds, https://www.axa-im.es/content/-/asset_publisher/qxx9OlkAqLWg/content/financing-brown-to-green-guidelines-for-transition-bonds/23818

- **Practice-related performance thresholds:** As technology neutral thresholds for measuring progress. Although these can be linked to technical screening criteria of the EU Taxonomy, the economic activity would also need to meet the other criteria, such as the Do No Significant Harm (DNSH).
- **Phase out and divestment:** As a demonstration of commitment to the new pathway. However, care needs to be taken to ensure additionality and that divested assets do not simply change hands.

Based on the JRC analysis, some key factors deserve consideration in order to set transition criteria:

- <u>The scope of eligible activities</u>

  Evidence from the analysis to date of funds and equities suggests that initial criteria are needed that recognise transitions underway in the energy and manufacturing sectors. Whilst the EU Taxonomy provides the main starting point, with companies either investing to increase their revenue from, initially, low carbon activities and/or enabling activities, there may also be intermediate thresholds and practices that the EU Ecolabel could support e.g. intermediate vehicle emission targets. A related issue is the extent to which some activities or technologies that may be excluded by criterion 2 (environmental exclusions) should be permitted as long as the company can show that they are in transition e.g. natural gas or coal power generation revenues at >5%.

- <u>The definition and scope of Capex</u>

  There is the need to define the scope of investments that qualify under Capex disclosures. In some definitions it is understood to include activities relating to extension of the life span of green assets rather than investment in new green assets.

- <u>Evidence of past transition</u>

  To provide assurance to retail investors there may be for 1) a minimum initial % of green revenue and/or 2) the need to have a look back period for transition during which a shift in investment and green revenue can be shown. The aim would be to ensure that companies can demonstrate that initial progress made.

- <u>The scale and rate of transition</u>

  To provide further assurance to retail investors, it will be important to have a look forward period for transition. This would comprise the forward strategy for change and investment, including milestones in time. There is the need for the EU Ecolabel to define what the qualifying scale of transition, rate of change/growth and associated time frames would be. Depending on the metric chosen, this would have a differing definition.

The JRC has been analysing examples from the energy sector such as Drax Power, Orsted and Iberdrola in order to understand and inform potential time frames and rates of transition, but it is challenging to decide the parameters for transition can be defined on a generic basis. As such, a criterion would need to cover a range of energy and manufacturing related activities. It is understood that ADEME, the French Environment Agency, is currently analysing transition pathways for different sectors as part of the ACT programme and the LIFE funded FinanceClimAct project, and have therefore been invited to contribute.

Further reflections on the use of Capex

To date in discussion with EU Ecolabel stakeholders, the potential to include a criterion on companies in transition has focused mainly on the potential to use the metric of Capex. Discussions with data providers suggest that Capex is a relatively new metric for which there is limited current reporting in the frame of ESG or environmental performance. The sector in which it is understood to be most commonly reported is the oil and gas sector, as evidenced by a recent study carried out by the IEA on the potential to shift investment. There appears to currently be a lack of a common definition and scope to delineate between Capex and Opex.

The hypothetical case of three power plant operators that all have some renewables assets that generate 10% of their revenue from environmentally sustainable economic activities illustrates some of the issues to take into account when using Capex:

- Company x is currently making minimal planned investment over 2-3 years in the upgrading of its existing renewables plant to extend their lifespan and this represents 100% of Capex. Their remaining fossil fuelled plants from which it derives 80% of its revenue will continue operating.
- Company y plans to replace major parts of all its fossil fuelled plant over 5-6 years in order to become 50% taxonomy compliant.
- Company z is in the process of replacing all the major parts of all its fossil fuelled plant over 5-6 years in order to become 100% taxonomy compliant.

Contrasting the three cases: company x's performance is static, verification of company y's performance relies on its forward strategy and company z already has some evidence that it is on a path to transition and is now aiming to become a pure player. In all cases 100% of the Capex being made would be Taxonomy compliant but this on its own does not provide enough information about the nature of the transition being made, if at all.

5.2 CRITERION 3: Exclusions based on environmental aspects

Previous (second) proposal for criterion 2: Excluded activities – Environmental aspects

2.1 Exclusions relating to economic activities

The investment portfolio shall not contain equities or corporate bonds issued by companies that derive more than 5% of their revenue from the excluded activities listed below.

The investment portfolio may contain use-of-proceeds bonds issued by such companies, provided that the proceeds are not used to finance excluded activities.

For fixed-term and savings deposit accounts, corporate loans shall not be made to these companies and project loans shall not finance the excluded activities.

2.1.1 List of exclusions

Agriculture

- Production of pesticides, including plant protection products, that are not approved for use in the EU and which are identified in the Rotterdam Convention Prior Informed Consent (PIC) procedure.[43]
- The development, distribution and cultivation of food or feed from genetically modified varieties of plants that have not passed a risk assessment carried out according to the criteria in Annex II to Regulation EN 503/2013 or equivalent.
- Production of agricultural products, including vegetable oils, on land obtained as a result of deforestation of primary forest or the drainage of peatlands or wetlands after the year 2000.
- Production of agricultural products without the use of integrated pest management systems and procedures.
- Production of agricultural products using water for irrigation in areas where there is severe water scarcity.

Forestry

- Timber production and exploitation, unless the economic operator can demonstrate the following:
  - that the timber is covered by valid FLEGT or CITES licences and/or is controlled by a due diligence system which provides the information set out in Regulation (EU) 995/2010 [44], or
  - that the harvest is not from the clear felling or unsustainable exploitation of old growth, primary forests that have a high biodiversity value and/or carbon stock.

Energy sector

- Solid, liquid and gaseous fossil fuel exploration, extraction and refining for fuel. This includes unconventional sources such as hydraulic fracking and shale deposits.
- Use of solid, liquid or gaseous fossil fuels for electricity generation.
- All activities relating to the nuclear fuel cycle, including power generation.

Waste management

- Waste management facilities and services that do not operate any form of material segregation for the purposes of preparation for reuse, recycling and/or energy recovery, as well as the processing or stabilisation of organic waste.
- Landfill sites without leachate and methane gas capture.
- Incineration not equipped with flue-gas treatment that complies with Directive 2000/76/EC on the incineration of waste or equivalent internationally recognised standards and without a high level of heat recovery and/or power generation.

[43] UNEP and FAO, *Annex III Chemicals*, the Rotterdam Convention http://www.pic.int/TheConvention/Chemicals/AnnexIIIChemicals/tabid/1132/language/en-US/Default.aspx

[44] Third party forest and forest products certification systems that meet the due diligence criteria set out in Article 6 of the Regulation may therefore be used as a tool within a due diligence system.

Manufacturing

- Production of hazardous chemicals that are not authorised or registered for use in the EU and which are identified in the Rotterdam Convention Prior Informed Consent (PIC) procedure.[43]
- Production of fluorinated greenhouse gases with a Global Warming Potential (GWP) of >150.
- Production of substances with a high Ozone Depletion Potential (ODP) listed as controlled and as prohibited by the Ozone Regulation (EC) No 1005/2009.
- The mining, processing and production of asbestos and asbestos-based products.

2.1.2 Transitionary exclusions

Transportation

Production, distribution and sale of new passenger cars and light commercial vehicles, unless the company undertaking the activity complies with the following requirements:

- *For new passenger cars:* Manufacturers shall have made available to consumers at least one zero- and low-emission vehicle (ZLEV) model with tailpipe emissions of <50 g CO_2/km and the average tailpipe emissions of all models that they have registered in the last calendar year shall be 5% lower than the respective EU target applicable at the time.
- *For light commercial vehicles:* The average tailpipe emissions of all models that a manufacturer registered in the last calendar year shall be 5% lower than the respective tailpipe CO_2 emissions target.

Assessment and verification

Holdings or loans relating to any of the economic activities to which exclusions apply shall be clearly identified on a company basis. The applicant shall then provide a declaration of compliance for the fund or deposit account as a whole for each of the specific exclusions as they relate to the economic activities.

For the transitional exclusions a company report or specific technical reports which show overall compliance with the thresholds shall be required for each company in which equity is held or to which loans have been granted.

Further to the initial verification, internal checks shall be performed at least once per year and any changes communicated to the Competent Body who also retains the right to make random checks on compliance.

2.2 Exclusions relating to sovereign and sub-sovereign bonds

The investment portfolio shall not contain sovereign and sub-sovereign bonds excluded by the conditions below, except if the bonds comply with the EU GBS.

2.2.1 Ratification of the Paris Agreement

Bonds held by the portfolio shall be excluded if the issuer has not ratified the Paris Agreement on climate change. An exception shall be made where a sub-sovereign, which may include municipal authorities at regional, city or local level, has a formally adopted political commitment to meet the same targets and requirements.

2.2.2 Climate or environmental risk rating

Bonds held by the portfolio shall be excluded unless they are accompanied by a climate risk rating of the issuer or an environmental risk rating that addresses climate change. The risk rating aspect addressing climate shall include, as a minimum, a transition risk assessment of economic actions or structural progress in the economy to implement the Paris Agreement.

2.2.3 Ratification of other international environmental agreements

Sovereign bonds held by the portfolio shall be excluded if the issuer or the country has not ratified the following international agreements:

- the UN Convention for Biological Diversity;
- the Convention on International Trade of Endangered Species of Wild Fauna and Flora

(CITES);

- the United Nations Convention to Combat Desertification in those Countries Experiencing Serious Drought and/or Desertification (where applicable);
- the Ramsar Convention on the conservation and wise use of wetlands of international importance and their resources;
- the Basel Convention (transboundary movements of hazardous wastes and their disposal);
- the Rotterdam Convention on the Prior Informed Consent Procedure for Certain Hazardous Chemicals and Pesticides in International Trade;
- the Stockholm Convention on Persistent Organic Pollutants.

Assessment and verification

The applicant shall provide a list of the sovereign and sub-sovereign bonds held and their issuers. The applicant shall then provide a declaration of compliance for the fund or deposit account. For sub-sovereign bonds, additional information on equivalent commitments shall be provided. An additional declaration shall be made for each bond of the climate risk rating obtained and the agency that made the rating.

Further to the initial verification, internal checks shall be performed at least once per year and any changes communicated to the Competent Body which also retains the right to make random checks on compliance.

Third proposal for criterion 3: Exclusions based on environmental aspects

3.1 Exclusions relating to economic activities

Investment funds and insurance products shall not contain equities or bonds issued by companies that derive more than 5% of their revenue from the excluded activities listed below.

For fixed-term and savings deposit accounts, green loans shall not be made to companies whose activities are in the list of excluded activities and project loans shall not finance the excluded activities. Bonds held shall not be issued by companies whose activities are in the list of excluded activities.

3.1.1 List of excluded activities

A. *Agriculture*

A.1 Use of pesticides, including plant protection products, identified in the Rotterdam Convention Prior Informed Consent (PIC) procedure or in classes Ia or Ib in the World Health Organization Recommended Classification by Hazard.

A.2 Production, distribution and use of agricultural products, including vegetable oils, and livestock on land obtained as a result of conversion, fragmentation or unsustainable intensification of high-nature-value land, wetlands, peatland, forests, or other areas of high-biodiversity value or high-carbon stock in or after 2008, where high-biodiversity value and high-carbon stock land is defined according to Directive 2018/2001.

A.3 Cultivation of crops (for agricultural products) that does not minimise the use of pesticides and does not favour alternative approaches or techniques, according to Directive 2009/128/EC or the UN FAO International Code of Conduct on the Distribution and Use of Pesticides.

B. *Forestry*

B.1 Forestry management for production of timber as well as the production of timber-derived products, where the economic operator cannot demonstrate the following:

- That the timber is covered by valid FLEGT or CITES licences and/or is controlled by a due diligence system which provides the information set out in Regulation (EU) 995/2010; and
- That the forests are not located on land obtained from the conversion, fragmentation or

unsustainable intensification of high-nature-value land, wetlands, peatlands, forests, or other areas of high-biodiversity value and/or high-carbon stock in or after 2008.

C. Energy sector

C.1 Solid, liquid and gaseous fossil fuel exploration, extraction, refining and production of derivative products. This includes unconventional sources such as hydraulic fracking, arctic drilling, oil sands and shale deposits.

C.2 The supply of solid, liquid and gaseous fossil fuel for fuel or electricity generation using these fuels, unless the company operating the activity:

- is a company investing in transition, and :
- The company revenue from these excluded activities is below 30%, and
- The company has set a phase-out, closure or fuel-switching plan for natural gas and coal power stations on a ten-year timeframe.

C.3 Transportation, distribution and storage of fossil fuels.

C.4 All activities relating to the nuclear fuel cycle, including power generation.

D. Waste Management

D.1 Waste management facilities and services without any form of material segregation of non-hazardous waste, including waste handling, landfill and incineration, unless the company operating the activity:

- Is a company investing in transition, and
- The company revenue from these excluded activities is below 30%.

E. Manufacturing

E.1 Production, trade, distribution and use of chemicals and mixtures of chemicals that are listed or identified in the following:

- Regulation (EU) 2019/1021 on persistent organic pollutants (for companies domiciled in the EU) or the Stockholm Convention (for companies domiciled outside the EU),
- Regulation (EU) 649/2012 concerning the export and import of hazardous chemicals (for companies domiciled in the EU) or the Rotterdam Convention Prior Informed Consent (PIC) procedure (for companies domiciled outside the EU),
- Class Ia or Ib in the World Health Organization Recommended Classification by Hazard (for all companies),
- The candidate list of Substances of very high concern (SVHC) and Annex XVII under the Regulation (EC) 1907/2006 on the Registration, Evaluation, Authorisation and Restriction of Chemicals (for all companies),
- Regulation 1005/2009 on substances that deplete the ozone layer (for companies domiciled in the EU) or the Montreal Protocol on Substances that Deplete the Ozone layer (for companies domiciled outside the EU),
- Regulation (EU) 2017/852 on mercury (for companies domiciled in the EU) or the Minamata Convention (for companies domiciled outside the EU),
- Fluorinated greenhouse gases that are listed in Regulation (EU) 517/2014 and with a Global Warming Potential (GWP) according to the thresholds by product group listed in Annex III (for all companies).

E.2 The mining, processing, production, trade and use of asbestos and asbestos-based products.

F. Transportation

F.1 Production, distribution and sale of new passenger cars and light commercial vehicles with

engine technology based on combustion of fossil fuels, unless the company operating the activity:

- is a company investing in transition, or
- is a company investing in green growth.

Assessment and verification

The applicant shall provide a declaration of compliance for the fund or deposit account as a whole for each of the specific exclusions that are relevant because of the economic activities of holdings in the portfolio. In support of this declaration, information shall be provided on each company's link (tie) to each of the excluded activity, any related corporate actions at the moment of application, and ownership information if the company has links (ties) to the excluded business activity through a subsidiary or parent company.

Supporting evidence shall be submitted in one of the forms below:

- Company screening using controversy proxies;
- Business involvement indicators;
- Company environmental reports;
- Company compliance reports.

To demonstrate compliance with criterion C.2, a strategic plan shall be made available. The plan shall include a time plan of the phasing-out, closure or fuel-switching for natural gas and coal power stations, important intermediate milestones for meeting the plan, and expected increase in renewable energy capacity. An official communication of the plan shall moreover be made available on the company's website.

Further to the initial verification by the Competent Body, the fund manager shall carry out assessment on compliance with environmental exclusions at least once per year and communicate any inconsistencies to the Competent Body.

If the fund manager receives information or identifies the existence of severe and/or systematic allegations in terms of conformity with environmental exclusions, then as a response the company shall be requested to develop within three months a plan and list of actions to resolve the issue. If the issue remains unresolved after 1 year, the respective assets shall be sold.

The Competent Body retains the right to make random checks on compliance.

3.2 Exclusions relating to sovereign and sub-sovereign bonds

The following exclusions apply to sovereign and sub-sovereign bonds and their issuers.

3.2.1 Ratification of the Paris Agreement on Climate Change

Sovereign bonds shall be excluded from being held by the portfolio if:

- the issuer or the supranational organisation to which it belongs is not party to the Paris Agreement on climate change, and
- the issuer has not published a credible CO_2 reduction trajectory compatible with a 2 degrees scenario.

An exemption shall be made for sub-sovereigns in the case that they can demonstrate a formally adopted political commitment to meet the same targets and requirements.

3.2.2 Ratification of other international environmental agreements

Sovereign bonds shall be excluded from being held by the portfolio if the issuer or the supranational organisation to which it belongs are not party to the following international agreements:

- the UN Convention for Biological Diversity;
- the Convention on International Trade of Endangered Species of Wild Fauna

and Flora(CITES);

- the United Nations Convention to Combat Desertification in those Countries Experiencing Serious Drought and/or Desertification (where applicable);
- the Ramsar Convention on the conservation and wise use of wetlands of international importance and their resources;
- the Cartagena Protocol on Biosafety to the Convention on Biological Diversity;
- the Basel Convention (transboundary movements of hazardous wastes and their disposal);
- the Rotterdam Convention on the Prior Informed Consent Procedure for Certain Hazardous Chemicals and Pesticides in International Trade;
- the Stockholm Convention on Persistent Organic Pollutants;
- The Montreal Protocol on Substances that Deplete the Ozone layer;
- The Minamata Convention.

Assessment and verification

The issuers of the sovereign and sub-sovereign bonds that are held shall be identified. The applicant shall then provide a declaration of compliance for the fund or deposit account. For sovereign carbon reduction trajectories relevant information and data contained within a sovereign climate risk rating shall be accepted as a form of verification. For sub-sovereign bonds, additional information on equivalent political commitments shall be provided.

Further to the initial verification, internal checks shall be performed by the licence holder at least once per year and any changes in the fund composition, together with revised declarations of compliance, shall be communicated to the Competent Body which also retains the right to make random checks on compliance.

5.2.1 Rationale of the proposed criterion text

The overall aim of this criterion is that investment in activities that are environmentally harmful is avoided. The needs for a requirement that excludes a list of economic activities was identified from existing financial product labels and has been requested by stakeholders, who have commented on which activities they consider should be in the list of exclusions. Applying a negative screening (i.e. a set of exclusions) has the consequence of creating a portfolio allocation that differs from the market portfolio. This may in turn shift asset prices and create incentives for companies that fulfill exclusion criteria to enact sustainability-driven reforms. Evidence also suggests that the more specific the exclusions and screening are, the more effective they can be in driving changes in companies' practices and new investments. For this reason, the formulation of a criterion on environmental exclusions was deemed necessary.

5.2.2 Outcomes of the 1st AHWG meeting and main changes in TR2

Feedback received on TR1and further research conducted by JRC can be found in the previous version of the report (TR2).

The environmental exclusions included in TR1 were solely for the purpose of discussion with stakeholders and needed to be further checked for their applicability and consistency. Therefore, criterion 3 in TR2 differed quite substantially from the previous version by developing the exclusions further and ensuring their operational feasibility.

In summary, the main changes introduced to criterion 3 in TR2.0 were:

- It was specified how the exclusions apply to equities, bonds, fixed-term and saving deposit accounts;
- Additional activities were proposed to be excluded: genetically modified food or feed, production of agricultural products causing deforestation, without the use of integrated pesticide management or leading to severe water scarcity, nuclear energy, production of hazardous chemicals, fluorinated greenhouse gases, mining of asbestos;
- Exclusion areas proposed in TR1 were made operational in TR2 by specifying the reference to legislation or to specific activities or to the means of verification the activities;
- Transitional criteria were developed for the transportation sector, in order to support the transition of the sector to a low carbon economy;

A new section was created, defining the exclusions for sovereign and sub-sovereign bonds. The requirements included the ratification of several international environmental agreements and a climate or environmental risk rating.

5.2.3 Outcomes of the 2nd AHWG meeting and the stakeholder consultation

This section summarises stakeholders' comments received after the 2nd AHWG meeting, held on March 25th 2020. The JRC received in total 264 comments on environmental exclusions from 57 stakeholders. The major comments have been clustered and are summarised below. Based on these comments, the JRC identified the needs for further research.

1) Alignment of requirements for equities and bonds

It was commented that the current set-up of the criteria applies a different approach to equities and bonds, creating confusion as to how it is applied to companies that issue both equities and bonds (e.g., a company may qualify in an equity fund but not in a bond fund). Therefore, it was requested to apply the exclusionary criteria also based on the activities of the issuer of the bond.

2) Exclusion threshold

Stakeholders had split views on the partial threshold of the environmental exclusions. While some agreed with the current proposal (5%), as it represents a good compromise between the credibility of the label and the data availability, other stakeholders would welcome a more relaxed threshold (e.g. 10%), in order not to restrict excessively the eligible universe, especially in the energy utilities sector. Some stakeholders warned against the verification risk of setting a strict exclusion threshold (0%). Finally, it was suggested to set different thresholds depending on the sector of the economic activity.

3) Alignment with the EU Taxonomy

Stakeholders asked for a clear alignment of the EU Ecolabel's environmental exclusions with the Taxonomy, from two main points of view:

- Timing: in order to ensure policy consistency and coherence, stakeholders asked to delay the EU Ecolabel criteria development process until adoption and implementation of the Taxonomy Delegated Acts (2020-2021);
- DNSH criteria: stakeholders asked to define the environmental exclusions in a way that the investment portfolio cannot include companies that do not meet the Do No Significant Harm (DNSH) criteria of the EU Taxonomy. This would ensure coherence,

reduce the complexity of the EU Ecolabel and improve the data availability in the coming years.

4) *List of excluded economic activities*

Stakeholders commented on specific aspects of each excluded economic activity, mainly referring to:

- Strictness of the exclusion: it was often asked to extend the exclusion in order to cover additional activity-related aspects;
- Clarity of the exclusion: it was asked to make sure that the definition of the activities is made in a specific and precise way, leaving no room for interpretation to the competent bodies;
- Verifiability of the exclusion: it was asked to make sure that relevant data are available so that the requirement can be verified. Agriculture, Forestry, Waste Management, and Manufacturing were said to be the sectors for which the least coverage of data exist.

5) *Energy sector*

Many stakeholders suggested to set some form of transitionary exclusions for the energy sector – for example, natural gas power generation - stating that many actors/technologies are contributing to the transition to a low carbon Europe and they should be supported by allowing them to be part of an EU Ecolabel portfolio.

6) *Additional economic activities to be excluded*

A small number of stakeholders asked to expand the list of excluded activities, focusing on:

- Marine resources, water resources and biodiversity;
- Factoring farming; over-fertilization; agricultural production processes that significantly harm other environmental objectives, such as draining wetlands; agricultural companies that receive more than 50% of their returns by planting and harvesting bioenergy crops for bioenergy reasons, biofuels which don't comply with the sustainability criteria of EU Directive 2018/2001;
- Banks that finance fossil energy expansion activities with more than EUR 1 billion (annually);
- Airplanes and airports, or airport expansion; shipping, such as cruise shipping and ships running on heavy or fossil fuels; biofuels and natural gas used in transport.

7) *Assessment and verification method*

Stakeholders commented that the assessment and verification paragraphs are too general and not specific enough, highlighting the importance of having a straightforward interpretation, implementation and controllability/verification of the exclusions.

8) *Climate risk rating for sovereign and sub-sovereign bonds*

Stakeholders were generally not in favour of requesting a climate risk rating of the issuer of a sovereign bond, because:

- It would be a "rating" system, with different rating providers likely capturing different facets of the environmental characteristics of the issuer, whereas the EU Ecolabel should aim at harmonising the environmental investments across the EU;

- It would not add much value to the criteria, as the fact that a rating agency has analysed climate risks of a sovereign bond does not mean that the issuer has taken action regarding those risks;
- There exists no established or standardized method for assessing climate-related risks of sovereign and sub-sovereign bonds;
- The availability, comparability and quality of national GHG emissions data on global scale is still an issue.

5.2.4 Further research and main changes in the third proposal

The environmental exclusions presented in the second technical report have been comprehensively revised in the light of the comments received. Horizontal issues were addressed first, leading to the development of the methodology for revising the criterion on environmental exclusions. Then, each economic activity was addressed individually to make sure that the exclusion is coherent with existing legislation (and especially the DNSH criteria under the EU Taxonomy) as well as cross-checking data availability, on top of anticipating an EU Ecolabel retail investor's expectations.

Alignment of requirements for equities and bonds

The approach used in the EU Ecolabel criteria for equities and bonds has been revised in this third proposal, and the requirements for equities and bonds have been aligned as much as possible. In the context of criterion 3, the environmental exclusions have to be applied equally to equities and bonds issued by companies. Therefore, the wording of the criterion has been changed to reflect that the requirements have to be complied with also by companies issuing bonds, hence covering both the case of general purpose bonds and use-of-proceeds bonds.

Revenue threshold of the environmental exclusions

The proposal in the TR2 set the threshold at 5% of the revenue from excluded activities at the company level. This threshold serves as a screening threshold for portfolio managers.

Previous stakeholder consultations supported the choice of partial exclusions by setting a 5% revenue threshold at the company level (as opposed to strict exclusions with a 0% threshold), as it would represent a good balance between excluding the most environmental polluters whilst allowing an acceptable share of the eligible universe. The partial exclusion thresholds as found in existing national labels is reported in *Table 8*.

Three labels (FNG Label, VKI and Nordic Swan) set a 5% partial exclusion threshold. GreenFin sets a considerably higher threshold (33%), FebelFin sets a moderately higher threshold (10%), whereas LUXflag sets a strict exclusion criterion (0%). According to a German study[45], 44% of socially responsible investors believe that a sustainable fund should never invest in any controversial companies, while 12-13% of them believe that it may be acceptable to invest in companies that derive up to 5 % of their turnover from controversial products/practices. However, setting a zero limit threshold has the following drawbacks:

- Declaring 0% revenues can have legal liability for the company and the asset manager;
- It can be very resource-intensive and difficult to ensure;

[45] Wins, A., Zwergel, B., 2016. Comparing those who do, might and will not invest in sustainable funds: a survey among German retail fund investors. Business Research 9, 51–99. DOI: 10.1007/s40685-016-0031-x

- Feedback from data providers indicate that a large share of the potential investment universe would likely be excluded as it is currently challenging to find companies doing activities fully respecting the 0% thresholds in all environmental areas/exclusions considered in the criterion 3;
- Major data provider organise the data in revenue classes, the lowest class being '<5% of company revenue'.

Table 8 - Comparison of partial exclusion threshold as found in existing national labels.

National label	Partial environmental exclusion threshold
FNG Label (Germany)	5%, except for companies that base their power production on coal energy (25%)
VKI (Austria)	5%
GreenFin (France)	33%, except for the exploration-production and exploitation of fossil fuels and the entire nuclear sector (0%)
Nordic Swan (Scandinavia)	5%[1]
LUXflag Climate Finance (Luxembourg)	0%, except for thermal coal mining and power plants and oil exploration (30%)
FebelFin (Belgium)	10% for thermal coal extraction or unconventional oil & gas extraction) and 0% for companies with expansion plans for coal extraction or unconventional oil & gas extraction

[1] *The Nordic Swan Labelling has in place a point system and allows for exemptions from the 5% threshold in the case that some conditions are fulfilled.*

Four ESG rating agencies were reviewed, in order to investigate the type of data that can made available to asset managers. At the moment of the revision, three agencies provide data on companies' revenue derived from each specific activities in the form of ranges. The ranges '<5%' and '5-10%' are common to all three ESG agencies mentioned above. On the other hand, one agency provides data in the form of actual numbers. Therefore, the choice of an exclusion threshold of 5% in terms of company revenues seems the one that best fits both the scope of the EU Ecolabel and data availability. For three of the reviewed agencies, a 5% threshold works as a 'limit of detection' to evaluate a company's revenue derived from certain activities.

Exclusions for companies investing in transition and in green growth

It was argued by many stakeholders that setting a 5% threshold would most likely cut out a large part of the energy utilities that, despite relying on fossil fuels, are now investing in their transition towards renewable energy, and which are triggering environmental change. To be eligible for inclusion in the portfolio, according to this third proposal of the criteria, companies investing in the energy sector have to comply with a greenness requirement that was designed specifically for them (criterion 2.1 on 'companies investing in transition'). Setting an environmental exclusion on fossil fuels at 5% implies that energy companies investing in transition cannot be eligible for an EU Ecolabel, despite complying with criterion 2.1. Therefore, it is proposed to allow assets and/or bonds issued by companies operating fossil fuelled power stations provided that those companies comply with the requirements of the new criterion 2 for companies investing in transition and green growth.

For these companies, a 30% revenue threshold from fossil fuelled power station is proposed as applying. This threshold is in line with three of the national ecolabelling schemes (FNG Label, Greenfin and LUXflag). Moreover, an additional requirement is asked for these companies in

order to be eligible for financial products applying for the EU Ecolabel, which is to have set a phase-out,closure or fuel-switching plan for the fossil fuelled power stations that they operate. This requirement ensures that the investments are allowed only to companies that are on a demonstrable path of transitioning towards a low carbon economy.

Another key economic sector where companies are transitioning towards greener solutions is the waste management sector. While the greenhouse gas (GHG) emissions of waste management activities were below 4% in 2016[46], this sector has the potential of large GHG savings in other parts of the economy, especially via recycling activities. The focus on waste prevention, reuse and recycling has increased rapidly recently, with a large body of regulations covering it, especially in the EU: the new Waste Framework Directive, directives that target the material recovery of individual waste streams (e.g. the Directive on Packaging and Packaging Waste) and the EU Circular Economy Action Plan, which sets out the focus and the time frame of new upcoming legislations in this area. This rapid growth of rules also means that most companies have not completed their transition but are still in a transitioning phase towards increased material valorisation, identifying the need of economic investments to finance their transition. Therefore, it is proposed that waste management activities complying with the definition of 'companies investing in transition' are allowed in an EU Ecolabel retail financial product if not exceeding a threshold of 30% in terms of company revenue derived from waste management facilities and services without any form of material segregation of non-hazardous waste.

Finally, the second proposal of criterion 3 on environmental exclusions set dynamic exclusions for the transportation sector, and specifically car manufacturing. However, it is the opinion of the JRC not to adopt an approach that sets additional performance thresholds compared to those already recommended by the TEG. Instead, it is proposed to allow investments to companies involved in the production, distribution and sale of new passenger cars and light commercial vehicles with engine technology based on combustion of fossil fuels only if the companies fulfil the requirements set in the new criterion 2 for companies investing in transition and in green growth.

Alignment with the DNSH criteria under the EU Taxonomy

Stakeholders were in favour of a better harmonisation of the EU Ecolabel with the EU Taxonomy, and particularly in favour of a better harmonisation of the environmental exclusions with the Taxonomy DNSH criteria.

In the interest of reducing the complexity of the EU Ecolabel (by aligning the criteria with already existing legislations) and of improving the data availability in the coming years (as required by the EU Taxonomy), each of the environmental exclusions proposed in the TR2 was checked against the DNSH criteria as proposed in the TEG's recommendations to the EU Taxonomy[46]. More specifically, in the cases where the activities of the EU Ecolabel environmental exclusions are mentioned in the DNSH criteria, the wording and the requirement of the exclusion have been aligned with the DNSH criteria, to the extent possible.

The next sections describe in detail the methodology applied for revising the list of the excluded economic activities, as well as the outcome of the revision.

Methodology used for this third criterion revision

The list of excluded economic activities in the First Technical Report originated from a broad list of thematic areas that were selected based on other existing ecolabelling schemes and screened against the stakeholders' opinion. Such list was then developed further based on a

[46] EU Technical Expert Group on Sustainable Finance, Taxonomy Report: Technical Annex. Updated methodology & Updated Technical Screening Criteria, March 2020.

'checkpoint' methodology , where thematic areas suggested by stakeholders were selected for exclusion in the case of available policy reference (EU or international, specifically considering the Taxonomy Regulation) and the possibility to create an operational requirement (i.e. a requirement that can be specific and verifiable).

Based on the feedback received after the 2nd AHWG meeting, each economic activity included in the list was further revised. The methodology used for this revision mainly consisted in checking the excluded activities (in the TR2 version) against EU or international policy reference, and especially trying to align with the TEG recommendations for the DNSH criteria under the EU Taxonomy. Then, the excluded activities were checked against the proxies/indicators used by ESG rating agencies in their company evaluation processes. The requirements were thus modified to ensure harmonisation with both the EU Taxonomy and, importantly for verification, data availability.

List of excluded economic activities

Each economic activity was addressed individually. While a detailed summary of the revision checkpoints can be found in the Annex, an overview of the main focus of the follow-up research and the outcomes from it can be found in *Table 9* below.

Table 9 - Summary of stakeholders' comments, main focus of JRC research, and outcome of the further research for each of the economic activities excluded under criterion 2.1 of the EU Ecolabel (TR2 version).

Abbreviations: CBs: Competent Bodies; CITES: Convention on International Trade in Endangered Species of Wild Fauna and Flora; DNSH: Do No Significant Harm; ECHA: European Chemical Agency; EFSA: European Food Safety Authority; ESG: Environmental, Social and Governance, EUEB: European Union Ecolabelling Board; F-gases: fluorinated greenhouse gases; FLEGT: Forest Law Enforcement, Governance and Trade; FSC: Forest Stewardship Council; GHG: greenhouse gas; GMOs: genetically modified organisms; GWP: global warming potential; HFCs: hydrofluorocarbons; IPM: Integrated Pest Management; MS: Member State; NAP: National Action Plan; PFCs: perfluorocarbons; POPS: persistent organic pollutants; RED II: revised Renewable Energy Directive; SF_6: sulphur hexafluorides; SVHCs: substances of very high concern; TEG: Technical Expert Group on Sustainable Finance; TR2: 2nd Technical Report; WHO: World Health Organisation

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
Pesticides Production of pesticides, including plant protection products, that are not approved for use in the EU and which are identified in the Rotterdam Convention Prior Informed Consent (PIC) procedure.	Strictness of the exclusion: • It was requested to make the exclusion stricter in order to exclude a larger number of chemicals • It was requested to expand the exclusion in order to cover also the distribution and use of pesticides, as the TR2 version of the exclusion together with the exclusion of non-Integrated Pest Management (IPM) practices would not effectively exclude the use of pesticides	Existing international standards were reviewed to identify those substances that have been agreed on at an international level to be the most hazardous. In addition to the UN Rotterdam Convention (mentioned in TR2 already), the WHO Recommended Classification of Pesticides can be used. Both agreements are in the form of negative lists and both are mentioned in the TEG's 'Do No Significant Harm' (DNSH) criteria. Moreover, data on company controversies related to these standards are provided by ESG rating agencies.	• Reference is made to pesticides included in the UN Rotterdam Convention and in class Ia or Ib of the WHO Recommended Classification of Pesticide. This change ensures that the requirement is aligned with the TEG's DNSH criteria and with existing data proxies; that the coverage of the requirement is made international; that more substances are covered by the requirement. • Reference is made to the *use* of pesticides (and not the production only), thus including those Taxonomy-compliant activities that have DNSH criteria on pesticides, e.g. forestry activities (afforestation, reforestation, conservation, etc.). The production and distribution of pesticides is moved under the *Manufacturing* exclusions. This change ensures an increased coverage of pesticide-related activities in the EU Ecolabel exclusions.
	Verifiability of the exclusion: it was commented that there are no data available on the revenue from the production of pesticides not authorised in the	The JRC reviewed the sources of data that could be used to demonstrate compliance with this requirement.	The reference to *"pesticides [...] not approved for use in the EU"* is removed. Reference is made instead to pesticides included in the UN Rotterdam

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
	EU.	In the EU, according to Regulation 1107/2009, each approval or non-approval of a pesticides leads to an EU Regulation. A positive list of approved active substances is given in Regulation 540/2011. Moreover, an EU pesticides database[47] exists, linking the substances for which an authorisation was requested to the company requesting the authorisation. While asset managers and competent bodies could use this database for the verification of the requirement, this was not considered feasible.	Convention and in class Ia or Ib of the WHO Recommended Classification of Pesticides, which are negative lists for which data proxies exist. This change ensures that the requirement is aligned with data availability, and that the verifiability of the exclusion is possible and clearly defined.
<u>*Genetically modified plants*</u> The development, distribution and cultivation of food or feed from genetically modified varieties of plants that have not passed a risk assessment carried out according to the criteria in Annex II to Regulation EN 503/2013 or equivalent	Verifiability of the exclusion: • It was commented that there is no data available on company revenue from the production of GMOs not authorised in the EU. Removal of the exclusion: • It was asked to remove the exclusion, as it would significantly limit the availability of climate resilient crops, water scarcity and food scarcity. Moreover, no negative impacts have been identified from GMOs already in the market yet. Strictness of the exclusion • It was requested to keep the exclusion and expand it in order to cover also textiles and biofuels coming from genetically modified crops	The JRC has reviewed a number of the major sources of data that could be used to demonstrate compliance with this requirement. On the one hand, the EU Register of genetically modified organisms (GMOs) contains the list of all products authorised and withdrawn in the EU market, including the company requesting the authorisation, the EFSA report with the conclusion of the assessment and the Commission Decision. This database could in principle be used to verify compliance with the requirement. However, it may be challenging for fund or asset managers to link the company's revenue to activities relating to a specific non-authorised GMO. On the other hand, ESG rating agencies provide data in the form of 'positive' proxies (e.g. the IFOAM Norms for Organic Production or Sustainable Agriculture Standards, implicitly excluding GMOs) or indicators that exclude the	The exclusion is removed. This change is due to the fact that no data is available at a level of granularity that could enable the verification of such a requirement. In addition, no mention is made to GMOs in the DNSH criteria under the EU Taxonomy, which is also likely not to trigger improved data availability for verification in the coming years. It is therefore proposed to remove this exclusion and review the position again in the 1st criteria revision process. Support at an international level for the principle of risk assessment of GMO varieties to avoid harm to the environment is proposed to be introduced into the environmental exclusions for sovereign and sub-sovereign bonds. Reference is proposed to be made to the need for issuers to be party to the Cartagena Protocol on Biosafety to the Convention on Biological Diversity, which has 173 ratifying

[47] https://ec.europa.eu/food/plant/pesticides/eu-pesticides-database/public/?event=homepage &language=EN

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
		entire GMO sector (e.g. the involvement of companies in genetic engineering or genetically modified plants or seeds). The use of these proxies/indicators would most likely lead to an overestimation of the exclusion. At the moment, the only technical basis for setting an exclusion on GMOs that is coherent with the EU approach to scientific assessment of the risks that the GMO may present for human and animal health and for the environment would be the one proposed in TR2: to exclude GMOs that are not authorised in the EU (i.e. that have not passed the risk assessment procedure). However, the lack of data at the necessary level of granularity results in the exclusion not fulfilling one of the checkpoints used as a methodology to develop EU Ecolabel exclusions – namely the ability to verify at a company level using readily available data sources, including proxies/indicators used by ESG rating agencies in their company evaluation processes. Moreover, the use of genetically modified plants or seeds is not mentioned in the TEG's recommendations as being potentially harmful to environmental objectives, thereby also not fulfilling a second checkpoint used as a methodology to develop EU Ecolabel exclusions (alignment with the "do no significant harm" criteria under the EU Taxonomy). Given all the above, it was not possible at this stage to formulate a technical exclusion on genetically modified plants or seeds.	parties.
<u>*Agricultural products (1)*</u> Production of agricultural products, including	Strictness of the exclusion: • It was requested to refer not only to vegetable oils but to those products which are the main	The JRC reviewed the TEG's Recommendations for the forestry sector. While the Taxonomy eligibility criteria build on the	• Wording is aligned to the DNSH criteria, expanding the exclusion to "land obtained as a result of conversion, fragmentation or

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
vegetable oils, on land obtained as a result of deforestation of primary forest or the drainage of peatlands or wetlands after the year 2000	responsible for deforestation • It was requested to expand the coverage of the requirement, excluding also those cultivations that lead to the degradation and/or fragmentation of primary forest Clarity of the exclusion • it was requested to better specify the conditions under which agricultural products are excluded	EU Common Agricultural Policy, the DNSH criteria specifically require the "no-conversion, fragmentation or unsustainable intensification of high-nature-value land, wetlands, forests, or other areas of high-biodiversity value in or after 2008". The DNSH criteria are in turn built on the RED II, which define land with high-carbon stock and high-biodiversity value as no-go areas for cultivation of feedstock biofuel. The cut-off date of 2008 also comes from the RED II sustainability criteria. A link with the Directive would enable the use of existing sustainability schemes to demonstrate compliance (at least for feedstock for biofuel). Moreover, a direct link with these Regulations would allow precise definitions and increased availability of data. However, "high-carbon stock land" and "peatland" are not mentioned in the DNSH criteria, but are mentioned in the RED II, which is why they are proposed to be included in the EU Ecolabel as well. Further research was conducted on the main commodities causing deforestation. According to an EC study[48], over the period 1990-2008 the EU imported and consumed an amount of crops and livestock equivalent to a deforested land area of 9 million ha. In terms of crops and livestock types, palm, soy, beef, and pulp & paper are estimated to	unsustainable intensification of high-nature-value land, wetlands, peatland, forests, or other areas of high-biodiversity value in or after 2008", where high-biodiversity-value land is defined according to Directive 2018/2001. High-carbon stock land and peatland are also proposed to be excluded, according to Directive 2018/2001. These changes ensure that the requirement is aligned with the Taxonomy DNSH criteria and Directive 2018/2001; that more types of high-nature-value land are excluded compared to the TR2 proposal; that the requirement is clearer from a verification point of view, since a definition of high-biodiversity-value and high-carbon stock land is given; that data availability improve in the coming years as a result of the adoption of the Taxonomy criteria, not only for feedstock for biofuels. • Reference is made to the production of livestock, which should come from land obtained as a result of conversion, fragmentation or unsustainable intensification of high-nature-value land, wetlands, forests, or other areas of high-biodiversity value or high-carbon stock in or after 2008. The production of pulp & paper is dealt with in

[48] Tagliaferri M., 2013, The impact of EU consumption on deforestation. Available at: https://europa.eu/capacity4dev/public-flegt/documents/impact-eu-consumption-deforestation

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
		have 50-80% of their production methods causing deforestation[49]. These four commodities are also mentioned in the New York Declaration on Forests[50], which is used by some providers as an indicator for evaluating companies' exposure to controversies. While the cultivation of palm and soy was excluded already in the TR2 proposal, beef and pulp & paper were not.	the *Forestry* sector. This change ensures that the requirement is made more comprehensive, covering the production of those commodities which are responsible for a large part of global deforestation.
Agricultural products (2) Production of agricultural products without the use of integrated pest management systems and procedures.	Clarity and verifiability of the exclusion: it was requested to better specify the conditions under which agricultural products are excluded, also in order to make the criterion verifiable by the Competent Bodies	Existing pieces of legislation and international standards and/or treaties were reviewed in order to provide clear definitions that could be linked to existing requirements. At EU level, the general principles of IPM are defined in Annex II of the Directive 2009/128/EC on the sustainable use of pesticides and integrated pest management. According to the regulation, it is up to MSs to submit National Action Plans and promote IPM. However, a 2019 report on the implementation of Directive 2009/128/EC by the Committee on the Environment, Public Health and Food Safety concluded that approximately 80 % of MSs' NAPs contain no specific information on how to quantify the achievement of many of the objectives and targets, particularly as regards targets for IPM. The Taxonomy DNSH criteria of the agricultural and forestry activities also refer to Directive 2009/128 to ensure that the use of pesticides is	The wording of the requirement is aligned with the one in the Taxonomy DNSH criteria to pollution of the agricultural and forestry activities: "Minimise the use of pesticides and favour alternative approaches or techniques, such as non-chemical alternatives to pesticides, in line with the Directive 2009/128/EC on the sustainable use of pesticides, with exception of occasions that this is needed to control pest and diseases outbreaks". Moreover, reference is made to Directive 2009/128/EC and the UN FAO International Code of Conduct on the Distribution and Use of Pesticides. These changes ensure that the principles of IPM are clearly defined and that the verification is possible as data proxies are already available.

[49] Lawson S, Consumer Goods and Deforestation: An Analysis of the Extent and Nature of Illegality in Forest Conversion for Agriculture and Timber Plantations. 2014. Available at: https://www.forest-trends.org/wp-content/uploads/imported/for168-consumer-goods-and-deforestation-letter-14-0916-hr-no-crops_web-pdf.pdf

[50] https://forestdeclaration.org/

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
		minimised. At international level, the IPM principles are defined in the UN FAO International Code of Conduct on the Distribution and Use of Pesticides. This code of conduct is also mentioned and used as a verification proof for IPM cotton in the EU Ecolabel for textiles. Moreover, data are provided by ESG agencies on companies that do not respect the UN FAO International Code of Conduct. Referring to the UN FAO International Code of Conduct on the Distribution and Use of Pesticides would ensure harmonisation with DNSH criteria, other EU Ecolabels and data availability, in addition to provide clarity in the definition of what is considered as IPM.	
Water scarcity Production of agricultural products using water for irrigation in areas where there is severe water scarcity.	Clarity of the requirement: it was commented that the definition is unclear, making the requirement not possible to be complied with.	The JRC conducted further research in order to formulate a version of the requirement that could be aligned with existing legislation and be verifiable. In the EU, apart from the Water Framework Directive, Annex II to Regulation 1306/2013 defines, among the standards for good agricultural and environmental condition of land, the standards for the authorisation procedures of water for irrigation. Moreover, it is envisaged that the EU Circular Economy Strategy may provide additional guidance (e.g. proposing legislation setting minimum requirements for reused water for agricultural irrigation). In the EU Taxonomy, while substantial contribution criteria focus on water collection, treatment and supply activities, the DNSH criteria related to the water environmental objective are not specific enough to be used in the context of the EU Ecolabel.	The exclusion is removed. This change is due to the fact that no data could be found that could enable the verification of such a requirement. In addition, the DNSH criteria to the water environmental objective are not envisaged to trigger better data availability in the coming years. It is therefore proposed to remove this exclusion and address the shape of this requirement in the next revision process.

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
		From the data availability point of view, none of the ESG agencies' methodologies reviewed by JRC supply information on the water usage for agricultural products. The absence of proxies represent a fundamental problem that cannot be overcome. This aspect is confirmed by the fact that none of the other ecolabelling schemes set a similar requirement.	
<u>*Forestry*</u> Timber production and exploitation, unless the economic operator can demonstrate the following: - that the timber is covered by valid FLEGT or CITES licences and/or is controlled by a due diligence system which provides the information set out in Regulation (EU) 995/2010; or - that the harvest is not from the clear felling or unsustainable exploitation of old growth, primary forests that have a high biodiversity value and/or carbon stock.	Strictness of the requirement: • It was requested to increase the stringency of the exclusion, in order to make the two proofs of compliance a cumulative requirement (i.e. replace the "or" with "and") • It was requested to extend the requirement in order to exclude the whole timber value chain • It was requested to exclude also the "degradation and fragmentation" of forests of high biodiversity value and/or carbon stock. • It was requested to accept compliance with FSC and PEFC as methods of verification Verification of the requirement: • it was commented that the "old growth, primary forest that have a high biodiversity value and/or carbon stock" is not a known and straightforward definition and would lead to verification issues	The regulation and licences mentioned in the requirement were investigated to evaluate the need for expanding the coverage of the requirement. The EU Timber Regulation requires operators to exercise 'due diligence', which implies undertaking a risk management exercise so as to minimise the risk of placing illegally harvested timber or timber products on the EU market. Timber and timber products with FLEGT or CITES licenses are considered to comply with the Regulation. FLEGT licences are issued by countries that have ratified a Voluntary Partnership Agreement with the EU, and confirm that timber or timber products comply fully with the relevant laws of the country of export. CITES is a convention which requires that international trade in species listed in one of its Appendices is only permitted if not detrimental to the survival of the species in the wild. Compliance with the EU Timber Regulation ensures that no illegal timber enters in the EU. However, the notion of 'illegal' depends on the country of origin. Making the requirements cumulative, i.e. in the EU Ecolabel criterion substitute "or" with "and", would ensure that deforestation is excluded, regardless of the	• The "or" is substituted by an "and". This change expands the coverage of the requirement, as it ensures that areas with high-biodiversity value and/or high-carbon stock are not degraded for the purpose of the timber market, regardless of the legislation in the country of origin. • Reference is made to "forestry management for production of timber as well as timber-derived products", and not to "timber production and exploitation". This change expands the coverage of the requirement to the forest management part of the timber value chain, and it ensures that the requirement applies also to timber-derived products, especially to pulp & paper products, which are considered to be largely causing deforestation. • Wording is aligned to the DNSH criteria, extending the exclusion to "land obtained as a result of conversion, fragmentation or unsustainable intensification of high-nature-value land, wetlands, peatlands, forests, or other areas of high-biodiversity value or high-carbon-stock in or after 2008". High-carbon stock land and peatland are also proposed to be excluded,

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
		legislation in the country of origin. Moreover, the JRC reviewed the TEG's Recommendations for the DNSH criteria on 'no deforestation'. These criteria require the "no-conversion, fragmentation or unsustainable intensification of high-nature-value land, wetlands, forests, or other areas of high-biodiversity value in or after 2008" (see the row on *Agricultural products (1)* for further details). Aligning the wording of the EU Ecolabel exclusion (second bullet point) with the DNSH criteria would extend the coverage of the requirement and enable the use of existing sustainability schemes to demonstrate compliance, in some cases. Moreover, the data availability would be expected to improve in the coming years as a result of the adoption of the Taxonomy criteria. As the DNSH refer to forest management, the alignment would extend the part of the timber value chain that has to comply with the requirement. FSC certifications where also reviewed. Since its principles are aligned with the EU Timber Regulation, the FLEGT and the CITES, the acceptance of FSC certifications for the verification of the EU Ecolabel requirement would facilitate the verification process (to be mentioned in the User Manual).	according to Directive 2018/2001. These changes ensure that the requirement is aligned with the Taxonomy DNSH criteria and Directive 2018/2001; that more types of high-nature-value land are excluded compared to the TR2 proposal; that the requirement is clearer from a verification point of view, since an official definition of high-biodiversity-value and high-carbon stock land is given.
<u>*Fossil fuels (1)*</u> Solid, liquid and gaseous fossil fuel exploration, extraction and refining for fuel. This includes unconventional sources such as hydraulic fracking	Strictness and clarity of the requirement: • It was requested to extend the exclusion to cover also transportation, distribution and storage • It was requested to specifically mention the types of unconventional sources which are excluded.	A large body of EU legislations and international conventions fosters the transition of a fossil fuel-dependent society to a renewable energy-based one. Different types of renewable energy targets are in place. Moreover, the TEG recommended to exclude completely the fossil fuel sector from the taxonomy: "[…] unabated fossil fuel combustion,	• A new requirement is introduced that excludes "transportation, distribution and storage of fossil fuels". This change ensures the exclusion of the entire fossil fuel value chain. • The types of unconventional sources for fossil

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
and shale deposits.		namely coal and natural gas, will be ineligible under the Taxonomy". The exclusion of the whole fossil fuel value chain would be in line with the European (and global) direction towards a green economy.	fuels are listed in the requirement: "hydraulic fracking, arctic drilling, oil sands and shale deposits". This change ensures improved clarity of the requirement.
<u>*Fossil fuels (2)*</u> Use of solid, liquid or gaseous fossil fuels for electricity generation.	Exclusion threshold for companies in transition: it was commented that a 5% exclusion on fossil fuels would likely cut out the whole energy utility sector. Setting an exemption for the utility companies transitioning their activities would support their transition and reward their efforts.	The JRC conducted further research on companies in transition in the energy economic sector. Energy utilities are understood to be an important asset within UCITS funds. Therefore, in the context of new criterion 2, companies investing in transition are proposed to be eligible, provided that certain requirements concerning capital investments, future green revenue plans and change-supporting engagement are fulfilled. However, most energy companies fulfilling these requirements under criterion 2 would not be eligible for an EU Ecolabel portfolio due to the criterion on environmental exclusions. The inclusion of companies in transition in the EU Ecolabel would have two potential benefits in terms of investor impact and investable universe (see criterion 2 for further details), in addition to support the transition of such companies. Setting a threshold of 30% in terms of revenue from fossil fuelled power generation and the setting of a phase-out, closure or fuel-switching plan of the power plant would ensure these companies are already on a transition path. The 30% threshold would be in line with current practice under other financial ecolabelling schemes and would ensure that the company has already invested in renewable energy. The phase out plan would be in line with the Taxonomy requirements for the definition of transitional activities and would ensure that the company is on a decreasing	Companies using fossil fuels for fuel or electricity generation are eligible in an EU Ecolabel portfolio provided that, cumulatively: o The company complies with the requirements for companies in transition (criterion 2.1); o the company revenue from coal-,oil- and natural gas- fired power stations is below 30%; o the company has set a phase-out, closure or fuel-switching plan for natural gas, oil and coal power stations in a ten-year timeframe This change ensures that utility companies investing in transition are not excluded. Additional requirements ensure that the transition is both of a look-back (the 30% threshold) and look-forward (the phase-out plan) approach.

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
		emissions pathway.	
Nuclear energy All activities relating to the nuclear fuel cycle, including power generation	Removal of requirement: • It was commented that nuclear energy should not be excluded as its role within the EU Taxonomy is still to be determined as it currently plays an important role in climate change mitigation and has further future potential for investment. • Nuclear waste management, dismantling of nuclear power plants and research in nuclear fusion should not be excluded activities	The JRC has reviewed the current situation of the nuclear energy sector with respect to the TEG's recommendations on the Taxonomy. Within their work on assessing substantial contribution of economic activities to the climate change mitigation objective and the related "do-no-significant-harm" (DNSH) criteria towards the other environmental objectives, the TEG assessed the activity of generating electricity from nuclear energy. The TEG recommendations state that while the substantial contribution of nuclear energy towards low carbon energy supply is extensively proven and clear in the literature, the evidence on its potential significant harm to other environmental objectives is more complex and difficult to evaluate. Significant data gaps hindered the TEG's assessment of DNSH aspects for nuclear energy, and "it was not possible for TEG, nor its members, to conclude that the nuclear energy value chain does not cause significant harm to other environmental objectives". As a result the TEG position was inconclusive and "did not recommend the inclusion of nuclear energy in the Taxonomy at this stage", instead making a recommendation for further technical work to assess the DNSH aspects. In order to analyse the DNSH aspects of nuclear energy, the JRC has been tasked with conducting a review of the state-of-the-art to assess nuclear energy generation under the DNSH criterion and conducting a specific assessment on the current status and perspectives of long-term management and disposal of nuclear waste. The deliverable (a report presenting the evidence to help in evaluating the existing pros and cons of existing and proposed	The JRC recommends that the outcome of the study on the DNSH aspects of nuclear technology should be taken into account in the final decision making. While there is therefore currently no technical basis for justifying the exclusion of nuclear energy, the final decision on whether to retain this exclusion or not will rest with the Member States that will vote on the EU Ecolabel criteria adoption. No change is made to the proposal, which is kept as in the second technical report: All activities relating to the nuclear fuel cycle, including power generation, are excluded.

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
		solutions) is due by December 2020. This report will then be reviewed by two groups of experts on radiation protection, waste management and other environmental impacts. Given all of the above, at this stage the JRC does not currently have a technical basis for making a proposal for the exclusion or non-exclusion of nuclear energy in the EU Ecolabel for retail financial products. In the interest of finding an interim way forward, a survey was carried out among the EUEB (EU Ecolabelling Board) members in June 2020. It tested the possibility of allowing in EU Ecolabel financial products investments in nuclear energy activities for those companies which have set a phase-out or decommissioning plan for the nuclear power station assets that they own, reflecting the approach adopted by a number of large utility companies that are investing to increase their green revenue. The opinion of the EUEB members was unanimously to exclude all nuclear activities, regardless of potential decommissioning plans.	

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
<u>*Waste management*</u> • Waste management facilities and services that do not operate any form of material segregation for the purposes of preparation for reuse, recycling and/or energy recovery, as well as the processing or stabilisation of organic waste. • Landfill sites without leachate and methane gas capture. • Incineration not equipped with flue-gas treatment that complies with Directive 2000/76/EC on the incineration of waste or equivalent internationally recognised standards and without a high level of heat recovery and/or power generation	Strictness of the requirement: it was requested to increase the strictness of the requirement by e.g. increasing the percentage limit of material separation (first bullet point), excluding incineration of non-hazardous waste with or without energy recovery, or excluding landfill without leachate and methane gas capture and treatment. Clarity of the requirement: it was requested to change the wording of the requirements, as the first bullet point seemed to contradict the following two.	The further research conducted by the JRC suggests that the waste management sector in the EU is undergoing substantial change, as a result of the focus of recent legislations on waste prevention, reuse and recycling, which have the potential to trigger GHG emission reductions in other sectors of the economy. In the EU Taxonomy, 'separate collection and transport of non-hazardous waste in source segregated fractions' and 'material recovery from non-hazardous waste' are included as activities with substantial contribution to climate change mitigation. The DNSH criteria of several activities include high targets in terms of waste recovery. Therefore, a requirement that excludes all waste management activities not operating material recovery (including landfill and incineration) would be better aligned with the TEG's recommendations for the Taxonomy. Allowing investments to waste management companies that are transitioning would ensure important incentives. An exclusion threshold of 30% for revenue from waste management facilities and services that do not operate any form of material segregation would ensure that the company has already invested in a transition to a green economy.	The exclusions of landfills and incineration are removed. Waste facilities and services that do not operate any form of material segregation are eligible if, cumulatively: o The company complies with the requirements for companies in transition (criterion 2.1); o their revenue from the waste management activities listed above is below 30%. These changes ensure that investments are not made to waste management activities operated by companies that are not on a transition path towards high material recovery.
<u>*Hazardous chemicals*</u> Production of hazardous chemicals that are not authorised or registered for use in the EU and which are identified in the Rotterdam Convention Prior Informed Consent	Strictness of the requirement: • it was requested to extend the requirement in order to exclude more hazardous chemicals, e.g. POPs and SVHCs • it was requested to extend the requirement also to the distribution, trade and use of excluded chemicals	The JRC reviewed further EU and international agreements that could be used to set up the exclusion of additional chemicals. At international level, the Stockholm Convention, the WHO Recommended Classification by Hazard (classes Ia and Ib) and the Rotterdam Convention PIC procedure are internationally recognised lists of hazardous chemicals (for POPs, pesticides and	• The substances listed on the following lists are added to exclusion requirement: o Regulation 2019/1021 (for companies domiciled in the EU) and the Stockholm Convention (for companies domiciled outside the EU); o Regulation (EU) 649/2012 (for companies domiciled in the EU) and the

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
(PIC) procedure		other substances). These agreements are mentioned in the TEG's recommendations as DNSH criteria to pollution of agriculture activities. At EU level, Regulation (EU) 2019/1021 and Regulation (EU) 649/2012 implement the Stockholm Convention and the Rotterdam Convention PIC procedure. In the contest of pesticides, Regulation (EC) No 1107/2009 to establish a list of substances identified as "candidates for substitution". The current draft list identifies 77 active substances with certain properties. The JRC crossed checked a number of these 77 substances against the WHO list. The majority of substances are included in the WHO list with different level of hazard (and reflecting the number of fulfilled candidate for substitution criteria). Also at the EU level, Article 57 of Regulation 1907/2006 sets out the criteria for identifying substances of very high concern. Listing a substance on the candidate list of SVHCs imposes a requirement for authorisation for some or all uses of this substance. The list is regularly updated by ECHA and currently contains 209 SVHCs (las update June 2020). Regulation 1907/2006 also includes in its Annex XVII all the substances for which manufacture, placing on the market or use is limited or banned in the framework of REACH and the previous legislation, Directive 76/769/EEC. Finally, Regulation (EU) 2017/852 covers the full life cycle of mercury, complementing a large body of existing EU environmental law on the prohibition of mercury. At international level, this restriction is covered in the Minamata Convention.	Rotterdam Convention PIC procedure (for companies domiciled outside the EU) o The WHO Recommended Classification by Hazard (classes Ia and Ib) (for companies domiciled outside the EU); o The candidate list of SVHCs and Annex XVII of REACH (for all companies) o Regulation (EU) 2017/852 (for companies domiciled in the EU) and the Minamata Convention (for companies domiciled outside the EU). This change makes the requirement more stringent, excluding a larger number of hazardous chemicals. • Reference is made to the production, trade, distribution and use of these substances, and not to the production only This change makes the requirement more stringent, prohibiting not only the production of listed hazardous chemicals, but also their distribution and use.

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
		The review of data availability from data providers suggests that data proxies exist for Stockholm Convention and the WHO Recommended Classification by Hazard. Moreover, at least one data provider has got a data proxy covering compliance with REACH legislation. Since companies operating excluded activities may be domiciled outside the EU, where EU Regulations are not effective and/or known, and since available proxies/indicators are mostly at the international level, it is proposed to refer to both EU legislation and international agreement.	
<u>*Fluorinated GHGs*</u> Production of fluorinated greenhouse gases with a Global Warming Potential of > 150	Strictness of the requirement: • it was requested to exclude all fluorinated GHGs • it was requested to extend the requirement also to the distribution and use of excluded chemicals	The JRC reviewed available information that asset managers could use to ensure that companies involved in the production of fluorinated GHGs are excluded. At EU level, Regulation 517/2014 lays down rules on the containment, use, recovery and destruction of F-gases, where by F-gases is meant HFCs, PFCs and SF_6. Additionally, the Regulation bans the sale of certain products containing F-gases and sets an overall yearly limit on the climate impact of HFCs. In its Annex III, the Regulation lays down GWP thresholds of the F-gases allowed to be used in certain product types. A direct reference to this Annex would ensure that the most relevant GWP is applied for each product type. Additionally, the Montreal Protocol on Substance that Deplete the Ozone Layer is an international treaty that phases out the production of numerous substances that are responsible for ozone depletion, including HFCs. A direct reference to Regulation 517/2014 would strengthen the clarity of the requirement (by giving guidance of what substances are covered) while	• Reference is made to fluorinated greenhouse gases that are listed in Regulation EU/517/2014. Annex III of this Regulation is mentioned for the GWP limit to be used in each specific product type using F-gases. This change increases the clarity of the requirements and improves the verification exercise of CBs • Reference is made to the production, trade, distribution and use of these substances, and not to the production only This change makes the requirement more stringent, prohibiting not only the production of listed hazardous chemicals, but also their trade, distribution and use.

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
		improving the verification done by competent bodies. The Montreal Protocol would only partly cover F-gases. Reference to this Protocol would be more appropriate in the user manual.	
Ozone depleting substances Production of substances with a high Ozone Depletion Potential (ODP) listed as controlled and as prohibited by the Ozone Regulation (EC) No 1005/2009	No major comments were received on this requirement, although it was mentioned to check the feasibility of its verification method	The JRC evaluated the data availability for this requirement. In the TR2 proposal, reference is made to the Ozone Regulation. While no data proxies were found on for this requirement, it should be feasible to be verified by asset managers and competent bodies, as a list of ODSs is available in the Annex. On the other hand, the TEG's recommendations make specific reference (in the DNSH criteria of agriculture activities) to the Montreal Protocol on Substances that Deplete the Ozone Layer. This Protocol has an international coverage, and the exclusion of the substances listed in the Protocol would widen the coverage of the requirement. Moreover, information on companies involved with substances listed on this Protocol is available from data provider.	• Reference is made also to the Montreal Protocol on Substances that Deplete the Ozone Layer This addition ensures an international coverage of the criterion, and moreover increase the data availability for this requirement • Reference is made to the production, distribution and use of these substances, and not to the production only This change makes the requirement more stringent, prohibiting not only the production of listed hazardous chemicals, but also their distribution and use.

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
<u>*Mining activities*</u> The mining, processing and production of asbestos and asbestos-based products.	Comprehensiveness of the requirement: it was requested to exclude the full mining sector	The exclusion of mining activities is considered of high importance because of environmental impacts in terms of e.g. biodiversity, human health, pollution, and soil erosion. However, the position of the TEG on the mining and quarrying sector highlights its relevance for providing the critical materials needed for low-carbon technologies, as well as the value chain link with energy-intensive manufacturing sectors. While the TEG was not able to complete a full assessment, it recommended that further work should apply a life cycle approach in order to account for potential savings in other life cycle phases or other parts of the economy. While it is fundamental that the sourcing of raw materials occurs in a sustainable and responsible way, a full exclusion of the mining sector under the EU Ecolabel may potentially create a bottleneck in terms of lack of critical materials needed to create a climate neutral, circular and resource efficient economy.	Reference is made also to the use of asbestos. No other change is made to the requirement. It is proposed to address the activities included in this requirement in the 1st criteria revision process.
<u>*Transportation*</u> Production, distribution and sale of new passenger cars and light commercial vehicles, unless the company undertaking the activity complies with the following requirements: For new passenger cars: Manufacturers shall have made available to consumers at least one zero- and low-emission	Alignment with Taxonomy Regulation: it was commented that the proposed criterion is not aligned with the TEG's recommendations for 'Passenger cars and commercial vehicles'	The JRC reviewed the requirement with the aim of aligning with the TEG's recommendations. It is the opinion of the JRC that the EU Ecolabel exclusions should not set additional performance thresholds compared to those already recommended by the TEG. On the other hand, the emission thresholds proposed in the TEG's technical screening criteria for 'passenger cars and commercial vehicles' cannot be used for the environmental exclusions, as they would restrict the eligible universe to what is green only, and not to what does significant harm to one of the environmental objectives, as the other	• Performance-based transitional exclusions are removed. • Equities and/or bonds are allowed in an EU Ecolabel product only if the companies production, distribution and sale of new passenger cars and light commercial vehicles with engine technology based on combustion of fossil fuels are companies investing in transition or companies in green growth (according to criterion 2).

Excluded economic activity (TR2)	*Issue/comments received*	*Main focus of further research*	*Outcome of the further research*
vehicle (ZLEV) model with tailpipe emissions of <50 g CO2/km and the average tailpipe emissions of all models that they have registered in the last calendar year shall be 5% lower than the respective EU target applicable at the time. For light commercial vehicles: The average tailpipe emissions of all models that a manufacturer registered in the last calendar year shall be 5% lower than the respective tailpipe CO2 emissions target.		exclusion requirements intend to do. Instead, it is proposed to insert the requirement that investments can be made to companies involved in the production, distribution and sale of new passenger cars and light commercial vehicles with engine technology based on combustion of fossil fuels only if these companies are investing in transition or in green growth.	

Additional economic activities

The JRC reviewed the activities suggested by stakeholders as additional exclusions.

Some of the exclusions suggested (Marine resources, water resources and biodiversity) indicated environmental objectives rather than economic activities. Thematic areas cannot be suitable for exclusion as they would not be operational for the EU Ecolabel. Therefore, these suggestions were not included in this third proposal of criterion 3. However, the Cartagena Protocol on Biosafety to the Convention on Biological Diversity was inserted in the list of international agreements that have to be ratified by sovereigns and sub-sovereigns, in order to issue EU Ecolabel-compliant bonds.

Other suggestions have been included while revising the list of excluded economic activities (see Table 2 for the revision summary). Examples are: over-fertilisation, now excluded according to requirement A.4; agricultural production processes draining wetlands, now excluded according to requirement A.3; Biofuels which don't comply with the sustainability criteria of EU Directive 2018/2001, now excluded according to requirements A.3 and B.1.

The suggestion of excluding the aviation and shipping sector was investigated. These companies have not been assessed by the TEG for inclusion in the Taxonomy. At the moment, there is no reference point in the EU Taxonomy nor its DNSH criteria which can form the basis for establishing an exclusionary approach in the EU Ecolabel. Therefore it is proposed that these activities are considered in the first revision of the EU Ecolabel criteria, as by then there may be a clearer outlook on what basis form the exclusion.

Finally, the banking sector was suggested to be excluded when financing fossil fuel projects with more than 1 billion euros annually. However, for the time being the focus of the EU Ecolabel exclusions is set on companies issuing equities or bonds. However, future revisions of the criteria may explore the setting of the exclusions on activities of other issuers.

Assessment and verification method

The assessment and verification section was reviewed and restructured in line with the stakeholders' request for more specific and straightforward requirements.

The assessment and verification paragraph in the criterion text has been expanded. Overall, a declaration of compliance with all environmental exclusions is requested for all companies in the portfolio, including subsidiary or parent companies. Moreover, companies shall provide information on the activities they are involved with, at any ties.

A list of methods for checking the compliance of the applicant have been included in the assessment and verification. While this list represents a non-exhaustive example of the information that can be used for the verification, for the time being it is proposed to keep the assessment and verification more on a general level, addressing the proof of compliance with specific sub-requirements in the user manual. Specific guidance is given for sub-requirement C.2, especially in terms of the content of the phase-out, closure or fuel-switching plant.

Moreover, a new paragraph has been inserted describing the procedure to adopt in case of allegations. The paragraph is in line with the social exclusions, and requires fund managers to develop a list of actions to carry out to deal with the identified allegation. The company is given three months to demonstrate how the issue can and is expected to be addressed. If the issue remains after a year unresolved, the respective assets shall be sold.

Sovereign and sub-sovereign bonds

The requirement of a climate risk rating for sovereigns has been removed, in line with the comments received by stakeholders.

With respect to the ratification of the Paris Agreement, it is set that bonds issued by sub-sovereign can be included in an EU Ecolabel financial product in the case that the sovereign has not ratified the Paris Agreement, but the sub-sovereign has adopted commitments aligned with

it. Moreover, the exclusion on sovereign bonds not ratifying the Paris Agreement has been complemented by the additional requirement of the issuer publishing a CO_2 reduction trajectory compatible with a 2 degrees scenario.

Three new international agreements have been included in the list of criterion 3.2.2. The Cartagena Protocol aims to ensure the safe handling, transport and use of living modified organisms (LMOs) that may have adverse effects on biological diversity, taking also into account risks to human health. Article 15 of that protocol requires that risk assessments shall be carried out in a scientifically sound manner. The Montreal Convention and the Minamata Convention refer to the ban on ozone depleting substances and mercury, and mirror the exclusions related to economic activities.

Finally, the sentence that GBSs could be accepted even if issued by a sovereign not complying with criteria 3.2.1 and 3.2.2 has been removed.

5.2.5 Summary of the changes made

In summary, the main changes made when compared to TR2 are:

- the list of excluded economic activities from TR2 have been reviewed and restructured, in particular with reference to the TEG Taxonomy DNSH recommendations and data availability. In the majority of cases the exclusions have been made more specific and verifiable, either by referring to legislation, or specific activities or to the means of verification.
- Some new proposals made by stakeholders, such as biofuels not complying with the sustainability criteria of EU Directive 2018/2001, have also been incorporated.
- Two activities were removed from the list of exclusions: the one relating to the production of genetically modified organisms and the one relating to the production of agricultural products using water for irrigation in areas with sever water scarcity.
- Special requirements have been set for ‘companies investing in transition’ and ‘companies investing in green growth’ operating economic activities in the sectors of energy generation, waste management and car manufacturing.
- The assessment and verification section has been extended and made more straightforward to interpret and apply
- The climate risk rating has been removed for the requirements to be complied with by sovereign and sub-sovereign bonds and may instead be used as proof that a sovereign has developed a 2 degree carbon reduction trajectory.
- Three new international agreements have been included in the list of agreements that must be ratified by sovereign: the Cartagena Protocol, the Montreal Convention and the Minamata Convention.

5.3 CRITERION 4: Social and governance aspects

Previous (second) proposal for criterion 3: exclusions based on social and governance aspects

3.1 Exclusions applying to companies

The investment portfolio shall not contain equities, corporate bonds or use-of-proceeds bonds issued by companies excluded on the basis of social aspects or corporate governance practices as defined below. For fixed-term and savings deposit accounts, loans shall not be made to these companies.

A company is excluded on the basis of **social aspects** if it, throughout its business activities, does not comply with the following conditions:

- Respect[51] the protection of internationally proclaimed human rights and relevant domestic laws and regulations of the country in which they operate and from which they source raw materials. [UN Global Compact, OECD Guidelines for Multinational Enterprises]
- Ensure they are not complicit in human rights abuses. [UN Global Compact]
- Uphold the freedom of association and the effective recognition of the right to collective bargaining. [ILO Convention, UN Global Compact]]
- Ensure the elimination of all forms of forced and compulsory labour. [ILO Convention, UN Global Compact]
- Uphold the effective abolition of child labour. [ILO Convention, UN Global Compact]
- Ensure the elimination of discrimination in respect of employment and occupation. [ILO Convention, UN Global Compact]
- Abide by local legislation that addresses corruption, bribery and extortion, and work against corruption in all its forms, including extortion and bribery by formulating and operationalising adequate business policies. [UN Global Compact, UN Convention against Corruption]

A company is also excluded on the basis of **social aspects** if it derives revenues from following activities:

- Tobacco production or any tobacco-related activities at any stage from raw material to sale of the final products to consumers.
- The production and trade of weapons.
- Production or trade of any printed or digital material with pornographic content.
- Corporate activities which violate minorities' and indigenous communities' rights with reference to the World Bank's Social Safeguard Policies.

A company is excluded on the basis of **corporate governance practices** if they, throughout its business activities, do not have in place:

- corporate policies on social aspects and operational procedures necessary to embed compliance throughout the business activities;
- an up-to-date management system covering all business activities with the capability to identify, evaluate, prevent, mitigate and remediate existing adverse impacts or potential risks on social aspects;
- good corporate governance practices.

At a company level, exclusions apply to both transnational and other business enterprises, regardless of their size, sector, location, ownership and structure.

3.2 Exclusions applied to sovereign bonds

The investment portfolio shall not contain sovereign bonds issued by countries that:

- have not ratified the following international conventions on labour rights and corruption:

[51] Respect in this context means: Companies should avoid causing or contributing to adverse human rights impacts through their own activities, and address such impacts when they occur. It also means that companies should seek to prevent or mitigate adverse human rights impacts directly linked to their operations, products or services by their business relations, even if they have not contributed to those impacts.

- the eight fundamental conventions identified in the International Labour Organisation's declaration on Fundamental Rights and Principles at Work;
- ILO Declaration on Social Justice for a Fair Globalization;

- have ratified less than half of the 18 Core International Human Rights Treaties[52];
- are subject to EU or UN financial sanctions for special social violations;
- achieve a score worse than 38, when evaluated according to the Corruption Perception Index;
- produce, trade or possess controversial weapons that are subject to EU or international restrictions, including non-ratification of:
  - Chemical Weapons Convention,
  - Biological Weapons Convention,
  - Ottawa Convention (Ban on Anti-Personnel Mines),
  - Oslo Convention on Cluster Munition and Arms Trade Treaty), and
  - the Non-Proliferation of Nuclear Weapons.

Assessment and verification

The fund manager shall demonstrate to the Competent Body that following have been assessed, with respect to companies in which investments are held and/or the issuers of sovereign debt that is held:

- Excluded activities: The status of each country and company shall be checked against the exclusions list.
- Compliance of corporate policies on social aspects with social exclusions.
- Compliance of risk identification, evaluation, prevention, mitigation and remediation targets, as included in the management system, with corporate policies on social aspects.
- Compliance of good management practices to Corporate Governance (CoGo) codes and standards.

For use-of-proceeds bonds the EU GBS may be used as proof of compliance.

For large companies, reporting under the Non-financial Reporting Directive (2014/95/EU[53]) shall be accepted as basis for verification. Small and medium-sized enterprises (SMEs) shall disclose information about their social responsibility, human and labour rights and their anti-corruption policies, approved at the most senior management level.

Further to the initial verification by the Competent Body, the fund manager shall carry out assessment on compliance with social exclusions at least once per year and communicate any inconsistencies to the Competent Body. Furthermore, the Competent Body retains the right to perform random checks on compliance.

Third proposal for criterion 4: exclusions based on social and governance aspects

4.1 Exclusions applying to companies

The investment portfolio shall not contain equities, corporate bonds or use-of-proceeds bonds issued by companies excluded on the basis of social or corporate governance aspects as defined below. For fixed-term and savings deposit accounts, loans shall not be made to these companies.

A company is excluded on the basis of **social aspects** if, throughout its business activities, it does not comply with the following conditions:

- Respect[54] the protection of internationally proclaimed human rights and relevant domestic laws and regulations of the country in which it operates and from which it sources raw

[52] United Nations. *The Core International Human Rights Treaties and their monitoring bodies*. Oct 2019, https://www.ohchr.org/EN/ProfessionalInterest/Pages/CoreInstruments.aspx. Compliance can be checked using the United Nations Human Rights interactive dashboard, available at: https://indicators.ohchr.org/

[53] Directive 2014/95/EU of the European Parliament and of the Council. Available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0095&from=EN

[54] Respect in this context means: Companies should avoid causing or contributing to adverse human rights impacts through their own activities, and address such impacts when they occur. It also means that companies should seek to prevent or mitigate adverse human rights impacts directly linked to their operations, products or services by their business relations, even if they have not contributed to those impacts.

materials. [UN Global Compact, OECD Guidelines for Multinational Enterprises, UN Guiding Principles on Business and Human Rights, International Humanitarian Law]

- Ensures it is not complicit in human rights abuses. [UN Global Compact]
- Upholds the freedom of association and the effective recognition of the right to collective bargaining. [ILO Convention, UN Global Compact]. Only in reference to that point, if the excluded company is part of a holding that operates elsewhere, the other activities of the holding are not excluded subject of their compliance.
- Ensures the elimination of all forms of forced and compulsory labour. [ILO Convention, UN Global Compact]
- Upholds the effective abolition of child labour. [ILO Convention, UN Global Compact]
- Ensures the elimination of discrimination in respect of employment and occupation. [ILO Convention, UN Global Compact]
- Abides by local legislation that addresses corruption, bribery and extortion, and works against corruption in all its forms, including extortion and bribery by formulating and operationalising adequate business policies. [UN Global Compact, UN Convention against Corruption]

A company is also excluded on the basis of **social aspects** if it derives revenues from following activities:

- Tobacco production or any tobacco-related activities at any stage from raw material to sale of the final products to consumers.
- The production or trade of controversial weapons that are covered by the following international treaties:
  - Chemical Weapons Convention,
  - Biological Weapons Convention,
  - Ottawa Convention (Ban on Anti-Personnel Mines),
  - Oslo Convention (Ban on Cluster Munition)
  - and the Treaty on the Non-Proliferation of Nuclear Weapons.
- The production or trade of conventional weapons and/or military products used for combat if there is evidence of sales in countries under EU restrictive measures
- Corporate activities which violate minorities' and indigenous communities' rights with reference to the World Bank's Social Safeguard Policies.

A company is excluded on the basis of **governance aspects** if, throughout its business activities, it does not have in place:

- corporate policies on social aspects and operational procedures necessary to embed them throughout the business activities;
- an up-to-date management system covering all business activities with the capability to identify, evaluate, prevent, mitigate and remediate adverse social impacts.

At a company level, exclusions apply to both transnational and other business enterprises, regardless of their size, sector, location, ownership and structure.

4.2 Exclusions applied to sovereign bonds

The investment portfolio shall not contain sovereign bonds issued by countries that:

- have not ratified the following international conventions on labour rights and corruption:
  - the eight fundamental conventions identified in the International Labour;

    Organisation's declaration on Fundamental Rights and Principles at Work;

- ILO Declaration on Social Justice for a Fair Globalization;

- have ratified less than half of the 18 Core International Human Rights Treaties[55];
- are subject to EU or UN restricted measures (including sanctions);
- achieve a score worse than 40, when evaluated according to the Corruption Perception Index;
- produce, trade or possess controversial weapons that are subject to EU or international restrictions, including non-ratification of:
  - Chemical Weapons Convention,
  - Biological Weapons Convention,
  - Ottawa Convention (Ban on Anti-Personnel Mines),
  - Oslo Convention (ban of cluster munition) and
  - Treaty on the Non-Proliferation of Nuclear Weapons.

Assessment and verification

The fund manager shall demonstrate to the Competent Body that followings have been assessed, with respect to companies in which investments are held and/or the issuers of sovereign debt that is held:

- Excluded activities: The status of each country and company shall be checked against the exclusions list.
- Compliance of corporate policies on social matters with social exclusions.
- Compliance of risk identification, evaluation, prevention, mitigation and remediation targets, as included in the management system, with corporate policies on social matters.

For use-of-proceeds bonds, the EU GBS may be used as proof of compliance.

All companies shall disclose information about their social responsibility, human and labour rights and their anti-corruption policies, approved at the most senior management level. If data are provided by third party data providers, the methodology for obtaining these data and the used proxies, if any, shall be documented.

For large companies, reporting under the Non-financial Reporting Directive (2014/95/EU[56]) shall be accepted as basis for verification if it is sufficient to prove compliance with the social exclusions criterion.

Further to the initial verification by the Competent Body, the fund manager shall carry out assessment on compliance with social exclusions at least once per year and communicate any inconsistencies to the Competent Body.

If the fund manager receives information or identifies the existence of severe and/or systematic allegations in terms of conformity with social exclusions, then as a response the company shall be requested to develop within three months a plan and list of actions to resolve the issue. If the issue remains unresolved after 1 year, the respective assets shall be sold.

The Competent Body retains the right to perform random checks on compliance.

5.3.1 Rationale of the proposed criterion text

The need for a social exclusions criterion was imposed by the requirements laid down in Regulation (EC) 66/2010 of the European Parliament and of the Council on the EU Ecolabel. Article 6(1) of this Regulation specifies that EU Ecolabel criteria shall be based on the

[55] United Nations. *The Core International Human Rights Treaties and their monitoring bodies*. Oct 2019, https://www.ohchr.org/EN/ProfessionalInterest/Pages/CoreInstruments.aspx. Compliance can be checked using the United Nations Human Rights interactive dashboard, available at: https://indicators.ohchr.org/

[56] Directive 2014/95/EU of the European Parliament and of the Council. Available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0095&from=EN

environmental performance of products, taking into account the latest strategic objectives of the Community in the field of the environment, yet it also requires – in Article 6(3e) – that in determining EU Ecolabel criteria, where appropriate, social aspects also be considered.

Apart from the EU Ecolabel Regulation, the Taxonomy Regulation was also consulted to articulate the social exclusions criterion. Article 13 of the Taxonomy Regulation requires 'environmentally sustainable economic activities' to comply with minimum social safeguards. The review clause in Article 17 also refers to a potential extension to activities contributing to social objectives.

The first proposal for a social exclusions criterion was formulated to address societal concerns associated with sustainable investments considering the EU Ecolabel Regulation and stakeholders' opinions. Consequently, it was drafted accordingly and expressed in the First Technical Report. Further on, the criterion is updated reflecting the outcomes of the 1st AHWG meeting and the consultation process which has followed. In that frame, relevant stakeholders' suggestions have been considered, additional research carried out to tackle any remaining issues, and social exclusions were revised at a company and country level. At the national level, the social exclusions refer to sovereign bonds while at the company level the investment portfolio may contain diverse assets as defined in the scope of this study.

5.3.2 Outcomes of the 1st AHWG meeting and main changes in TR2

Feedback received on TR1and further research conducted by JRC can be found in the previous version of the report (TR2).

In the frame of the consultation process, there were comments referring to specific features of the social exclusion criterion which are focusing on

- The term '**Ethical'** is not considered as a social exclusion requirement due to the subjectivity of the term and the difficulty to reach consensus on its definition.
- **Weapons** and as to whether the criterion shall only refer to controversial weapons and how is this term defined. JRC suggested restrictions that go beyond the production of weapons and also cover their trade. In terms of controversial weapon, TR2.0 excludes their production, trade and possession and provides a list of treaties that are associated with them. In this version
- Exclusions requirements on **corruption and bribery** at corporate level. Stakeholders stated that this is subject of further review and that the corruption perception index at sovereign level needed further research. JRC reviewed this section. Hence, the corruption perception index is updated while a compliance score of 38 was suggested. Moreover, corporate policies against corruption and a respective management system to address any corruption attempts are required in the TR2.0, which shall be approved by the highest management level of the company. At corporate level, anti-bribery requirements are set similar to those of corruption. Nevertheless, at sovereign level, JRC could not identify a bribery metric that is officially approved and implemented by the EC.
- The TR2.0 excludes investments in **tobacco-related activities** due to the respective EU policies against smoking and its adverse health effects.
- The stakeholder review revealed that the requirement on **human and labour rights** need to consider international treaties and local regulations and that existing SRI labels could serve as a source of inspiration. On this topic JRC has updated the requirements so they refer, in the TR2.0 to all business operations undertaken by the company and not only to revenues from specific activities. Moreover, corporate operations should respect minorities and indigenous communities' rights. On top of that, the list of relevant treaties has been reviewed and updated. JRC has also reviewed human rights

exclusions at sovereign level by suggesting a minimum number of relevant treaties ratifications.

- The consultation identified a need to review and strengthen **verification**. Reflecting on this, the JRC has identified ways to facilitate assessment and verification of the social exclusions criterion at a corporate level by suggesting the adoption of policy statements and the implementation of due diligence procedures as means of proof.
- There were contradictory opinions as to whether the social exclusions shall be aligned with the **requirements set in the EU Taxonomy** or shall go beyond this stringency level, and if local regulations shall also be considered. TR2.0 suggest social exclusions beyond those of the EU Taxonomy as these are referring to minimum social safeguards only. Yet, the EU Ecolabel went beyond that by setting social exclusions that extend beyond minimum safeguards. In doing so, the EU Ecolabel acts as a label of excellence and provides protection from socially negative impacts and adverse effects.
- Many of the stakeholders asked if possible, the exclusion requirements to not refer to **governance issues** such as poor corporate management and/or poor human capital development as these issues are not uniformly defined across board and potential reference to these matters could raise controversies. Additionally, verification can be extremely challenging. On the opposite, there were stakeholder supporting the idea of setting requirements for governance matters as that could increase transparency on business policies and improve decision-making whereas any potential mismanagement and reputation risks could be avoided. JRC suggested to include a requirement on good governance to prevent/address broader social issues that could emerge in practice, although not to develop a separate criterion on governance. That is in alignment with the Regulation (EC) 66/2010 of the European Parliament and of the Council on the EU Ecolabel does not explicitly refer to governance criteria.

5.3.3 Outcomes of the 2nd AHWG meeting and the stakeholder consultation

This part of the report describes the stakeholders' comments which were received after the 2nd AHWG meeting with reference to social exclusions. In total, the JRC received 61 comments from 27 stakeholders. The comments were clustered into specific categories and are described below. Based on this, the JRC has identified needs for further research.

Stringency level of social exclusions

Stakeholders kept on commenting that the proposed social exclusions are very detailed and restrictive and believe that only very few funds in the market will be eligible for the EU Ecolabel. Therefore, it is suggested to strike a balance between the ambition level of social exclusions and the necessity to encourage the transition towards a climate neutral EU Economy by 2050. Following that, it is proposed to align requirements on social aspects with the minimum social safeguards as described in the EU Taxonomy. Moreover, it is argued that since the EU Ecolabel aims at promoting environmentally sustainable investments, it shall not be confused with labels that aim at identifying and awarding excellence in aspects beyond environmental sustainability.

Stakeholders have suggested that strict social exclusions fit better in a label that mainly focuses on social aspects and that social exclusions should be supported by a respective EU Taxonomy on social matters. Some stakeholders also suggested to define a minimum of mandatory social exclusion and to adopt a set of recommendations for other social aspects. In the case that the latter is met, it could add points on a point-based evaluation system. It is also commented on the need to define a partial social exclusions requirement as otherwise the investment portfolio could be further restricted.

Concluding, some stakeholders highlighted specific requirements of the exclusions such as e.g. the freedom of association and the effective recognition of the right to collective bargaining. It is argued that national laws prevail, and in this case the affected companies cannot act differently.

Exclusionary requirements on weapons

Stakeholders made various comments regarding weapons. For instance, they have proposed to exclude production and sale of controversial weapons entirely, but to allow for including investments in production or trade of conventional weapon. Following this, some stakeholders highlighted that conventional weapons are essential for the security of the citizens, and therefore they recommended aligning the exclusion with the one on sovereign bonds. Some stakeholders suggested addressing the issue of parallel activities of the defence industry, such as, e.g. software development, which might not always be related to weapons. In another direction, it is argued that the criterion shall also cover military products, which can be used in combat, their key components and encompass any activities that can be directly associated with weapons, such as repairs, maintenance, upgrades etc.

Issues relating to corporate governance

Stakeholders commented that there is inherent subjectivity in defining good corporate governance, and there are also divergences on the term across countries. It was commented that an attempt to define good corporate governance practices could create controversies due to the lack of harmonisation of existing guidelines on this subject matter.

Social exclusion on sovereigns

It is argued to treat differently sovereign bonds for refinancing a country's debt and green bonds issued by a sovereign for financing environmentally sustainable projects. Some stakeholders suggested that the social exclusions list for sovereigns is long and therefore, its practicality is questioned. Finally, it is recommended to exclude sovereign bonds of countries that apply the death penalty.

Assessment & verification issues

In terms of assessment and verification, stakeholders asked on how companies, which have violated an international treaty, but take measures to correct it, are treated and how the EU Ecolabel envisages to deal with allegations on violating social exclusions. It is also highlighted the difficulty, given the ESG information currently disclosed, for companies do gather data on social matters. Further on, the credibility of ESG information was questioned as well as the use of proxies by obtaining data on social aspects.

It is stated that often asset managers do not have the means to verify whether disclosed or provided data on social issues are correct. It is also commented that the sample check process, carried out by the Competent Bodies, must be quite extensive, in order to create strong incentives for fund managers to address issues voluntarily. Moreover, they suggested that reporting should be carried out annually and reports shall be publicly available.

Other comments of relevance

There are also comments on specific social aspects that could not be allocated to the existing clusters, and therefore a new cluster is created for this specific comment. In the written consultation stakeholders suggested testing the impact of social and governance exclusions on the eligible universe of the assets under management. Moreover, it is argued that under the criterion proposal (TR2.0), it is unclear whether the social and governance exclusions will have to be applied along the whole supply chain or they only cover core business activities. Another

comment referred to local laws and if they prevail in the case of no conformity with international treaties or standards. The suggested score 38 for excluding sovereigns in terms of corruption is questioned as well. Concluding, stakeholders commented on the definition of 'pornographic content' which is quite vague.

5.3.4 Further research and main changes in the second proposal

Stringency level of social exclusions

In the 2nd AHWG meeting, stakeholders have strongly commented, to focus on the environmental dimension of the EU Ecolabel and to align social exclusions with the EU Taxonomy social safeguards. However, Art.6.3 of the EU Ecolabel Regulation requires considering where appropriate social aspects. Given the retail investor perceptions in this domain, it was deemed to be important - also based on stakeholder feedback in the 1st AHWG and in writing on 1st Technical Report - that such issues should be addressed.

The legal framework of the Taxonomy Regulation is different to the EU Ecolabel, and only deals with minimum social safeguards. However, ESG data providers can already realise data that extend beyond those required in the EU Taxonomy. Hence, aligning social requirements with those in the EU taxonomy could cause harm to the EU Ecolabel reputation.

Moreover, the EU Taxonomy is a tool for incentivising disclosures at the activity level, whereas the EU Ecolabel aims at best-in-class retail financial products. Taking into the account all the above, JRC keeps on suggesting that the updated criterion shall include more enhanced social exclusions than the EU Taxonomy's minimum social safeguards.

The TR3.0 cannot consider the option of setting up a minimum of mandatory social exclusions and cover additional social aspects on an optional basis, which, nevertheless, could increase the credibility of the EU Ecolabel fund. Potential adoption of that approach is restricted by the pass/fail structure of the EU Ecolabel.

Partial exclusions on social aspects are also not adopted due to the potentially significant and irreversible consequences of social requirements violations. Therefore, it is suggested the criterion to maintain zero tolerance on social exclusions.

In the specific case which refers to the right for collective bargaining that could be prohibited due to local regulations, the TR3.0 suggest the following. Although the company cannot be held responsible, the international treaties prevail local laws, and therefore this company is excluded. However, if the company is part of a holding, which operates elsewhere, the other entities of the holding are not affected, subject to their compliance with the social exclusion criterion.

Exclusionary requirements on weapons

In general, weapons are treated based on stakeholders' preferences and the suggestions made in the 1st stakeholder meeting. The TR3.0 keeps on excluding production, trade and possession of controversial weapons at a company and sovereign level. As to conventional weapons, countries are not excluded, considering the necessity to have in place defence policies and support civil protection. However, companies that are involved in production and/or trade of conventional weapons and military products for combat will be excluded if there is evidence of sales in countries under EU restrictive measures. Countries under EU restrictive measures can be obtained from the respective EU map[57].

The TR3.0 maintains the exclusionary requirement for investments associated with controversial weapons at a corporate and sovereign level. In terms of conventional weapons at a

[57] Countries under EU restrictive measures available at: https://sanctionsmap.eu/#/main

corporate level, it sets the condition of not selling conventional weapons and other military products for combat to countries which are in the EU list of countries under restrictive measures.

Issues relating to corporate governance requirement

The two previous versions of the technical report consider corporate governance aspects, based on recommendations of some stakeholders, although the EU Ecolabel Regulations 66/2010 does not explicitly refer to these aspects. Additionally, in the 2nd stakeholder meeting and the written consultation, many stakeholders referred to the inherent subjectivity of governance aspects. They have pinpointed the potential divergences that might arise in defining good corporate practices at a national level, and the diverse interpretations of the term across different countries. Therefore, the TR3.0 sets requirements on governance aspects only if they are closely relating to social issues. It is proposed that the possibility of criteria with a broader focus on good corporate governance are explored as part of the first revision of the criteria.

Assessment and verification issues

In terms of assessment and verification the quality of disclosed data and the relevant information, which is mainly received from ESG providers, are the main issues along with a method to address allegations on potential breaches of conformity. The JRC has further explored a way to consider allegations while considering how national labels address this topic and concluded in the updated form of criterion 4. JRC has also investigated the existence of potential proxies that can be used to provide data. It also acknowledges that third party data providers may use different methodologies and proxies to assess social aspects and that the quality of disclosed data is difficult to be assessed. For the time being, it is the responsibility of companies to disclose info that accurately reflects the subject matter. Additionally, the EU Ecolabel fund needs to cite the ESG data provider.

Other comments of relevance

The JRC has curried out additional research to address specific comments not assigned to one of the existing clusters of social aspects as follows.

The corruption perception index is updated to score 40. This score excludes more than 50% of the countries covered in the list of countries according to Transparency International[58]. This score is suggested as it indicates a sufficient level of anti-corruption while the pool of eligible sovereigns is not restricted substantially.

To the best of the authors' knowledge, currently, there is no published study on how social exclusions affect the eligible universe. That would be challenging to access due to the use of different methodologies and the application of various proxies for obtaining data on social aspects.

The term business activities refers to all operations along the supply chain that a company is involved in. Business activities are not necessarily associated with the production of goods only.

The application of international standards and treaties prevails local laws as the former are the outcomes of a consensus at an international level on how issues on social matters can be addressed.

The TR3.0 suggests dropping the requirement of excluding investments in stocks relating to 'pornographic content'. JRC acknowledges the vague definition of the term. Additionally, this requirement is dropped to stick more on a green label and to come up with a pragmatic social exclusion list.

[58] Transparency International list of countries available at: https://www.transparency.org/en/cpi

5.4 CRITERION 5: Engagement

Previous (second) proposal for criterion 5: Engagement

The fund manager[59] 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.

The fund manager shall engage regularly with at least half of the companies that have less than 50% green activities.

Engagement activities shall 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 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 EU-Taxonomy-compliant;
- reduce and stop economic activities that are not EU-Taxonomy-compliant by selling or closing those activities;
- 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).

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 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.

[59] For unit-linked insurance products this policy shall be obtained by the insurance company from relevant underlying investment fund managers.

Third proposal for criterion 5: Engagement

5.1 Engagement policy

This criterion applies to investment funds and life insurance products with a general fund.

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

- Objective: How the environmental objectives of the EU Taxonomy will be used as the basis on which to engage with companies including, as a minimum, contributions to one of the six objectives;
- Strategy: How they plan to target and engage with companies to grow their green revenue share and their market share for environmentally sustainable economic activities in order to contribute to the medium to long-term performance of their assets.
- Methods: How they seek to use their influence, including by exercising their voting rights, increasing their influence by working with other shareholders, using differing intensities and frequencies of dialogue with investee companies and using other means , such as campaigns, to achieve their objective(s).
- Monitoring: The means of regular monitoring and reporting on the outcomes of their engagement with companies.

5.2 Exercising voting rights

The fund manager shall show how they exercise their voting rights and other rights attached to shares in order to fulfil the objectives of their engagement policy. They shall show how they use these rights to try to orientate those companies in the portfolio with <20% green revenue to:

- Achieve alignment of company strategies with the environmental objectives of the EU Taxonomy ,
- Achieve alignment of investment strategies with the need to grow green revenue and market share for environmentally sustainable economic activities.

They shall provide the following information to show how their rights have been used in relation to resolutions addressing these two areas:

- The numbers of resolutions raised, either singularly or in co-operation with other shareholders.
- How they have cast votes in the general meetings of companies in which they hold shares.
- Those cases where proposals were carried.

5.3 Dialogue with investee companies

5.3.1 Requirements for UCITS funds

The fund manager shall actively regularly engage at management level with at least one company or 10% of companies in the portfolio (*whichever is greater*) that are 'companies investing in transition' according to the requirements of criterion 2 *or* which have <20% green revenue and have responded positively to offers of management support to make a transition. These companies shall be selected from amongst those with the lowest % green revenue in the portfolio.

5.3.2 Requirements for retail AIF funds

The fund manager shall actively engage at management level with at least one company or 10% of companies (*whichever is greater*) that qualify as: 'companies investing in green growth' according to criterion 2. These companies shall be selected from amongst those:

- with the most significant prospects for % green revenue growth in the portfolio,
- or that are considered to not yet demonstrate their growth potential or are considered to require support to realise their potential

5.3.3 The engagement process used to achieve outcomes

Once engagement with a company has been initiated the process followed and the progress achieved shall be monitored and reported on. The following information shall be provided for each company:

- The specific topics raised via engagement with each company in planning strategic activities and investments within a specific period of time,
- The goals and targets discussed and raised with each company to achieve environmental objectives, which are as a minimum suggested to be measured based on:
  - Commitments made to green CapEx over a minimum 5 year period and associated plans to raise capital,
  - Targets set and measures taken to achieve projected increases in green revenue over a minimum 5 year period,
  - Targets set and measures taken to achieve growth their market share in key market segments relating to the economic activities that they carry out over a minimum 5 year period.
- The intermediate steps or milestones to achieving these goals and targets, including the development of plans and investment strategies,
- The frequency and means of ongoing communication and dialogue with the company, such as board meetings, analyst conferences, meetings with business field managers, or controlling tools,

In addition the measures that will be taken by the fund or asset manager shall be reported in the case that a company:

- deviates from or does not meet the proposed goals and targets.
- is considered to require a change in how the company is managed of in its investment strategy in order to meet proposed goals and targets.

Assessment and verification

The fund manager shall provide the verifier with the following information:

1. The fund or asset managers engagement policy structured to clearly address the points in section 5.1
2. Documentation of how their voting rights have been used, including the tracking of resolutions raised and proposals made by the fund manager or product provider, as well as their voting record on proposals and resolutions of relevance to the engagement policy.
3. Documentation of which companies have been engaged with, as well as the information as specified for each point in section 5.3.3,

Ongoing reporting of progress against the goals and targets established with each company engaged shall be provided on a 12 month basis to the Competent Body and also made available in the public domain. Any regulatory restrictions on engagement activities in specific EU or international jurisdictions will be taken into account in the assessment and verification.

5.4.1 Rationale of the proposed criterion text

Engagement, as a strategy, represents a means that can be used to propose, request and even drive improvements in the environmental performance of a company, as suggested by some stakeholders. In addition, existing market practices support the inclusion of engagement requirements in the Ecolabelling criteria. For example, the criteria of the Nordic and the Austrian labels include engagement as a separate criterion. Because the EU Ecolabel is intended to focus mainly on environmental performance, and social aspects are already addressed under the proposal for criterion 4 on social exclusions, this criterion is proposed as focussing exclusively on environmental performance. It is also now designed to complement:

- the use of the EU Taxonomy to verify the thresholds proposed under criterion 1, and
- the requirements set out for *'companies investing in transition'* and *'companies investing in green growth'* under criterion 2.

The most recent existing market studies (EUROSIF, 2018 SRI Study) indicate that the employment of sustainable investment strategies continues to grow in the market. Engagement, including the exercising of voting rights, has increased, showing that there is a greater commitment of investors to work with companies (more than a 14% increase). Moreover, literature provides evidence that shareholder engagement can be an effective mechanism through which investors can seek reforms that improve the quality of company activities and/or grow shareholder value.

In summary, the main changes with respect to TR2 are as follows:

- In-line with the approach taken in the Shareholder Rights Directive and by the engagement criteria in existing labels, the criterion have been restructured to focus in turn on 1) the overall engagement policy, 2) use of voting rights and 3) dialogue with companies in which shares are held.
- The requirement to provide a documented engagement policy has been restructured to make it more methodical, focussing in turn on the objective, strategy, methods and monitoring.
- The overall objectives of engagement have been aligned with the environmental objectives of the EU Taxonomy and the monitoring of outcomes, linked to the main metrics with which to monitor and track progress at company level have, been defined in accordance with the revised proposals for criteria 1 and 2 – namely % green revenue, % green CapEx and the % growth in green revenue.
- The companies in the portfolio that shall be the target for exercising voting rights shall be defined based on <20% green revenue, reflecting comments that those companies are likely to require more re-orientation.
- A distinction has been made in how companies shall be targeted for dialogue based on fund type. UCITS shall focus on companies investing in transition, given their likely use of this criterion 1 requirement, and retail AIFs are required to focus on companies investing in green growth as they must meet in criterion 1 more ambitious threshold for portfolio green revenue.
- The number of companies in the portfolio that shall be targeted for dialogue has been set at conservative level (1 company or 10% of companies, whichever is greatest) reflecting other label criteria and feedback from stakeholders. This will reduce the number of companies to enter into dialogue with, reflecting the resource intensity of dialogue.
- A specific structure for the engagement process that must be followed and reported on, has been updated and restructured, now including the topics raised, how goals and targets will be measured, the intermediate steps or milestones to achieving these goals and targets, and the means of ongoing communication and dialogue with the company.

5.4.2 Outcomes of the 1st AHWG meeting and main changes in the second proposal

Feedback received on TR1.0 and further research conducted by JRC can be found in the previous version of the report (TR2.0).

The criterion on Engagement was added to the EU Ecolabel set of criteria in the second technical report. This originated from various comments received by stakeholders that

engagement was an important strategy used by fund managers and asset managers to influence company's activities.

5.4.3 Outcomes of the 2nd AHWG meeting and stakeholder consultation

This section summarises stakeholders' comments received after the 2nd AHWG meeting. The JRC received in total 63 comments on engagement from 27 stakeholders. The major comments have been clustered and are summarised below. Based on these comments, the JRC identified the needs for further research which resulted in the revised criterion 5 on engagement as presented in this report.

Engagement strategy

It was commented that tabling climate resolutions at Annual General Meetings of shareholders may not be an effective activity or appropriate for the EU ecolabel; it should rather be a last resort. Evidence was submitted that outcomes are uncertain and that in many cases the objectives are not sufficiently aligned with medium to long term environmental policy objectives such as carbon reduction trajectories. Moreover, it was mentioned that the ability to make proposals at annual general meetings or for shareholders to 'act in concert' may be restricted in some Member States.

Stakeholders' proposals for the objective of the criterion can be divided into two types:

Pro-active options:

- To grow market share/value of already green companies

- To target the most polluting companies (<20-30% green) to foster their transition

- Collective engagement in coalition with other shareholders

Reactive options:

- To require follow-up engagement as a response to company allegations

- To set timescales to address controversies/bad practices before divestment

In relation to different types of fund strategies, it was noted that fund managers may hold shares in some companies for the long term and use engagement to encourage changes at a company level rather than using the threat of divestment.

A long-term perspective on engagement

Reference was made to engagement in order to build shareholder value, carried out horizontally at the level of the holdings of an asset (and not fund) managers who work with companies who share a long-term perspective. This means that:

- In some labels the rotation/turnover rate of ownerships has been restricted to promote a longer term approach
- Effective engagement may not be implemented just to meet the EU Ecolabel criteria, as it may be enacted as a policy at asset management level.

The Shareholder Rights Directive was referred to specifically as an important regulatory reference point.

Engagement objective

Stakeholders commented that engagement is both resource and time consuming. A clear focus should be set on quality and not quantity of engaging activities. Moreover, it was noted that the TR2 version of the criteria sets a requirement of engaging with companies with <50% green, without considering that some of these companies may carry out 'grey' non-taxonomy activities, therefore being impossible to foster towards transition. It was suggested not to set a specific threshold, as it may result in resources being expended engaging with companies that are not necessarily able to grow significantly their green revenue share. If any thresholds were to be set, it was also suggested to target 10% of the least green assets managed by the fund.

Impact of engagement

Stakeholders asked for monitoring/reporting on the end result of the engagement activity. This could be in terms of:

- the 'outcome' from engagement, which could be distinct to each company, or
- in terms of 'impact' of engagement on companies, expressed in terms of specific and quantifiable outcomes.

It was emphasised that care should be taken in referring to 'impact' given the limit evidence showing an investor impact in relation to ESG issues.

Assessment and verification method

Stakeholders commented that the assessment and verification should be made more specific, also in terms of the documentation to be provided to the competent bodies.

5.4.4 Further research and main changes in the third proposal

Based on the themes that emerged from discussions at the AHWG2 and in comments submitted to the TR2.0 public consultation, further research by the JRC has focussed on the following topics:

- A review of the engagement criteria of existing ecolabels,
- Specifying an engagement strategy
- Long-term engagement as promoted by the Shareholder Rights Directive
- Defining objectives and measuring the outcomes
- Exercising voting rights
- The investor impact of engagement
- Assessment and verification method

Review of the engagement criteria of existing ecolabels

During the AHWG2, views on the criteria were provided that reflected a range of experience with the framing of engagement criteria in existing ecolabels for financial products. The criteria of four existing ecolabels that address engagement have therefore been reviewed and the findings summarised in *Table 10*. The main commonalities between the criteria are as follows:

- The target of the criteria is the fund provider or manager, who is the one that shall demonstrate that they have the strategies in place or carry out the engagement.
- They all have a focus on shareholder's exercising their voting rights at AGMs. This is supported by requirements on fund managers to provide guidelines on the exercising of these rights.

- They all have to some extent a request for a formal policy on engagement activities, together a description of the method – which can include resources, tools, specific modes of communication, time planning, goals - with the aim of achieving clear improvements in an issuer's activities or performance. Bilateral or 'structural' contact with companies is supported. The targeting of voting strategy and policy is quoted as being targeted at a percentage of 10% or 50% of the companies' holdings. There should be transparency on the voting record.
- The intensity and frequency of engagement is an important factor. In the case of one of the national labels, regular engagement with 5-10% of the companies in which equities are held is required.
- The reduction pathway for carbon emissions is in one of the requirement linked to engagement goals for one label. In another labels, the exclusion of certain activities is linked to a requirement for an engagement policy with the aim of accelerating the transition of energy companies to a low carbon business model.

It can be seen that all address a combination of voting and engagement. These two areas should therefore be considered for the criterion n engagement, noting that in the comments received, there was a tendency towards direct engagement being a preferred strategy. In relation to direct engagement, there are a number of operational references from the other labels that can be considered for inclusion, as they are based on implementation experience.

The most notable difference in how engagement is addressed by these labels, is at the level of the whole criteria set, being, in the majority, a supplementary option to obtain more points of credits. In the case of the EU Ecolabel it is proposed as being a mandatory criterion.

Table 10 - Review of the engagement criteria of existing ecolabels for retail financial products

Label	**Summary of criterion on engagement**	**Comments**
FNG Label (Germany)	<u>Dialogue Strategies</u> Aims at assessing how fund providers raise issuers' awareness of sustainability. The following aspects are assessed: – (only for equities) Fund provider's guidelines for the exercise of voting rights and own practices which clearly address sustainability issues, the publication of a voting report, the support on sustainability-related shareholder proposals. – Engagement processes with issuers, in order to achieve clear improvements in an issuer's ESG performance. A formal policy on engagement activities must be in place, describing: planned goals, intermediate steps (analyst conferences, meetings with business field managers, controlling tools), outcome on contribution to improve an issue's ESG performance with at least yearly public reports.	The label includes two sets of criteria: a) Minimum requirements; b) Grading model. Based on the final score, 4 grades of the label are possible. The "dialogue strategies" criterion is among the optional criteria, and weights 25% of total score.

Austrian ecolabel	Exercise of voting rights/voting (3 points) Exercise of voting rights, voting at general assemblies, publication of the result Engagement (3 points) Structural contact to enterprises, demonstration of need for action and approaches to solutions, publication of the result Reduction path of the carbon footprints or carbon risks (5 points, only if in combination with engagement) Measurement of the carbon footprints /risks + at least 4 years reduction goal and annual targets, publication of the result.	Included as additional bonus points, in order to reward strategies which create additional and/or supplementary sustainability benefits
Nordic Swan	Regular voting (max 2 points) The fund manager has a clearly written voting policy and strategy for at least 10% or 50% of the holding, promoting ESG-related issues, and reports on the voting policy and strategy. Engagement and company dialogue The fund manager regularly engages with at least 5% or 10% of its holding companies in order to address ESG issues, concerns or performance. He must adopt a clear and systematic method, select clear and specific ESG-related goals, set up a strategy timeplan, describe the resources and tools expected to be used, report on the achievements.	The criterion on engagement is part of the minimum requirements to be fulfilled to obtain the label. The regular voting criterion contributes additionally, with a point system.
FebelFin (Belgium)	Corporate engagement and shareholder action. The product manager engages in a dialogue with the companies in which it invests and makes use of its voting rights at general meetings. A detailed engagement report must be published.	Optional requirement: Corporate engagement and/or shareholder action is encouraged as a strategy. It is mandatory only for the non-renewable energy and electricity utility sector

Specifying an engagement strategy

Whilst in the TR2.0 reference was made to literature analysing the effectiveness of the engagement strategies of ESG funds, a broader review of literature reveals a more extensive focus on investor management practices to grow shareholder value. Research from the EU and the USA points to the following conclusions that could be taken into account when specifying engagement strategies [60]:

- Shareholder influence: The asset or fund manager will have a variable level of influence they can wield depending on the extent of the shareholdings. Traditionally institutional investors have held controlling shares whereas 'portfolio investors' (equity, mixed and bond funds), and in particular diversified index funds, tend to have smaller shareholdings spread across many holdings.
- AGM resolutions: Proxy resolutions can be proposed but tend to have an advisory rather than a mandatory status, so their effectiveness and certainty of outcome varies.

[60] Martin,R, Casson,P.D, Nisar,T.M, (2007) *Investor engagement – Investors and management practice under shareholder value*, Oxford University press.

Moreover, depending on the local regulations the ability to propose additional resolutions may be restricted.

- Collective action: By co-ordinating action, investors can be more effective in seeking support for policy or strategy proposals and in seeking to influence the management of companies. Action can target activities that investors do not approve of or concerns about performance. The channels can range from contact with the company directors to requisitioning of EGMs. Without collective action there is also some evidence that the management of companies can play investors off against each other.
- Passive versus active strategies: In terms of the broader regulatory context, it is important to make a distinction between passive and activist shareholders. This is because, depending on the local regulations, activism may be curtailed to a greater or lesser extent. For example, in the USA shareholders are restricted in their ability to nominate or elect directors.

The potential influence of a shareholder appears to be a decisive factor in shaping strategies.

Discussions by the JRC with fund managers of specialist thematic environmental funds that have holdings mostly in small capitalisation and unlisted SME companies, suggest that, particularly in the case of the latter, the fund manager can have substantial shareholdings in companies and this can enable them to exert direct influence on their management. This can similarly be the case for large asset managers who hold long terms positions in companies and construct portfolios for fund managers, including institutional investors. These asset managers can play a decisive role in the support for company resolutions [61].

Long-term engagement as promoted by the Shareholder Rights Directive

In the EU, Directive (EU) 2017/828 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (the Shareholder Rights Directive)[62] provides the regulatory context for the development of engagement strategies. It legislates for transparency in how asset managers make investment decisions, which in turn provides a potentially useful framework for the engagement criterion.

The Directive focusses specifically on the need for investment decisions to be based on an evaluation of the medium to long-term performance of the companies in which shares are held. It also focusses on ensuring that *'intermediaries facilitate the exercise of the rights by the shareholder, including the right to participate and vote in general meetings'* ,and in Article 3g sets out the following requirements for institutional investors:

- The development and public disclosure of an engagement policy that describes how they integrate shareholder engagement in their investment strategy. The policy shall describe how they monitor investee companies on relevant matters, including:
  - strategy
  - financial and non-financial performance and risk,
  - capital structure,
  - social and environmental impact and corporate governance,
  - conduct dialogues with investee companies,
  - exercise voting rights and other rights attached to shares,
  - cooperate with other shareholders,

[61] Majority Action (2019) *Climate in the board room – how asset manager voting shaped corporate climate change action*, USA.
[62] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement

- communicate with relevant stakeholders of the investee companies, and
- manage actual and potential conflicts of interests in relation to their engagement.

- The annual public disclosure of how their engagement policy has been implemented, including:
  - a general description of voting behaviour,
  - an explanation of the most significant votes and the use of the services of proxy advisors.
  - how they have cast votes in the general meetings of companies in which they hold shares.

Although the form of implementation in each Member State will depend on how the Directive has been transposed, these requirements provide a context for an EU Ecolabel criterion focussed on engagement.

Defining objectives and measuring the outcomes

Based on the discussions and input from stakeholders, there is the need to link the criterion to clear objectives and outcomes. Based on feedback from asset managers, this could work at three levels:

1. in defining horizontal strategic objectives at the portfolio or asset management level,
2. at the level of individual company activities and their strategic investment plans, and
3. at the level of raising issues with other shareholders in the cases where individual influence is limited.

In the case of the first point, it is important to take into account that such objectives may be set across assets that are managed rather than at a specific product level.

ESG rating agencies have set in place methodologies to systematically perform and classify their engagement activities. Often, these agencies periodically publish an engagement report which summarises the engagement activities, including the information on the companies involved, the issue(s) at stake, the objectives targeted, the methodology used and the intermediate/final outcome. Additional information may include which sustainable development goal is relevant to the engagement activity, the timeline of the engagement, and the statistics of the dialogues.

One noticeable message from reviewing the engagement report of one selected ESG rating agency is that engaging with companies could take 6-7 years to achieve a specific engagement objective. This means that for measuring the success of an engagement activity, the time frame may exceed the validity period of the EU Ecolabel. Also, it appears that, at least in the case of ESG engagement, the majority of the engagement activities are initiated as a response to allegations, violations or accuses – a reactive engagement response.

An important limitation of engagement is the difficulty to benchmark its effectiveness, as there is not a broadly acceptable methodology nor a baseline to do so. The most effective forms of dialogue appear to take place at company's management level, with goals and objectives being set that are specific to each company and their financial position. This means that in practice, progress is tracked at a very granular company level and in relation to:

- strategic commitment,
- risks and opportunities,
- investment plans, and
- the quality of the management.

A way forward could be to adopt, as an engagement metric, the proportion of successfully realised engagement actions measured against the total actions undertaken in terms of

improving environmental aspects or shifting the business strategy towards environmentally sustainable activities. A classification of successful outcomes could be useful, e.g. a change in strategy with a commitment in CapEx would be an important success.

Exercising voting rights

Whilst the use of voting rights and the proposal of resolutions at AGMs has traditionally been the focus for ESG engagement, it is unclear how effective this strategy can be in achieving strategic change and stimulating green investment. Evidence suggests that two key areas of weakness would need to be addressed:

1. the setting of strategic objectives that are aligned with the medium to long-term EU and international environmental policy objectives.
2. alignment and consistency in voting, either directly or by proxy, with a sustainable investment policy that has clearly defined objectives.

In relation to the first point, evidence submitted by the 2 Degrees Investing Initiative suggests that the majority of resolutions proposing climate related targets did not have sufficient ambition (see *Figure 13*). In relation to the second point, analysis by the US NGO Majority Action suggests a wide disparity in the voting records of leading asset managers, although the context and explanation for such a disparity was not analysed in detail (see *Figure 14*).

Figure 13 - Support for climate related resolutions with a <2°C pathway
Source: 2 Degrees Investing Initiative (2020)

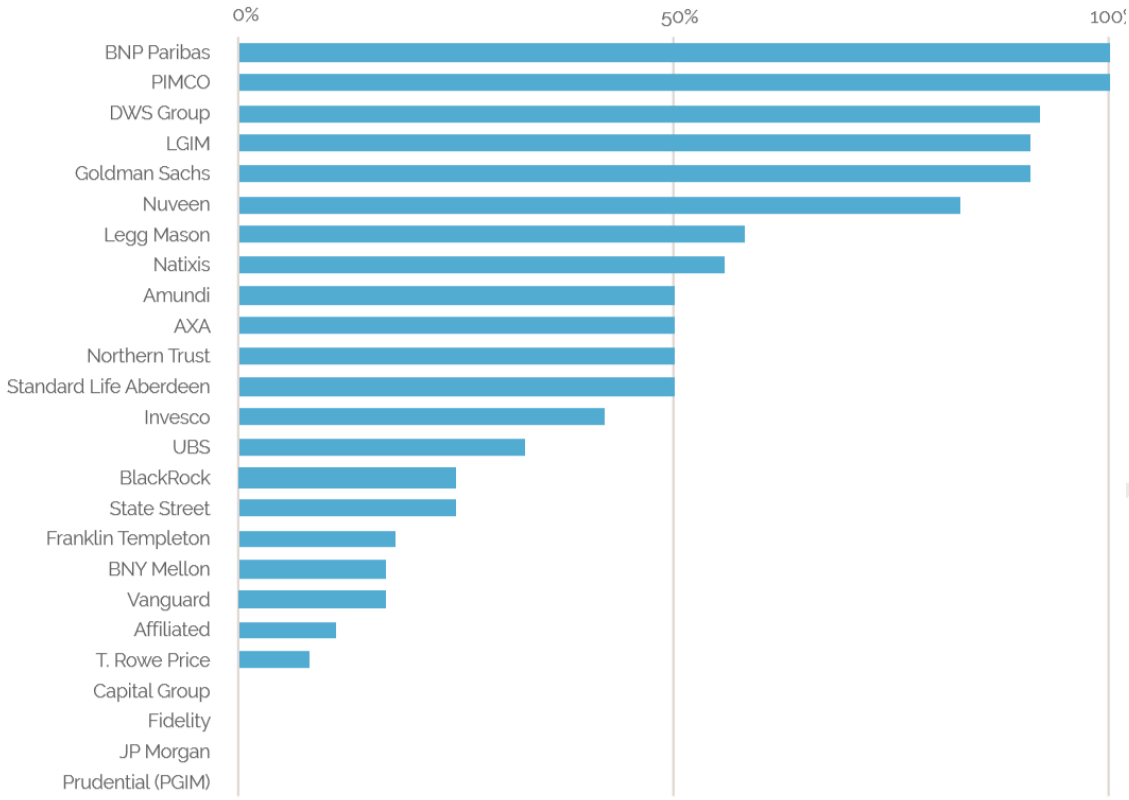


Figure 14 - Percent of resolutions on climate risks voted in favour, by asset manager, Source: Majority Action (2019)

The investor impact of engagement

The research summarised in the TR2.0 showed that there was evidence of investor impact on companies using active engagement strategies. The existence of more research evidence of investor impact in this area is understood to be linked to the fact that it is easier to study the causal effects. However, this conclusion should be treated with caution because the success achieved was depending on three main factors [63]:

1. The cost of the reform being requested: Requests relating to environmental issues had the lowest success rate, attributed to the type of reforms tending to entail greater costs.
2. The extent of the investors influence: The larger the shareholding the greater the chance of success. Groups of investors and large international asset managers can also exert greater influence.
3. The company's level of ESG experience: Previous compliance with ESG requests and/or high ESG ratings improve the success rate.

The probability of success of engagement is observed to be negatively correlated with the importance (or impact) of a proposed reform/measure. Thus, most successful engagement actions concern small changes, such as improvement of reporting requirements.

A review of the findings from Koelbel et al (2019) also emphasises that change will tend only to be implemented with the support of a company's management and not directly by the investor due to limitations of its influence. In addition, there are also legal boundaries to the extent an investor can influence corporate strategy and drive change, which vary by country. Nevertheless, the existing academic evidence in favour of the impact of engagement in adopting reforms in companies is stronger than for capital allocation as a mechanism

[63] Koelbel et al (2019) *Can sustainable investing save the world? Reviewing the mechanisms for investor impact*.

As was noted in the previous section on engagement strategies, there is a wider field of research analysing the effectiveness of engagement to grow shareholder value, as defined in traditional economic terms, as well as, more recently, what is commonly referred to as 'shareholder activism' to achieve goals. These findings may of greater potential relevance to the EU Ecolabel, because ultimately the aim of the EU Action on Plan on Sustainable Finance is to re-orient investments towards more sustainable technologies and businesses.

Stowell (2018) charts the wider rise of shareholder activism (as opposed to active shareholders) to drive shareholder value, recording that so-called 'activist funds' managed less than $12 billion in 2003, but that since 2016 they had expanded to more than $115 billion. Although in many cases this strategy is opportunistic, there is also evidence that it can be used to make significant improvements in companies [64].

Case study of effective active engagement: Hermes Focus Fund

A commonly cited example of effective engagement to grow shareholder value is that of the institutional fund Hermes UK Focus Fund by the institutional British Telecoms Pension Scheme. Although it is an example of an institutional investor, the mode of engagement can be seen to be more akin to that of an unlisted equity fund or venture fund [65].

Hermes intervenes using its engagement strategy when there is poor corporate performance and where it believes that there is a significant probability of success and substantial share price gains – with gains of between 12.6% and 14.3% quoted. The mechanisms used can be seen from the three main areas of intervention identified:

- Restructuring: a substantial restructuring of the operations of diversified firms in order to provide more focus (e.g., by selling noncore divisions and assets, and by limiting diversifying investments and acquisitions).
- Management: Replacement of the CEO or the chairman, with a view to appointing new executives who are more willing to implement the required business restructuring of the target firm.
- Dividends: seeking an increased cash payout to shareholders, often related to proposed divestment policies.

Table 11 provides an overview of the investment shares of companies held by the fund. The engagement carried out has been classified into three categories and mainly took a private form as opposed to participation in public meetings:

- Collaborative engagements, the target agreed with the changes sought by the fund and implemented them in cooperation with the Hermes fund.
- In confrontational engagements, there was disagreement about the fund's objective from the outset and it was often necessary to remove the CEO and/or the chairman to implement the Fund's objectives.
- In the mixed engagements, the demands of the fund were implemented reluctantly or grudgingly.

Amongst the activities identified as being effective, there are meetings with management, letters to companies placed in the public domain and therefore forming the basis for a press campaign and working with other investors. It can be seen that despite not holding substantial positions it was possible to obtain a strong outcome.

[64] Stowell,D.P. (2010) *An Introduction to Investment Banks, Hedge Funds, and Private Equity*, Academic press, Elsevier.
[65] Becht,M, Franks,J, Mayer,C & Rossi,S, *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund*, The Society for Financial Studies, May 2008

This case study does, however, illustrate the need to be conscious of the national regulatory context. This type of activism can only take place in markets where the shareholders can change a company's charter which, in the USA for example, is forbidden in law.

Table 11 - Ownership of companies targeted by Hermes Fund

		Investments		Engaged by attitude		
		All	Engaged	Collaborative	Mixed	Confrontational
Panel A: Ownership by Hermes Group						
	Mean (%)	4.0	4.8	3.2	3.9	6.9
	Median (%)	2.5	3.9	2.4	3.3	7.5
	Min. (%)	1.0	1.0	1.1	1.0	1.0
	Max. (%)	13.5	13.5	8.4	9.4	13.5
	No. of companies	41	30	7	12	11
Panel B: Large stakes in Hermes' targets						
Top three stakes in Hermes' targets (%)	Mean	19.9	18.9	13.3	15.5	25.6
	Median	19.7	19.6	12.6	16.8	27.3
	Min.	3.1	3.1	3.1	4.0	3.1
	Max.	45.2	45.2	24.8	23.1	45.2

Source: Becht et al (2008)

Assessment and verification method

The assessment and verification section has been updated according to the new structure and the documentation it entails. Based on a review of existing label criteria, the method should be precise in order to guide the user, but at the same time generic in order to allow for the wide diversity of engagement strategies.

5.5 CRITERION 6: Measures taken to enhance investor impact

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

This criterion applies to UCITS and AIF investment funds, profit participation life insurance products with a general fund and to bonds held by deposit accounts.

Fund managers shall make available a report on the investor impact of the product. The report shall provide information on which of the measures described in table 1 have been taken to enhance the investor impact. Supporting information shall be provided to describe how each measure has been implemented. A summary of the report shall be provided as information to prospective retail investors.

Table 1. Measures that can be taken by portfolio managers to enhance the investor impact of the product

EU Ecolabel criterion	Investor impact enhancement measures	
1. Investment in environmentally sustainable economic activities	1.1 Capital allocation to equities	1.1.1 Investments are made in new start-ups and/or unlisted companies.
		1.1.2 Investments are made in new listings – Initial Public Offerings (IPOs).
		1.1.3 Activities or market segments in need of more capital are actively identified and invested in.
		1.1.4 Activities in mainstream market segments with the potential for green growth are actively identified and invested in.
	1.2 Capital allocation to bonds	1.2.1 Bonds are purchased that are asset backed securities and/or support the recycling of funds to make new loans.
		1.2.2 Use of Proceeds bonds are used to provide loan facilities for investment in environmentally sustainable activities and/or companies investing in transition or green growth.
		1.2.3 The allocation of funds to new projects is monitored and each project impact is quantified and reported on.
		1.2.4 Use of Proceeds bonds are used to provide new financing for projects and the funds are allocated to a Special Purpose Vehicle.
2. Investment in companies investing in transition and green growth	2.1 Identifying opportunities and monitoring change	2.1.1 Opportunities to invest in companies investing in transition are actively identified.
		2.1.2 Frequent reporting is provided on the green capex and the change in % green revenue of companies in which equities are held or which have issued the bonds held.
		2.1.3 Opportunities to invest in companies investing in green growth are actively identified.
		2.1.4 Frequent reporting is provided on the % green market share of companies in which equities are held or which have issued the bonds held.
	2.2 Taking a long-term outlook	2.2.3 The fund manager can provide evidence that a long position has been taken on the specific shareholdings of companies investing in transition and/or green growth (as per criterion 2).

New proposal for criterion 6: Measures taken to enhance investor impact		
3. Environmental exclusions	3.1 Committing to transition	3.1.1 The fund manager can provide evidence that they have required phase out strategies with milestones for specific harmful activities.
		3.1.2 The fund manager can provide evidence that they have linked requirements for the phase out of excluded activities (as defined in criterion 3) to active engagement activities.
4. Engagement	4.1 Engaging to increase shareholder value from green growth	4.1.1 The fund manager can provide evidence of bilateral or collective engagement of shareholders with the management of companies in order to grow their green revenue share or market share in mainstream market segments.
	4.2 Engaging to increase shareholder value from companies in transition	4.1.2 The fund manager can provide evidence of the bilateral or collective engagement of shareholders with the management of companies to shift their investment strategies, complemented by a threat of divestment, action at shareholder level or public campaigns.

Assessment and verification

The fund manager shall provide an impact report detailing the measures taken to enhance the investor impact of the product and its associated investment strategy. The report shall include material that is presented in an accessible form for retail investors. For each measure, the type and portfolio value of the holdings addressed shall be detailed and information on the specific economic activities related to the holdings shall be provided. This information can be provided within the impact report.

5.5.1 Rationale of the proposed criterion text

The criterion proposal seeks to encourage fund and asset managers to identify and actively manage opportunities to enhance the investor impact of the service they provide to retail investors. In this context, investor impact has been previously defined[66] as '*the change that investor activities achieve in company impact'*, which in turn is defined as '*the change that company activities achieve in social and economic parameters*'. Furthermore, investor impact has been identified as having three defining characteristics:

1. It is based on change as measured relative to a baseline;
2. It relates to a clearly defined parameter;
3. It has implied causality, sometimes also referred to as additionality.

At the same time, this criteria proposal acknowledges that the financial communities understanding of the causal relationship between investment decisions and the potential impact on company activities and on the environment is still relatively limited (see *Figure 15*). However, literature[67][68] shows indications of a positive correlation between sustainability activities, the impact on sustainable development and the financial performance of companies.

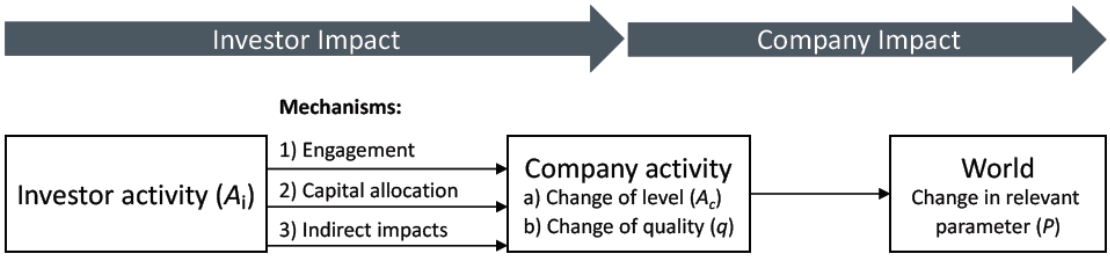
[66] Kölbel, JF., Heeb, F., Paetzold, F., Busch, T. (2020). Can Sustainable Investing Save the World? Reviewing the Impact of Investors on Companies. Available at SSRN: https://journals.sagepub.com/doi/full/10.1177/1086026620919202

[67] Weber, 0., Koellner, T. (2008). The relation between GRI indicators and the financial performance of firms. Progress in Industrial Ecology, Vol 5. No 3.

[68] De Angelis, Tiziano and Tankov, Peter and Zerbib, Olivier David, Environmental Impact Investing (July 14, 2020). Available at SSRN: https://ssrn.com/abstract=3562534 or http://dx.doi.org/10.2139/ssrn.3562534

Moreover, practices identified as having the strongest evidence of investor impact may only be applicable in specific contexts. For example, the monitoring of the impact of specific projects may be feasible for an AIF fund holding illiquid but not readily substitutable assets, but is less feasible for a UCITS fund holding the more readily substitutable shares of large capitalisation companies.

Figure 15 - Mechanisms for achieving investor impact and company impact on parameters related to environmental performance and impact



Source: Koelbel et al (2019)[69]

The proposed approach for the EU Ecolabel is based on the state of the art in investor impact management, as developed by the Impact Management Project in collaboration with industry [70]. The approach would require fund managers to report on which signals and mechanisms for enhancing investor impact they have addressed and which can be evidence by their investment strategies and decisions, as well as identification of which of the measures they are taking to actively manage and enhance their investor impact. In this way fund managers would be introduced to the concept of investor impact whilst retail investors can also be provided with information about which measures they can expect from a product.

The mechanisms for achieving investor impact have been identified from the findings of literature and from expert input from stakeholders. In the criterion proposal they have then been mapped onto the other proposed criteria 1 to 5, which themselves now include specific requirements that address some of these investor impact mechanisms. For example, the requirements on green bonds under criterion 1 include a requirement that the issuer shall demonstrate that they are either a 'company investing in transition', so as to ensure that the bond issued forms part of a concerted investment strategy on the pathway to increase green revenue.

On the other hand, for some sub-criteria, such as the green revenue thresholds for UCITS under criterion 1, it is not considered possible yet to include investor impact measures because of identified difficulties in applying the measures recommended in literature to this type of product. In which case, again taking the example of criterion 1, the investor impact enhancement measures identified serve to highlight to fund managers the opportunities to make more effective use of capital allocation in order to influence the companies in which they have holdings.

5.5.2 Outcome of the 2nd AHWG meeting, further research and main changes in the proposal

This section summarises stakeholders' comments received after the 2nd AHWG meeting. Although the topic was only commented on by a small number of stakeholders, and in discussion with some stakeholders such as NGOs it was not attributed as much importance, the

[69] JF Kölbel, F Heeb, F Paetzold, T Busch. Can Sustainable Investing Save the World? Reviewing the Impact of Investors on Companies. Available at SSRN: https://journals.sagepub.com/doi/full/10.1177/1086026620919202
[70] The Impact Management Project, https://impactmanagementproject.com/

issue of causality in relation to the environmental improvement potential of the EU Ecolabel criteria set is considered of sufficient importance to warrant further detailed investigation.

Interpreting and applying the findings of academic research

Following on from comments that there had been a misinterpretation of the findings of the review paper on investor impact authored by researchers from MIT, the University of Zurich and the University of Hamburg [71], a further review was made of their findings and related research in this field. The aim was to ensure a clear understanding of the opportunities and limitations associated with the principle mechanisms that can be mapped onto the proposed EU Ecolabel criteria – namely:

- Criterion 1 - Capital allocation
- Criterion 2/3 – Incentivising improvements and affecting growth
- Criterion 4 – Shareholder engagement and stigmatisation

Table 12 summarises what are understood to be the main mechanisms identified by Koelbel et al (2019) and the main findings by mechanism. There then follows a review of each mechanism and what can be inferred from the state of the art in terms of academic research. For each mechanism the link is then made to corresponding revisions made to the criteria set.

Table 12 - Mapping the investor mechanisms identified in literature onto the EU Ecolabel criteria proposals

Mechanism identified in literature	**2nd EU Ecolabel criteria proposal**	**Findings from Koelbel et al (2019)**
1. Shareholder engagement	Criterion 4: Engagement	*Strong evidence* for: - funds seeking to increase shareholder value - for subsequent ESG ratings and 'quality' of company activities
2. Capital allocation *2.1 Incentivising improvements* *2.2 Affecting growth*	Criterion 1: Investment in environmentally sustainable economic activities	*Partial evidence* with stronger effect: – on non-substitutable (illiquid) and less mature substitutable assets – where growth is dependent on external finance – young smaller firms in immature markets
	Criterion 3: Environmental exclusions Criterion 4: Social exclusions	*Some evidence* for a screening effect on asset prices, but requires exertion of the same exclusions by a threshold % of investors
3. Indirect impacts *3.1 Stigmatisation* *3.2 Endorsement* *3.3 Benchmarking* *3.4 Demonstration*	Criterion 3: Environmental exclusions Criterion 7: Retail investor information	*Unproven* due to lack of empirical evidence, with some evidence of improvements against low initial ESG ratings

Adapted from Koelbel et al (2019)

[71] Kölbel, JF., Heeb, F., Paetzold, F., Busch, T. (2020). Can Sustainable Investing Save the World? Reviewing the Impact of Investors on Companies. Available at SSRN: https://journals.sagepub.com/doi/full/10.1177/1086026620919202

Mechanism 1 - Evidence for the impact of shareholder engagement

There is understood to be more research evidence of investor impact in this area because it is easier to study the causal effects. However, this conclusion should be treated with caution because the success achieved is dependent on three main factors [72]:

1. The cost of the reform being requested: Requests relating to environmental issues had the lowest success rate, attributed to the type of reforms tending to entail greater costs.
2. The extent of the investors influence: The larger the shareholding the greater the chance of success. Groups of investors and large international asset managers can also exert greater influence.
3. The company's level of ESG experience: Previous compliance with ESG requests and/or high ESG ratings improve the success rate.

The probability of success of engagement is observed to be negatively correlated with the importance (or impact) of a proposed reform/measure. Thus, most successful engagement actions concern small changes, such as improvement of reporting requirements.

It is also understood that change will tend only to be implemented with the support of a company's management and not directly by the investor due to the limitations of its influence. Moreover, there are also legal boundaries to the extent an investor can influence corporate strategy and drive change, which vary by country. Nevertheless, the existing academic evidence suggests that the potential impact of engagement is stronger than for capital allocation mechanisms.

How have these findings been taken into account in the 3rd criteria proposal?

- The engagement criteria (5) has been reconfigured to incorporate clearer strategic objectives for engagement that are aligned to the environmental objectives of EU Taxonomy.
- The company dialogue sub-criterion (5.2) has been reconfigured to focus on bilateral and/or collective engagement to at company level in order to achieve outcomes. The revised proposal is modelled on examples where shareholder value creation has been the driving force rather than ESG-related improvements (see chapter 5).
- The outcomes of engagement are aligned with the metrics of % green revenue, % green capex and % change in green revenue, so that monitoring and targeting of outcomes can be setup on a company by company basis.

Mechanism 2.1 – Capital allocation incentivising improvements

There is some evidence of the impact of 'negative screening' and 'norm-based screening', which equate to the proposal for environmental and social exclusions. For these types of screening to work the evidence is that the requirements shall be specific and be implemented by a critical mass of investors, with between 8-20% of shareholders cited in literature. The important effect of screening is that a portfolio has an allocation that is different from benchmark portfolios.

Criteria on exclusions can also be more effective by considering practice-based exclusions rather than industry wide or sectoral exclusions. This is because practice-based exclusions create the scope for incremental change and are potentially more accessible, whereas if a whole sector is excluded, a company undertaking activities in that sector will not have scope for change.

[72] Kölbel, JF., Heeb, F., Paetzold, F., Busch, T. (2020). Can Sustainable Investing Save the World? Reviewing the Impact of Investors on Companies. Available at SSRN: https://journals.sagepub.com/doi/full/10.1177/1086026620919202

How have these findings been taken into account in the 3rd criteria proposal?

- Where possible practice-based screening criteria or norm-based screening criteria linked to the phasing out of certain activities or substances have been set (see criterion 3).
- Specific rules have been included in criterion 3 addressing energy generation, waste management and car manufacturing activities that could be incentivised to investment in a transition to environmentally sustainable activities, accepting that the signals from a critical mass of investors may be needed for this to strongly incentivise additional new investment.

Mechanism 2.2 – Capital allocation affecting growth

Capital allocation allows investors to benefit from interest payments, dividend payments and/or fluctuations in the value or yield derived from investments made. If companies are well managed and succeed in maintaining or improving their market position then they will generate sufficient returns to be able to repay debtors, pay out dividends and make new investments. Shareholders may therefore seek to benefit from the success and stability offered by green (or greener) companies, but because the equity share of debt they are purchasing is likely to have already been issued their impact as an investor may be limited unless, in the case of equities, they then choose to use their shareholder rights (see mechanism 1). This is because the capital has already been raised from the equity shares (or bonds) issued and the company may subsequently have achieved a credit rating that facilitates ease of access to debt instruments.

In the context of the EU Ecolabel, recent market research has shown that retail investors may be interested in the growth of companies greener than market average and/or in incentivising a change (transition) from brown towards environmentally sustainable activities [73]. In order to contribute to the growth of companies, research evidence suggests that the companies targeted must have constrained access to capital. In this sense, capital allocation can be a vehicle to support change but this more usually associated with higher risk investments of the kind supported in the early stages of growth by venture capital funds or unlisted equity shares.

Capital allocation may also be more effective for small capitalisation companies making their first public listing. Models suggest that companies may be incentivised to implement changes so that they become eligible for finance. If the EU Ecolabel criteria require an investment strategy that actively identifies companies with a clear direction of travel to become listed (i.e. make an initial public offering), this could help to support companies seeking to grow and invest to increase their market share.

There is also the potential to identify activities that are projected to have a shortfall of capital investment and to support mechanisms designed to overcome any associated barriers – for example, the aggregation of many small projects in order to mitigate risks and improve their access to finance[74]. These types of investments can be packaged to manage their risk profile in a way that makes them more suitable for investors, e.g. in the case of renewable energy investment vehicles.

On the other hand, and considering the focus of the EU Ecolabel on UCITS equity funds, there is limited research evidence to date that capital allocation has an effect on firm growth in very liquid markets such as publicly listed equity or for large capitalisation companies. This is in part because these companies may already have access to the financial markets and therefore are not affected by green requirements linked to capital allocation. However, there is some theoretical evidence that green investors can affect asset prices and the cost of capital (see

[73] 2Dii (2020). Compliance of environmental impact claims associated with 'sustainable' retail funds - Analysis of a sample of 230 funds against the compliance criteria of the EU Multi-Stakeholder Dialogue on Environmental Claims. Available at: https://2degrees-investing.org/

[74] IRENA (2016), Unlocking Renewable Energy Investment: The Role of Risk Mitigation and Structured Finance

Tiziano et al 2020). The problem is, that it is very difficult based on current evidence to say how relevant this impact would be, or what the ideal parameters and incentives are.

Theoretical models are understood to focus on the change-effect of capital allocation (see Heinkel et al 2001), and show that if a sufficiently large share of investors has a preference for green, there would be an incentive for non-green companies to become more green. That could also incentivise large capitalisation companies to change through a marginal increase in share prices or a reduction in the cost of capital for a company. This would require the level of take-up of the EU Ecolabel to be sufficient to generate beneficial effects. The alignment with the EU Taxonomy could also play an important role as it will provide a formal list of positive screening criteria.

How have these findings been taken into account in the 3rd criteria proposal?

- The thresholds for retail AIF and deposit products have been raised in order to ensure a high ambition level for those products that provide the greatest flexibility in being able to support SMEs as well as new green enterprises and projects that require access to capital.
- Given that it is structurally difficult to require UCITS to play a substantial role in raising new capital, other than via the purchase of bonds, the potential to support clearly defined 'companies in investing in transition' and 'companies investing in green growth' has been introduced, accompanied by a requirement for an investment pathway and clearly defined metrics.
- The green bond requirements have been updated to ensure that there is a focus on the monitoring of allocation and the financing of new projects. The issuer must also be a company investing in transition, so as to ensure that the green bond forms part of a concerted investment strategy.
- Where refinancing using bonds is supported, then this shall be used for the purposed of recycling funds for loans and/or creating asset-backed securities, given their significant identified potential to expand the availability of capital.

The current state of the art in fund impact management

Although impact funds have existed in various forms for since the 1990s, they only account for a very small portion of the market [75]. This may in part be because they require holdings in illiquid assets and a more resource intensive process of monitoring to provide assurance to the investor that funds have been allocated to specific investments and that there has been an evaluation of the associated impacts.

As has been discussed earlier in this chapter, there is the potential for initiatives to enhance investor impact can encompass a broader range of activities than project-level monitoring. A new initiative has been highlighted by stakeholders that appears to represent the state of art in the assessment, management and disclosure of investor impact. The IMP+ACT Classification System (ICS) was launched in July of 2020 by The IMP+ACT Alliance. The Alliance is supported by the City of London Corporation, Deutsche Bank, the Impact Management Project (IMP) and Bridges Insights. It is designed to enable asset owners to [76]:

- understand and compare the types of impact created by the holdings in their multi-asset class investment portfolios,
- describe, in a simplified and comparable format, how they currently manage, measure and assess their social and environmental impacts.

[75]

[76] Impact Management Project, https://impactmanagementproject.com/investor-impact-matrix/

- market a fund as 'impact' in a standardised way, according to an investor involved in developing the system.

It is, moreover, understood to have been tested from the industry side by Aberdeen Standard, BlackRock, Bridges Fund Management, M&G and Nuveen.

The ICS is of potential relevance to the EU Ecolabel because it is one of the first systems to standardise the reporting of 'impact'. As illustrated in *Table 13*, this in turn requires the types of activity that are deemed to contribute to impact to be defined. The ICS is based on the Impact Management Project's ABC system, which focussed on three main areas of activity:

- 'Act to avoid harm';
- 'Benefit stakeholders'; and
- 'Contribute to solutions'.

Impact classes bring together the impact performance (or goals) of the assets being invested in (x-axis) and the strategies that the investor uses to contribute to that impact (y-axis). The 'signals' given by a fund manager to the market are an important feature of the approach.

Table 13. Impact classes used to group investment products with similar impact characteristics.

INVESTOR'S CONTRIBUTION	ACT TO AVOID HARM	BENEFIT STAKEHOLDERS	CONTRIBUTE TO SOLUTIONS
Signal that impact matters **1** + Engage actively + Grow new/undersupplied capital markets + Provide flexibility on risk-adjusted return	E.g. Ethical bond fund	E.g. Positively-screened / best-in-class ESG fund	E.g. Sovereign-backed bonds (secondary market) funding vaccine delivery to underserved people or renewable energy projects
Signal that impact matters **2** **+ Engage actively** + Grow new/undersupplied capital markets + Provide flexibility on risk-adjusted return	E.g. Shareholder activist fund	E.g. Positively-screened / best-in-class ESG fund using deep shareholder engagement to improve performance	E.g. Public or private equity fund selecting and engaging with businesses that have a significant effect on education and health for underserved people
Signal that impact matters **3** + Engage actively **+ Grow new/undersupplied capital markets** + Provide flexibility on risk-adjusted return	E.g. Anchor investment in a negatively-screened real estate fund in a frontier market	E.g. Positively-screened infrastructure fund in a frontier market	E.g. Bond fund anchoring primary issuances by businesses that have a significant effect on environmental sustainability, access to clean water and sanitation
Signal that impact matters **4** **+ Engage actively** **+ Grow new/undersupplied capital markets** + Provide flexibility on risk-adjusted return	*Investment archetype not widely observed*	E.g. Positively-screened private equity fund making anchor investments in frontier markets	E.g. Private equity fund making anchor investments in businesses that have a significant effect on income and employment for underserved people
Signal that impact matters **5** + Engage actively **+ Grow new/undersupplied capital markets** **+ Provide flexibility on risk-adjusted return**	*Investment archetype not widely observed*	*Investment archetype not widely observed*	E.g. Below-market charity bonds, or an unsecured debt fund focused on businesses that have a significant effect on employment for underserved people
Signal that impact matters **6** **+ Engage actively** **+ Grow new/undersupplied capital markets** **+ Provide flexibility on risk-adjusted return**	*Investment archetype not widely observed*	*Investment archetype not widely observed*	E.g. Patient VC fund providing anchor investment and active engagement to businesses that have a significant effect on energy access for underserved people

Source: Impact Management Project (2020)

Retail investor expectations of claims associated with sustainable fund products

Evidence was put forward by a stakeholder that had conducted market research into retail investor perceptions. A survey was conducted of 4,000 potential investors in Germany and France during 2019[77]. The findings which are illustrated in *Figure 16* revealed that:

- around 20% of potential investors favour a strategy that can be classified as 'do no harm' and which takes a strong symbolic stance.
- another 40% are interested in the environmental benefit of how their money is used.

Those falling into the first category favoured more symbolic gestures to demonstrate commitment, such as divesting from a certain activity. Those falling into the second category expect *'strong evidence that the product is effective in delivering environmental benefits'*. This suggest that these investors would need to be provided with information that tracks in some form the tangible outcomes from the activities, decisions and strategies adopted by their fund or deposit product.

Similarly with green bonds, evidence from the same survey was presented and showed either that there is an expectation that either:

- the issuers are pure green players,
- have the objective to become a pure player, or
- have the objective to align with climate or environmental goals.

These findings support to some extent the new proposed approach under criterion 1 and linked to criterion 2 to define companies investing in transition and green growth, so that the status of issuers and their trajectories can then be reported.

Both of these aspects of the findings suggest that there are a high proportion of potential retail investors who are interested in the 'impact' that they can have.

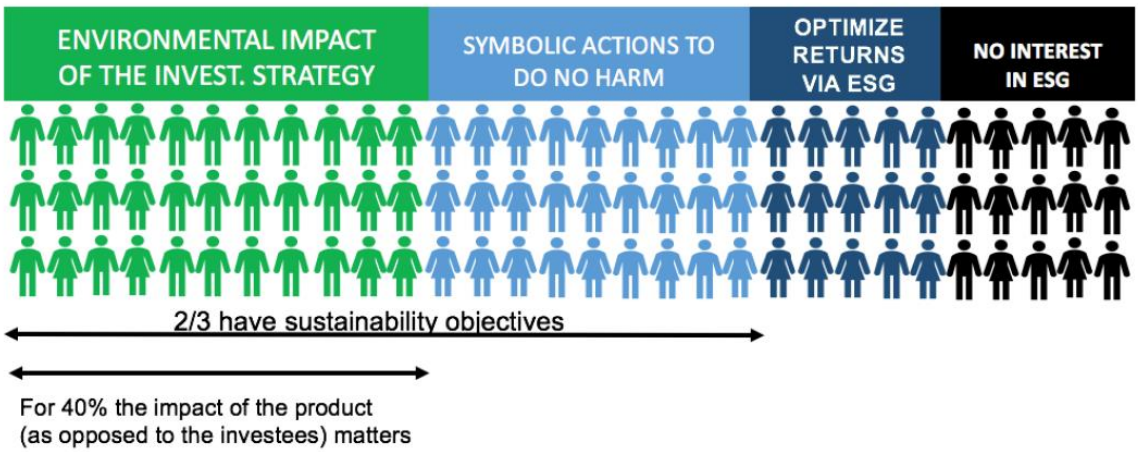


Figure 16 Categorisation of retail consumers based on survey results

[77] 2Dii (2020). Compliance of environmental impact claims associated with 'sustainable' retail funds - Analysis of a sample of 230 funds against the compliance criteria of the EU Multi-Stakeholder Dialogue on Environmental Claims. Available at: https://2degrees-investing.org/

Source: 2 Degrees Investing Initiative

The investor impact of purchasing use of proceeds bonds

Analysis by the 2 Degree Investing Initiative has identified some potential weaknesses in the use of proceeds bond model as a means to achieve investor impact, as well as opportunities to enhance the model and where to focus attention in order to use bond issuance to expand access to capital [78]. Two main obstacles to use of proceeds green bonds have been identified:

- Bonds are primarily refinancing instruments.
- Green bonds issuers are not constrained in their investment practices and do not necessarily invest in a greener way overall.

The first point highlights one of the main functions of bonds in the capital markets, which is to allow for the recycling of funds for loan finance by financial institutions. Whilst disclosure of the financing of new or existing projects forms part of the existing bonds schemes, opportunities have been identified to specifically support vehicles such as project bonds and Asset Backed Securities (ABS). ABS vehicles have traditionally been used to package many small loans, such as mortgages, and so could play a future role in the recycling of capital for domestic green loans.

The second of the points above questions the value of the green bond. It is asserted that this is because there is no accompanying requirement to track actual changes in issuers' investment plans, nor the alignment of these investment plans with climate goals. In this respect the investor, as highlighted in the follow-up research related to criterion 1, is exposed to the wider activities of the issuer.

The issue of investment potentially taking place in isolation is in part illustrated in *Figure 17*, where it can be seen that use of proceeds green bonds may initially only result in the segregation or ring fencing of green projects that would anyhow have received investment. The counter argument made by those involved in the development of green bond certification is that green bonds have and continue to play an important role in raising awareness of the potential for investments in green economic activities and in driving for greater transparency on the investment strategies of large multinational companies.

[78] Ibid 2Dii Investing Initiative

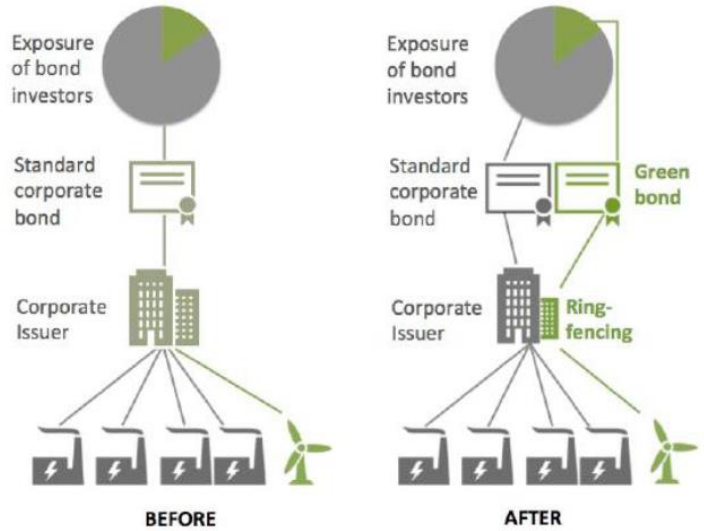


Figure 17 - Relationship of green bond issuance to investment plans and investor exposure
Source: 2Dii Investing Initiative (2018)

In order to address the concerns related to exposure of retail investors it could therefore possible in the case of corporate bonds to apply criteria to the issuer, but attention would need to be paid to whether this form of verification is readily available and whether it would constrain the number of bonds available from which portfolios could be constructed.

A number of existing labelling schemes already adopt this approach, focusing on exclusions related to company activities. However, if the aim is to provide retail investors with an opportunity to make forward looking investments, as suggested by market research on consumer expectations, then it could be possible instead to focus on how the green bonds issued will contribute to either a progressive increase in verified % green revenue or investment to maintain a carbon reduction trajectory.

5.6 CRITERION 7: Retail investor information

Previous (second) proposal for criterion 5: Retail investor information

5.1 Equity, bonds and mixed funds

As a minimum the following information shall be made available annually by the fund manager to the consumers:

- Information about the percentage of the total portfolio value in terms of assets under management (AuM) invested in companies whose economic activities comply with the requirements of criterion 1, i.e.:
  - share of AUM in shares of companies with >50% green activities;
  - share of AUM in shares of companies with 20%<x<50% green activities;
  - share of AUM invested in green bonds;
  - share of AUM going (indirectly) to green activities.
- Information on how the fund manager actively engages with companies on sustainability issues.
- Information about the type of exclusions considered. In the case of environmental exclusions, the applicant shall specify if they are total or partial exclusions, and report the percentage.
- Information the main principles for the selection of the companies.
- An electronic link to the full annual report described below.

Where the financial product is required to publish a prospectus, key investor information document (KIID) or key information document (KID) in accordance with European or national laws, only such information which is additional to that contained in the abovementioned documents needs to be disclosed separately or as additional information in the prospectus, KIID or KID.

As a minimum, the financial product manager shall issue a report annually to be uploaded on the financial product's manager website describing the environmental, social and engagement aspects as well as the activities and environmental performance of the financial product. The report shall be published on the fund manager's website. The report shall include at least the following:

- A description of the green economic activities in which the money held by the financial product was invested in during the reporting period, including the investment policy and how the companies are selected.
- A description of the main engagement activities (including voting and cooperating with other shareholders) and results within companies.
- A description of the methodology used for estimating the most relevant indicator (e.g. carbon footprint (GWP)) of the financial product and of the financial benchmark product. In the event that the GWP is the most relevant indicator, this description shall include the scope of the GHG emission covered. Additionally, the rationale for choosing the selected indicator and why it is relevant for the financial product shall also be included.
- The report shall include the engagement policy followed by the fund manager or an electronic link to it.
- Information on management and internal control procedures to identify and correct any non-compliance with EU Ecolabel criteria.

5.2 Sovereign bonds *(where held)*

As a minimum, the following information shall be made available annually to consumers by the fund or deposit manager:

- A climate or environmental risk rating for each sovereign issuer for which bonds are held.

5.3 Deposit accounts

As a minimum, the following information shall be made available annually to consumers by the deposit manager:

- An itemised list of projects and green economic activities for which loans have been approved, including their value. This may take the form of a selected list in a report together with a link to a website where a full list can be consulted.
- An annual report that as a minimum includes: details of the projects to which loans have been granted, their implementation status, the deposit account balance sheet showing the annual and historical deposit to loan ratio and the auditor's qualification of the ring fencing

procedure for the deposited money.

In the event of any observed deviations from any of the following the fund or deposit manager shall without delay communicate and publish the updated information and/or the updated report:
:

- changes in the methodology of computing the portfolio or deposit ratio;
- changes in the objectives / investment policy of the fund;
- relevant changes in the investment portfolio.

5.4 Monitoring

The consumer information should be updated regularly and therefore be based on regular monitoring of the portfolio.

Assessment and verification

The applicant shall provide a sample of the information to be provided to the consumers that clearly complies with the requirements of the criterion. The information can be added on the prospectus, KID or KIID or be provided as a separate information brochure.

Third proposal for criterion 7: Retail investor information

7.1 Equity, bonds and mixed funds

As a minimum the following information shall be made available annually by the fund manager to the retail investors, where applicable:

- Information about the percentage of the total portfolio value in terms of assets under management (AuM) invested in companies whose economic activities comply with the requirements of criterion 1, i.e.:
  - total share of AuM of companies with >50% revenue from environmentally sustainable activities;
  - total share of AuM of companies with 5%<x<50% revenue from environmentally sustainable activities;
  - share of green Capex in companies with 5%<x<50% revenue from environmentally sustainable activities;
  - share of growth in green revenues in companies with >50% revenue from environmentally sustainable activities;
  - share of AuM invested in green bonds;
  - share of AuM going (indirectly) to environmentally sustainable activities.
- The fund manager has to make publicly available the breakdown of portfolio holdings by value of AuM and for each company and bond issuer.
- Information on how the fund manager actively engages with companies on sustainability issues. The information provided shall comply with the requirements laid down in criterion 5.
- Information about the type of exclusions applied.
- Information on the measures that have been taken to enhance the impact of the fund.
- An electronic link to the full annual report described below.

The information shall be accompanied by a disclaimer. The disclaimer shall clearly state that the EU Ecolabel does not evaluate the environmental and social impacts of the fund.

Where the financial product is required to publish a prospectus, this prospectus shall contain a document providing information, which is additional to that contained in the key investor information document (KIID), or key information document (KID), in accordance with European or national laws. According to art. 8(3c)(ii) of the PRIIPs Level 1 Regulation the KID includes information on specific environmental or social objectives targeted by the PRIIPs product. Neither the PRIIPs Level 1 nor the PRIIPs RTS prohibit manufacturers of PRIIPs products to add a sign suggesting the product's

adherence to an environmental quality label. In this context reference to EU Ecolabel could be made in the "What is this product?" section of the KID.

As a minimum, the fund manager shall issue a report annually, to be uploaded on the fund's website, describing the environmental, social and engagement aspects addressed by the financial product and the EU Ecolabel criteria. The report shall include at least the following:

- A description of the objectives / investment policy of the fund;
- A description of the environmentally sustainable economic activities in which the money held by the financial product was invested in during the reporting period, including the investment policy and how the companies are selected;
- A description of the activities of the companies investing in transition, as defined in criterion 2 that are held by the financial product, including a description of the commitment and investment strategy of the company to increasing the green revenue;
- A description of the activities of the companies investing in green growth, as defined in criterion 2, that are held by the financial product, including a description of their investment and growth strategy;
- A description of the main engagement activities (including voting and cooperating with other shareholders) and results within companies;
- The report shall also include the engagement policy followed by the fund manager or provide an electronic link to it;
- Information on management and internal control procedures to identify and correct any non-compliance with EU Ecolabel criteria.

7.2 Deposit accounts

As a minimum, the following information shall be made available annually to the retail investors by the deposit manager:

- Documentation of the projects and environmentally sustainable economic activities for which loans have been approved, including their value. This may take the form of a selected list together with a link to a website where a full list can be consulted;
- An annual report that as a minimum includes: details of the projects to which loans have been granted, their implementation status, the deposit account balance sheet showing the annual records of the deposit to loan ratio, and the accounting procedure used to separate the deposited money.

7.3 Communications of changes

In the event of any observed deviations from any of the following, the fund or deposit manager shall without delay communicate and publish the updated information and/or the updated report:

- changes in the methodology of computing the portfolio or deposit ratio;
- changes in the objectives / investment policy of the fund;
- changes in the investment portfolio.

7.4 Monitoring

The retail investor information should be updated at least annually and whenever the fund or asset manager makes changes as described in 7.3.

Assessment and verification

By submitting the application, the applicant shall hand over to the Competent body a sample of the information to be provided to the retail investors. The information can be added on a prospectus along with the respective KID or KIID or be provided as a separate information brochure.

A documentation of changes in the methodology computing the portfolio or deposit ratio, objectives

or fund investment policy and/or alteration in the fund portfolio shall be handed over to the Competent Body before the change is applied.

5.6.1 Rationale of the proposed criterion text

There is a need to provide retail investors with clear information on the environmental and social performance of financial product(s). These requirements will allow them to take a well-informed decision and also enhance transparency. Such actions will enhance the credibility of the EU Ecolabel.

5.6.2 Outcomes of the 1st AHWG meeting and main changes in TR2

Feedback received on TR1 and further research conducted by JRC can be found in the previous version of the report (TR2).

Two levels of provision of information were suggested in this EU Ecolabel criterion for financial products, especially in the case of investment funds. The first one aimed at communicating to end consumers the most relevant aspects of the fund related to environmental and social aspects. This was proposed to be done through simple statements that could be provided additionally to the prospectus, KID or KIID given to the consumers at the time of purchasing. This information can also be annually revised while retail investors can obtain this information on the fund's webpage. This information was proposed to be accompanied by a link to an extensive and updated annual report addressing the requirements of the criteria.

The second level of information was related to environmental and social aspects that will be checked annually by the Competent Bodies to ensure compliance with the criteria. Therefore, the fund manager shall regularly, at least annually, issue a report describing the state of the investment, its performance as well as aspects related to the environmental and social issues. This report will be published on the fund manager's website.

The additional section to be included in the prospectus, KID or KIID related to the relevant information should inform the consumers about the following points.

- *Sustainability aspects taken into account*: this section introduces the areas where sustainability analyses have been taken into account by the manager of the awarded fund. These areas can be: environmental issues and social aspects. Additionally, the investment policy that covers the investment fund should be indicated (e.g. including the link to the investment policy document).
- *Engagement*: this section informs about whether the fund company actively engages with companies on sustainable issues and how the company carries out this engagement (e.g. company engagement on own account, company engagement in collaboration with other investors, voting at annual general meetings, participation in nomination committees, etc.).
- *Carbon footprint:* this section informs about the measures that reflect the amount of carbon dioxide emissions or equivalent, relative to revenue matching the fund's ownership share in the companies.
- *The fund excludes:* this section informs about companies that the fund manager avoids investing in, or deriving more than 5% of their revenue from selling goods and services to (other limits can be included in brackets after the category).

- *The fund selects:* this section informs on specific aspects that are key for the manager's stock selection (e.g. only companies with a certain share of activities that comply with the EU Taxonomy, only companies that have a good environmental[79] profile based on other risk analyses, only companies that do not invest in excluded economic activities may be selected for this fund).
- *EU Ecolabel:* this section informs about the registration number for the EU Ecolabel and includes the logo.

Further research was carried out to identify information that could be provided in the brochures and later on annually about an investment fund, awarded by the EU Ecolabel, in line with the requirements proposed in the EU Ecolabel criterion for consumer information and applicable regulation. Some examples are provided below:

- UCITs funds and their share classes should be accompanied by a key investor information document (KIID). This is a factsheet style document, which constitutes the pre-contractual information that must be provided to the investor prior to the investment. The points covered are: objectives and investment policy, risk and reward profile, charges, past financial performance and practical information. KIIDs are not required to include information on environmental, social and engagement aspects.
- The PRIIPs Regulation requires that basic pre-contractual information be provided through the key information document (KID) on the nature, risks, costs and potential gains and losses of the financial product. The sections included in the KID address the identification of the manufacturer and its regulator, an alert on complex products, information on the objectives, target consumers, details of any insurance benefits and terms, risk-reward profile of the product, guarantee schemes, costs, holding periods, consequences of cashing in early and, where applicable, specific environmental or social objectives targeted by the product.

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5.6.3 Outcomes of the 2nd AHWG meeting and the stakeholder consultation

Stakeholders have provided with their suggestions in the public consultation next to the 2nd AHWG meeting. Their comments have served as the basis for further research and potential improvements. The main outcomes of the consultation are summarised as follows.

Stakeholders highlighted the constraints to included additional information to the KID and KIID documents since the information included in these documents is dictated by the PRIIPs regulation, and therefore not subject of any modifications. Moreover, they stated that the KID and KIID documents are quite dense and any additional information could increase complexity.

Stakeholders have recommended adding a disclaimer in criterion 7. They argued that the EU Ecolabel does not carry out evaluation of environmental and/or social impacts and therefore not including a disclaimer could act misleading to the retail investors.

Some few comments pinpointed the need to inform retail investors on Capex and green revenue shares while considering their total value in the portfolio. Stakeholders have further advocated that this information needs to be reported separately for green and companies in transition.

[79] Good environmental profile in this context refers to the carbon footprint measured in GWP

5.6.4 Further research and main changes in the third proposal

JRC has considered the stakeholders' contributions that are provided in the consultation period and has performed additional research to update criterion 7. This criterion 7 updates take into account the applied modifications on the other existing and new criteria that are contained in TR3.0. The main changes introduced in criterion 7 are the followings.

The JRC has recognised the constraints to add information on KID and KIID documents, and suggested any retail investor information on the EU Ecolabel to be provided as a separate document or in a prospectus, which would also include the KID and KIID documents.

In terms of introducing a disclaimer, JRC deemed this requirement as justified and included a disclaimer on environmental and social impacts. In line with the introduction of the disclaimer, JRC dropped out the requirement to provide information about specific environmental indicators.

The JRC has also updated criterion 7 to include Capex and green revenue information. This information is provided for green and companies in transition separately.

TR3.0 contains the requirement for the fund manager to make publicly available the breakdown of portfolio holdings by value of AoM. It also states that the fund manager shall inform retail investors on how the fund engages with companies on sustainability issues. In accordance with the new criterion 6 on engagement, the fund manager should make available to consumers the measures that have been considered to enhance the impact of the fund.

The updated criterion 7 requires a description of the investment policy and the objectives of the fund. The fund shall also describe the activities of companies in transition, and how these companies aim to increase green revenues. A similar level of information is required for companies investing in green growth.

Finally, the procedure to carry out monitoring is altered. TR3.0 suggests that the fund manager provides retail investors with information every time he/she changes the methodology, investment portfolio or the investment objective or policy.

5.7 CRITERION 8: Information appearing on the EU Ecolabel

Previous (second) proposal for criterion 6: Information appearing on the EU Ecolabel
The applicant shall follow the instructions on how to properly use the EU Ecolabel logo provided in the EU Ecolabel Logo Guidelines: http://ec.europa.eu/environment/EU Ecolabel/documents/logo_guidelines.pdf If the optional label with a text box is used, it shall contain the following statements: The EU Ecolabel product: – Invests in activities contributing to environmental objectives – Does not invest in environmentally harmful activities – Encourages companies to become greener **Assessment and verification** The applicant shall provide a signed declaration of compliance along with a sample of the product label or product documentation where the EU Ecolabel is placed that clearly shows the label, the registration/licence number and, where relevant, the statements that can be displayed together with the label.
Third proposal for criterion 8: Information appearing on the EU Ecolabel
The applicant shall follow the instructions on how to properly use the EU Ecolabel logo provided in the EU Ecolabel Logo Guidelines available at: https://ec.europa.eu/environment/ecolabel/documents.html If the optional label with text box is used, it shall contain the following statements: – Investing in activities that contribute to a green and low carbon economy – Investing in activities contributing to climate change mitigation and adaptation – Avoiding investments in environmentally and socially harmful activities The following additional statement may be used for investment funds and insurance products: - Engaging with companies to become greener **Assessment and verification** The applicant shall provide a signed declaration of compliance along with a sample of the product label or product documentation where the EU Ecolabel is placed that clearly shows the label, the registration/licence number and, where relevant, the statements that are displayed together with the label.

5.7.1 Rational of the proposed criterion text

Information on the label is useful for reinforcing messages that endorse the consumer's choice of an EU Ecolabel product over alternatives that are not labelled. According to Article 8 (3b) of Regulation 66/2010, for each product group, three key environmental characteristics of the EU Ecolabel product may be displayed in the optional label text box. The guidelines for the use of the optional label with a text box can be found in the "guidelines for the use of the EU Ecolabel logo" available on the EU Ecolabel website.

5.7.2 Outcomes of the 1st AHWG meeting and main changes in TR2

Feedback received on TR1.0 and further research conducted by the JRC can be found in the previous version of the technical report (TR2.0). This section provides an overview of the issues addressed in the TR2.0.

In general, the three optional sentences for the text box were chosen to highlight the three pillar criteria of the EU Ecolabel: the criterion on investments in environmentally sustainable activities, the criterion on environmental exclusions and the criterion on engagement.

5.7.3 Outcomes of the 2nd AHWG meeting and the stakeholder consultation

This section summarises stakeholders' comments received after the 2nd AHWG meeting, noticing that this criterion could not be discussed at the meeting due to time constraints. The JRC received in total five comments from four stakeholders.

The comments in general welcomed the sentences chosen for the EU Ecolabel logo, pointing, however, that reference should also be made to the social exclusion criterion. Suggestions included: “does not invest in socially harmful activities” and “encourages companies to become more sustainable”.

5.7.4 Further research and main changes in the third proposal

The sentences to be optionally included in the text box were revised, mainly to reflect the changes made to other criteria. Few changes have been made to this criterion.

The sentence on environmental exclusions has been amended to include the reference to criterion 4, as requested by stakeholders. The modified sentence addresses both environmental and social exclusions.

A new sentence has been added, to reflect the fact that companies in transition can be included in an EU Ecolabel retail financial product, an important change from the second technical report.

The request from stakeholders of including a reference to the social pillar in the engagement sentence could not be taken on board, as criterion 5 mainly focuses on resolutions concerning environmental objectives. Moreover, this sentence has been made optional, as it can only be included in the logo in the case of investment funds and insurance products.

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Stimulating innovation
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European Commission
Joint Research Centre – Institute for Prospective Technological Studies

Title: **Draft criteria proposal for the product scope and ecological criteria: Working Document for the AHWG2 meeting.**

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