

Eurosif Statement on the Platform on Sustainable Finance's draft report on a Social Taxonomy

Introduction

Eurosif welcomes the opportunity to provide feedback on the draft report on a Social Taxonomy. Eurosif recognises the fundamental importance of the social dimension of economic activities and thus supports the Platform's efforts to define social impact activities and elaborate evaluation standards. The conduct and performance of companies in the social domain is increasingly appreciated as a key driver of value by investors.

The potential for private companies to become agents of positive change or have positive social impacts is also increasingly recognised. Furthermore, as acknowledged by the Platform, the need to address social issues is all the more evident since the outbreak of the Covid-19 pandemic and private sector entities and investors could play a more active role if enabled to do so. Accordingly, we commend the level of ambition displayed by the Platform on Sustainable Finance in the draft report and endorse a Social Taxonomy in principle.

In this Statement we will set out what we consider to be;

1. **The Advantages of a Social Taxonomy**, as; (i) a valuable transparency tool that defines social objectives and social impact, and; (ii) in facilitating the application of existing EU Sustainable Finance Regulation, and;
2. **Uncertainties to Address**, including; (i) those related to the design of the Social Taxonomy, (ii) the definition of 'socially harmful' activities, and; (iii) the need for flexibility in the application of the AAAQ approach.

One of the key success factors for a Social Taxonomy will be its user-friendliness. While we very much see merit in the Vertical dimension of the Taxonomy, identifying sectors making a significant social contribution, we are cautious about the Horizontal dimension proposed. The Horizontal dimension in its objective of ensuring all economic sectors and entities comply with social and human rights standards seems to have some similar approaches to the work EFRAG is expected to do on social indicators in the context of developing European Sustainability Reporting Standards. Equally, the Horizontal dimension is also likely to display some overlap with the potential legislative proposal being considered in the area of sustainable corporate governance and supply- or value-chain due diligence. It is essential that a Social Taxonomy is well coordinated and streamlined with these other initiatives to avoid unnecessary duplications and contradictions, which will increase the reporting burden on companies and investors without translating into more social investments.

I. The Advantages of a Social Taxonomy

i. A valuable transparency tool that defines social objectives & social impact

A Social Taxonomy could provide a valuable instrument for investors that focus on social impact. It could also provide a useful evaluation tool for assessing the social impact and performance of companies. It could potentially enhance the visibility and recognition of socially desirable investments and thus, theoretically, unlock private investment flows. While investors already regard the social performance of companies as a major factor in determining their value, there is as yet no systematic instrument or tool that defines social objectives, social impact activities and social performance, and thus no means to direct or measure the impact of social investments.

At present, the sheer diversity of social issues can render identifying the most material or relevant social risks and/or opportunities highly challenging. Investors consider a hugely varied range of social issues in their investment and stewardship policies, which has made prioritising a set number of social factors, measuring impact and evaluating performance a highly complex exercise. The range of social issues currently considered by investment professionals includes: workforce conditions, human rights, diversity, modern-day slavery, fair pay, anticorruption practices, labour rights, health & safety issues, human capital, among a multitude of others.

This diversity of issues, and the tendency for them to be sector-specific or geographically concentrated, can create significant complexities for firms in identifying and prioritising the social issues most relevant to them throughout the investment process. This challenge is compounded by the lack of consistent and reliable data on social issues – which stems partly from the difficulty in quantifying and measuring them. **Accordingly, a Social Taxonomy could prove useful to investors by providing criteria to identify and evaluate the social impact of economic activities and/or the performance of economic entities.**

More broadly, a Social Taxonomy would also represent the next logical step in the development of the EU Sustainable Finance framework by extending it to encompass both environmental and social sustainability issues. As is widely acknowledged, a holistic view of sustainability requires environmental (E), social (S) and governance (G) issues to be addressed collectively. As such, it could be complementary to the environmental Taxonomy and would further enhance the integrity of the ESG investment market in the EU. Consequently, we would advocate in favour of Model 2 (see accompanying Eurosif questionnaire response) whereby there would be one Taxonomy encompassing both social and environmental objectives with DNSH criteria for both. From a technical standpoint, we believe that Model 2 would result in a framework that is both comprehensive and coherent. **However, we agree with the assessment of the Platform that pursuing Model 2 may result in fewer economic activities and/or investments qualifying for Taxonomy-alignment due to the wider range of criteria to satisfy.**

ii. **Facilitating the application of existing EU Sustainable Finance Regulation**

A Social Taxonomy could also have the potential to enhance the usability and proper application of the environmental Taxonomy by providing a basis for assessing compliance with Article 18 - insofar as it provides guidance on how to apply minimum safeguards. Satisfying minimum safeguards requires adherence to the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights (encompassing the eight fundamental conventions referenced in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work), and the International Bill of Human Rights. However, in practice, it has proven challenging to verify compliance with the minimum safeguards requirement when assessing the taxonomy-alignment of companies. The Social Taxonomy could further elaborate upon how the minimum safeguards requirement could be satisfied. That said, for the purposes of clarifying the application of minimum safeguards, excessively granular evaluation standards should be avoided.

In addition, to some extent, we can envisage the Social Taxonomy enhancing the Sustainable Finance Disclosure Regulation (SFDR) by defining investments making a substantial contribution to social objectives. This could render it easier for financial market participants to qualify their investment products in accordance with Article 8 and Article 9.

2. **Uncertainties to Address**

The draft report of the Social Taxonomy clearly demonstrates that significant effort has been invested in identifying social objectives and conceptualising the potential design and structure of a Social Taxonomy. However, we acknowledge that the Social Taxonomy is still in its infancy and there are a number of pertinent questions as to the optimal design of the Social Taxonomy and with respect to how it would accommodate the broad and diverse range of social issues.

In particular, from Eurosif's perspective, we have a number of initial reflections to offer on different aspects of the Social Taxonomy, as currently envisaged by the draft report. These relate to;

- (i) **Uncertainties in relation to the proposed design of the Social Taxonomy;**
- (ii) **the definition of 'socially harmful' activities, and;**
- (iii) **the need for flexibility in applying the AAAQ approach.**

i. **Uncertainties in relation to the proposed design of the Social Taxonomy**

We understand that the Platform envisages a Social Taxonomy separated into **two distinct but sometimes overlapping dimensions**; a vertical dimension and a horizontal dimension. The vertical dimension would cover a limited number of sectors with the potential to make a **substantial contribution** to social objectives. Separately, the horizontal dimension would relate to the internal processes, practices, policies and business conduct of economic entities with greater emphasis on applying the **Do No Significant Harm (DNSH) principle**. Since it is process and conduct-oriented,

the horizontal dimension would apply universally or to a much wider range of sectors than the vertical dimension.

In theory, we understand the Platform's desire to model the Social Taxonomy on the existing environmental Taxonomy. We also understand the logic of including a vertical and horizontal dimension. That said, **we believe that how this approach would function in practice needs to be considered very carefully and further clarified.** The interaction between the vertical and the horizontal dimension has not been articulated sufficiently clearly and has led to multiple possible interpretations.

At present, it would appear that, by either; (i) substantially contributing to a social objective through the pursuit of a social impact activity as defined by the vertical dimension on the one hand, **OR**; (ii) satisfying the DNSH principle in accordance with the horizontal dimension on the other - an entity or activity would be eligible for Social Taxonomy-alignment.

In the environmental Taxonomy, in order to be taxonomy-aligned, an activity must make a substantial contribution **AND** avoid significant harm. In the case of the Social Taxonomy, the substantial contribution criterion and the DNSH criterion have been decoupled from one another in some cases and yet overlap with one another, confusingly, in others.

For example, the Platform suggests that in the horizontal dimension, applying international conventions and labour standards would effectively constitute a substantial contribution if doing so **leads to an amelioration in, for example, working conditions** - while at the same time also satisfying the DNSH principle. In the case of the vertical dimension, the Platform has acknowledged that the DNSH criterion will be largely irrelevant.

The challenge that we perceive is the following; if Social Taxonomy-alignment requires both a substantial contribution **AND** DNSH, the number of activities eligible for alignment would be limited to those identified in the vertical dimension. **This would effectively exclude a large number of economic activities and sectors from screening.**

By contrast, if economic activities and/or entities covered by the horizontal dimension **were eligible for Social Taxonomy-alignment merely on the basis of DNSH then alignment would be too easily attainable to be meaningful.**

What remains uncertain is whether alignment with the Social Taxonomy's horizontal dimension **should be made conditional on a company pursuing internal processes, practices, policies and conduct that actively seek to improve social performance or impact in its capacity as, for example; an employer, producer, supplier or customer.** For instance, internal policies could include; ensuring inputs are sourced on a fair trade basis (as a customer), or seeking to recruit and retain a higher proportion of women or members of disadvantaged communities (as an employer).

However, we recognise that there are significant challenges associated with applying the approach to the horizontal dimension described above. In particular, deciding on whether a policy should achieve a certain outcome or meet reasonable social performance thresholds in order to be regarded as credible. This raises the additional question of when social performance would be assessed (ex ante, in situ or ex post). Furthermore, how reasonable those social performance thresholds are would depend on the specificities of the economic sector, activity and entity concerned.

As acknowledged by the Platform, social risks and the opportunities for social impacts vary greatly across different economic sectors. Accordingly, social performance thresholds would have to be carefully calibrated on a sector-by-sector and/or activity-by-activity basis. **The local context in which these activities are carried out would also have to be taken into account when determining the applicable social performance thresholds.**

For example, as identified by the platform, what constitutes a living wage varies dramatically from region to region – even within the Eurozone. All the while, this approach would be at risk of being overly prescriptive and inflexible – particularly as local and/or sector-specific social risks and opportunities are dynamic and may evolve over time. A number of examples used in the report to illustrate the practical application also presupposes a level of specific and granular knowledge and access to information on behalf of investors or data provider/service providers they use, which is often not the case in reality. **This level of expectation will make the Social Taxonomy very unwieldy and difficult to use, making it less likely to be a success.**

Finally, we note that a number of the sectors identified as ‘inherently social’ or as social impact activities, such as education, healthcare and basic utilities (such as the provision of water) tend to be either fully under the remit of public authorities or are closely regulated and managed by them. **Consequently, the application of the Social Taxonomy to public entities will need to be taken into account and clarified.** While the principal end-users of the Social Taxonomy will be businesses and investors the activities of public authorities in the social domain cannot be ignored and further clarification is required as to the potential role (possibly through public-private partnerships (PPPs)) envisaged for private investment in these areas. Finally, the platform should not underestimate the fact that the presence and political acceptability of having private capital and investors in sectors such as education and healthcare may vary significantly amongst EU Member States.

ii. Definition of “socially harmful” activities

We are concerned by the proposal to define certain economic activities as being “socially harmful” per definition and automatically excluded from the scope of a Social Taxonomy. We would advise the Platform against including a list of “socially harmful” activities in any future Social Taxonomy. Categorising certain economic activities as harmful would be prejudicial to economic sectors identified as such by the Platform – many of which are culturally significant (as in the case of wine, beer, coffee, chocolate and sugar confection) or strategically vital for national and regional security (defence industries).

Assessing the ‘social harm’, value or contribution of certain economic sectors, such as defence, winemaking, coffee, etc. is subjective. The social significance and impact of an economic sector varies depending on the vantage point from which it is viewed – whether one takes the perspective of workers, consumers and/or local communities. We believe it would be challenging to achieve political consensus on a list of ‘socially harmful’ activities. That said, from a theoretical standpoint, we believe a Social Taxonomy could provide a useful transparency tool to enable analysis of the negative impacts of certain economic activities from a social perspective. However, we fear that creating a negative list would prove to be very divisive politically and may even detract from the broader goal the Social Taxonomy would be pursuing. Therefore, as with the case of the environmental

Taxonomy, we would suggest a Social Taxonomy focused on identifying sectors that make a positive contribution to social objectives and on which political consensus is achievable.

iii. **Limitations of the AAAQ approach**

We also see potential for **significant divergences to emerge in the application of the Availability, Accessibility, Acceptability and Quality (AAAQ) approach**. As acknowledged in the draft report, availability and accessibility are uncontroversial. Increasing the availability and/or accessibility of a social good is universally recognised as desirable. It is in relation to standards of 'acceptability' and 'quality' where divergences are likely to arise.

At a fundamental level – notions as to what is 'acceptable' are liable to vary significantly (in other words, it would be challenging to find agreement on a definition of 'acceptable' that would be universally acceptable). In the case of material goods, such as social housing, acceptability and quality are interdependent – the acceptability of social housing will depend on whether it is of sufficiently high quality. However, according to what standard would the social housing be regarded as of 'sufficiently high quality'?

Quality standards vary dramatically depending on the local context – even within Europe. What may be regarded as acceptable in terms of quality in the Netherlands may not be considered acceptable (in terms of quality) in Italy. Moreover, the needs of the local environment may be different in terms of climatic conditions, etc.

Accordingly, it should be recognised that not all criteria of the AAAQ approach may be fulfilled at the same time. There may be cases in which investors may have to choose between one or another of the criteria or emphasise one at the expense of others. **As a result, we would underline the need for investors to have the flexibility necessary to exercise their discretion when applying the AAAQ approach.**

Conclusion

The draft report provides a good starting point for the development of a Social Taxonomy. It would provide a valuable tool to define, identify and evaluate social impact investments while also complementing existing EU Sustainable Finance regulation.

However, certain aspects of the Social Taxonomy's design - as proposed in the draft report – clearly require further elaboration. Significant challenges also relate to how to quantify, measure and evaluate social impact – particularly when it comes to assessing substantial contribution under the horizontal dimension and across such a wide range of different social issues which vary in character and severity depending on the sector and local context.

Nevertheless, Eurosif supports the Platform's ongoing work to develop a Social Taxonomy and commends the Platform for the significant effort invested thus far.