

OSSERVATORIO ESG

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The labelling of “green”, “environmentally focused” or “sustainable inside” financial products has increased over the last years. This note aims to answer to typical questions of some retail investors: What actually defines a sustainable fund? How does the taxonomy complete existing labels? What is happening to Sustainable finance?

NATIONAL LABELS & EU ECOLABEL

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Introduction

The labelling of “green”, “environmentally focused” or “sustainable inside” financial products has increased over the last years. This note aims to answer to typical questions of some retail investors: What actually defines a sustainable fund? How does the taxonomy complete existing labels? What is happening to Sustainable finance?

In order to respond to the problem caused by misleading claims (so-called “greenwashing”) and with “the aim to redirect capital flows towards a more sustainable economy” the EU is pursuing the most ambitious legislative package globally, which started with the publication of its Action Plan. As part of the EU Action Plan, the Commission aims to expand the EU Ecolabel, which currently exists for various goods and services, to financial products.

Several national and regional labels for sustainable financials products already exist and at present, France is the only country in which the government has

established and supports two public labels: the SRI Label and the Greenfin label (with an environmental focus).

In Europe, there are numerous labels, with about nine well-known¹. Some labels are more focused on the environment, other ones cover the full ESG aspects. Certain ones prioritize aspects of the social impact of responsible investing. Therefore, these labels differ considerably in the interpretation of “green investments” or “sustainable investments” due to the application of different methodologies and taxonomies. But it can be said that ESG labels are one way of demonstrating that a fund or other financial product meets certain objective standards or criteria.

Sustainability labels in Europe

In general sustainable labels can be divided into two categories: on the one hand, labels focusing on ESG; on the other hand, labels focusing on green. ESG analysis of portfolio assets is mandatory for all labels, but the threshold definitions vary from one label to another. For both kind of labels, the most used approaches are two:

1. ESG integration (positive criteria);
2. Negative sectorial screening.

¹ SRI Label and Greenfin (France), FNG-Siegel (Germany, Austria, Switzerland), LuxFlag ESG and LuxFLAG Environment and LuxFLAG Climate

Finance (Luxembourg), Towards Sustainability (Belgium), Umweltzeichen (Austria), Nordic Swan Ecolabel (Nordic countries).

In the table below, there is an overview of well-known sustainable labels.

Labels	Country of Implementation	Type of Labels	Social exclusions	Environmental exclusion	“Taxonomy alignment requirements”	ESG analysis requirements
SRI	France	SRI/ESG investment process	<ul style="list-style-type: none"> - Norm-based exclusions framework - Unconventional weapons - Conventional weapons 	Best-in-class approach - no exclusion mandatory	N	<ul style="list-style-type: none"> - ESG screening of more than 90% of the portfolio - 20% reduction of the investable universe, or “significantly” better average ESG score than initial universe
FNG-Siegel	<ul style="list-style-type: none"> - Germany - Austria - Switzerland 	SRI/ESG investment process with climate exclusions. Point system		Exploration and extraction: <ul style="list-style-type: none"> - Coal (5%) - Non-conventional Oil & Gas (5%) Electricity generation: <ul style="list-style-type: none"> - Coal (3%) - Nuclear Energy (5%) 	N	ESG screening of 100% of the portfolio
LuxFlag ESG	Luxembourg	SRI/ESG investment process	N	Best-in-class approach - no exclusion mandatory	N	100% portfolio screening, in compliance with an ESG strategy (e.g. best-in-class)
Towards Sustainability	Belgium	Quality standard combining requirements on the investment process and exclusions	<ul style="list-style-type: none"> - Norm-based exclusions framework - Unconventional weapons - Conventional weapons - Tobacco 	Exploration and extraction: <ul style="list-style-type: none"> - Coal (10%) - Non-conventional Oil & Gas (10%) - Conventional Oil & Gas (oil only 60%) Electricity generation (Based on carbon intensity of the energy mix (gCO₂/kWh)): <ul style="list-style-type: none"> - Fossil fuels - Coal - Nuclear Energy 	N	100% ESG screening, with temporary derogations
Umweltzeichen	Austria	SRI/ESG investment process with climate exclusions. Point system	<ul style="list-style-type: none"> - Norm-based exclusions framework - Unconventional weapons - Conventional weapons - Genetic engineering 	Exploration and extraction: <ul style="list-style-type: none"> - Coal (5%) - Non-conventional Oil & Gas (5%) - Conventional Oil & Gas (5%) Electricity generation: <ul style="list-style-type: none"> - Oil only (5%) - Coal (5%) - Nuclear Energy (5%) 	N	<ul style="list-style-type: none"> - Mandatory integration of ESG selection criteria - Less than 50% of the total investment universe can be investable
Nordic Swan Ecolabel	Nordic countries	SRI/ESG investment process with climate exclusions & green reporting. Point system	<ul style="list-style-type: none"> - Norm-based exclusions framework - Unconventional weapons - Conventional weapons - Tobacco - Genetic engineering 	Exploration and extraction: <ul style="list-style-type: none"> - Coal (5%) - Non-conventional Oil & Gas (5%) - Conventional Oil & Gas (5%) Electricity generation: <ul style="list-style-type: none"> - Fossil fuels (5%) - Coal (5%) - Nuclear Energy (5%) 	<ul style="list-style-type: none"> - Taxonomy used: Based on categories used for the Green Bond Principles (ICMA) - Minimum threshold of aggregated turnover from eco-activities in portfolio: at least 10% 	<ul style="list-style-type: none"> - ESG screening of more than 90% of the portfolio - More than 50% of the fund must be invested in holdings with “strong ESG practices”
LuxFLAG Environment	Luxembourg	Thematic investments and ESG criteria	N	Non mandatory	<ul style="list-style-type: none"> - Taxonomy used: Environment related sectors as defined in the main classification systems. 	N

Source: Internal; SG Cross Asset Research/ESG; Overview of European Sustainable Finance Labels, Novethic, 2020

Labels	Country of Implementation	Type of Labels	Social exclusions	Environmental exclusion	"Taxonomy alignment requirements"	ESG analysis requirements
LuxFLAG Climate Finance	Luxemburg	Thematic investments and ESG criteria. Climate exclusions	N	Exploration and extraction: - Coal (30%) Non-conventional Oil & Gas (internal criteria) Conventional Oil & Gas (exploration only 30%) Electricity generation: - Coal (30%) Nuclear Energy (new projects only) Restrictions and other exclusions: - Restrictions apply on geothermal plants, mining, as well as biofuel and biomass (related to food security and deforestation issues) - Exclusion of hydro-electric dams above 20MW in capacity, except if built according to high precautionary standards, such as Gold Standard	Taxonomy used: Common Principles for Climate Change Mitigation and Adaptation Finance Tracking (IDFC) Minimum threshold of aggregated turnover from eco- activities in portfolio: 37.5%	N
Greenfin Label	France	Thematic investments and ESG criteria. Climate exclusions	N	Exploration and extraction: Coal (5%) Non-conventional Oil & Gas (5%) Conventional Oil & Gas (5%) Electricity generation: Fossil fuels (5%) Coal (5%) Nuclear Energy (5%) Restrictions and other exclusions: - Companies generating 33% or more of their turnover from forest exploitation, except if sustainably managed, and peatland agriculture are excluded - Large dams (above 15MW) are not viewed as an eco-activity, but are not strictly excluded	Taxonomy used: Based on CBI's taxonomy (ClimateBonds Initiative), slightly modified Minimum threshold of aggregated turnover from eco- activities in portfolio: 15.5%	N

The EU Ecolabel

Mindful of the proliferation of labels that exists across Europe, the main European sustainable finance participants have called for a harmonization in order to:

1. promote green investments;
2. avoid greenwashing;
3. make assets more transparent (methodologies, reporting, etc.).

According to the JRC Technical Report 4.0, the EU Ecolabel is a pass-or-fail system, which means it is binary: either the financial product earns the label or it doesn't.

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

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

For the first criterion, "environmentally sustainable economic activities" will mean economic activities that qualify as 'environmentally sustainable' under the EU Taxonomy. In the first stage, the EU Taxonomy² 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, comply with minimum

² The EU Taxonomy is a central element of the EU's goal to promote sustainable finance. The legislative proposal requires an environmentally sustainable economic activity to fulfil the following requirements:

- Contribute substantially to at least one of the six environmental objectives set by the Commission;

- Do not significantly harm any of the other environmental objectives;
- Comply with a number of minimum social and governance safeguards;
- Comply with quantitative or qualitative Technical Screening Criteria.

social safeguards and meet the technical screening criteria. In the future, the EU Taxonomy will identify economic activities that significantly contribute to the achievement of any of the six EU Taxonomy objectives.

The portfolio composition in terms of environmentally sustainable economic activities adopts an overall green threshold for each retail financial product, where the greenness of companies is evaluated by considering the contribution of a company's green turnover and green capex. According to the fourth proposal for Equity fund (UCITS), at least 5% of the total portfolio value of the assets under management (AuM) shall be invested in environmentally sustainable economic activities, according to the formula:

$$G = \sum_{n=1}^0 PC_i \frac{GT_i + GC_i}{T_i}$$

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
GTi	% Green Turnover (EUR) of company i of the last year prior the application
GCi	the highest annual Green Capex (EUR) of company i over the past 3 years prior the application
Ti	Turnover (EUR) of company i of the last year prior the application

For UCITS bond funds, at least 70% of the total portfolio value of the assets under management (AuM) shall be invested in environmentally sustainable economic activities, through the purchase of Green bonds or, general purpose corporate bonds(i.e. that are not use-of-proceeds bonds) issued by a company with a green capex.

For 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.

For Fund of funds (FoFs), at least 90% of portfolio value in terms of assets under management (AuM) of the FoF shall be invested in funds that have been awarded the EU Ecolabel.

In addition to the identification of green economic activities, the second step aims to ensure that the EU Ecolabel is awarded to the best environmental performing products. Consequently, exclusions based on environmental aspects focus on the potentially harmful environmental effects of activities financed. The proposed 5% threshold applies at a

company level and is linked to revenues. The third requirement aims to link the EU Ecolabel to the minimum social safeguard clauses underlying the EU Taxonomy. The engagement criterion has been introduced in the second report with the aim to encourage companies to change their activities and behavior. Finally, information for the consumer and information about the EU Ecolabel stipulates they should be communicated to consumers with the aim of providing transparency.

Although the cited report does not represent the final version of the EU Ecolabel, it is important to note that the EU Ecolabel is based on the EU taxonomy.

Consequently this represents the first source of innovation and difference compared to existing national labels. Given the very stringent criteria and also, problems related to the assessment of EU Taxonomy alignment, the EU Ecolabel will be a niche at first while at the same time restoring investors' confidence in the labelled financial products. Surely the key challenges for the development of this market practices will be represented by the availability of a sufficiently detailed breakdown of how companies generate their revenues.

The Draft criteria "for financial products" will be discussed during year 2022 after the EU Taxonomy Delegated Act for technical screening criteria on climate change adaptation and mitigation process has been concluded. Guaranteeing, in this way, that all the EU Ecolabel financial products will be aligned to EU Taxonomy and in relation to art. 8&9 ESG-Disclosure Regulation.

Conclusion

Sustainability considerations are becoming increasingly important in our economy and society. It is not easy for consumers to know whether a product is really sustainable or not. In addition, it should be remembered that these market practices (SRI Labels, Green Labels, EU Ecolabel), while improving transparency on investment processes and increasing standardization, are not always synonymous with an overall ESG rating of the fund greater than a market index. Indeed, while labels are obtained on the fund managers' initiative, fund ratings can be attributed to all funds. Fund ratings assess the outcomes of the aggregate company ESG ratings in a fund, while fund labels mainly reward a well-defined selection and investment process that considers ESG criteria. Therefore, it could be argued that ESG Ratings are designed to help investors to understand ESG risks and opportunities, while fund labels provide more information on the fund manager's intention and approach. Furthermore, we also see a danger that, based on the label, investors consider thematic green investments (EU Ecolabel, "Green Label") as the only way to contribute to a sustainable economy, while in fact also other funds that invest into a broad mix of sectors and

thereby focus on more sustainable companies or engage with them to improve their sustainability, may have an equally strong effect on the real economy and help align the economy to the goals of the Paris-Agreement and the SDGs.

In this context, investors can choose to be guided by either ESG Ratings or Labels or by both signals, depending on whether they care most about the ESG performance of the current investments in the fund or by the intention or approach of the fund manager. With the growing range of SRI fund labels and ESG rated funds, investors have now increased the number of possibilities to express their preference among different shades of sustainability.

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