

## Feature

### KEY POINTS

- On 12 July 2021, the Platform on Sustainable Finance (PSF) released for public consultation a draft 61-page report outlining a proposal for the integration of a Social Taxonomy into the EU Sustainable Finance Framework.
- The report distinguishes between a horizontal and a vertical dimension of the Social Taxonomy.
- Financial market participants will need to understand how to operationalise horizontal and vertical dimension requirements and to balance intrinsic conflicts between the delivery of basic human need products and services in a market-based economy with access to basic human needs such as, eg the human right to water.

Authors Dr Oliver Heiland and Dr Harald Glander

# ESG integration and Social Taxonomy developments in the EU Sustainable Finance Framework

This article considers recent Social Taxonomy developments under the EU Sustainable Finance Framework and what the introduction of a Social Taxonomy could mean for financial market participants and financial products.

## ESG INTEGRATION AND INCREASING ATTENTION TO SOCIAL OBJECTIVES

The Paris Agreement and the UN's 2030 Agenda for Sustainable Development have spurred a growing sense of urgency for ESG issues. Policy makers and investors alike now understand that ESG integration is at its core about managing risks and the strategic hedging of long-term returns. While ESG integration addresses environmental (E), social (S) and governance (G) issues in equal measure, environmental objectives targeting climate change have attracted greater attention over the last few years, not least due to the diagnosed systemic relevance of climate-related risks for the financial system. Social objectives, on the other hand, which are also targeting pressing issues such as economic inequality, racial injustice, gender disparity, employee rights or public health matters, have not received similar attention, as evidenced by the annual funding gap of approx. \$2.5trn for the delivery of the Sustainable Development Goals (SDGs). However, as the COVID-19 pandemic has demonstrated, social issues also have a systemic relevance for societies and business. The focus of regulatory development in the context of ESG integration has therefore increasingly shifted beyond mere environmental risks from the "E" in ESG to the question what social risks form part of the "S" and how these can be operationalised.

## THE EU SUSTAINABLE FINANCE FRAMEWORK AND THE CURRENT NOTION OF THE "S"

While still work in progress, the EU Sustainable

Finance Framework is the most advanced comprehensive legal framework that puts financial market participants such as asset managers, banks, insurance companies or pension funds at the centre of its regulation. Nevertheless, sustainable finance is not a legally defined term. It rather serves as an umbrella term incorporating a growing body of EU law and interpretative materials addressing ESG integration from different viewpoints. Core legal instruments are the EU Taxonomy Regulation (Regulation 2020/852/EU) (EU Taxonomy) and the EU Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU) (SFDR). The SFDR uses dedicated sustainability definitions for "sustainability factors", "sustainability risk" and "sustainable investment" and addresses "environmental" and "social" (as well as "governance") aspects. The centrepiece of the EU Sustainable Finance Framework, the EU Taxonomy, only defines what constitutes an "environmentally sustainable investment" and exclusively serves as a "Green Taxonomy" classification system.

## STATUS QUO: PRIORITY FOR THE SCIENCE-BASED "E" OVER THE "S"

By design, the EU Taxonomy's focus as of today is environmentally sustainable investments. So far, social objectives are only part of the (social) minimum safeguards test as the last step of the review process for environmentally sustainable investments, which requires that a taxonomy-aligned activity complies with major social and human rights standards (see EU Taxonomy, Recital (35)). In practice, financial

market participants must carry out risk-based human rights and business conduct due diligence on those economic activities, which they intend to qualify as taxonomy-aligned. Beyond this link between green and social objectives, the EU Taxonomy outlines that "other objectives" such as social objectives, are required to be added at a later stage to achieve a *fully realised taxonomy* (see Final Report of the Technical Expert Group on Sustainable Finance (March 2020), p 51). Reflecting this staged approach, Art 26 2(a) EU Taxonomy has vested the Platform on Sustainable Finance (PSF), an advisory body to the EU Commission comprised of external experts, to report on how a Social Taxonomy could be achieved.

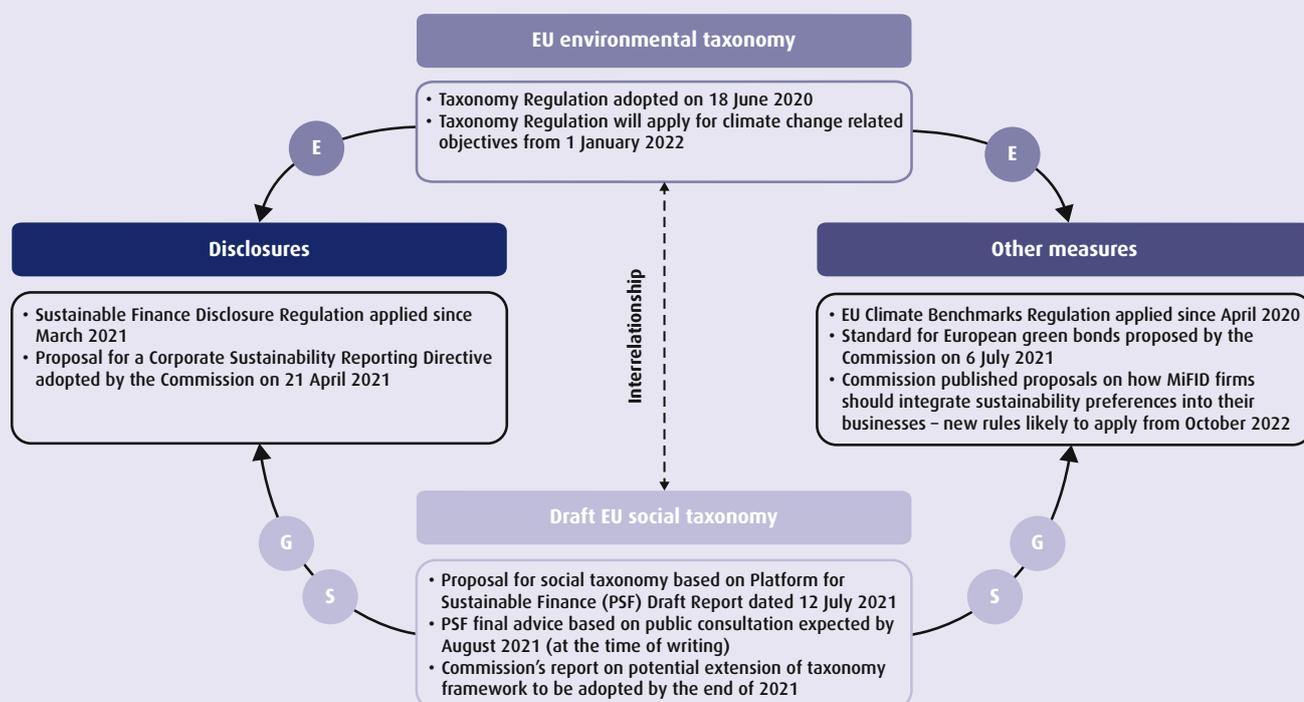
## SOCIAL TAXONOMY UNDER DEVELOPMENT: KEY FEATURES AND CHALLENGES

On 12 July 2021, the PSF released for public consultation a draft 61-page report outlining a proposal for a Social Taxonomy. The consultation closes end summer 2021 (see Platform on Sustainable Finance, Draft Report by Subgroup 4: Social Taxonomy, 12 July 2021). The mandate of the PSF – to describe how social objectives could be covered by a taxonomy – appears straightforward, but the task is complex for several reasons. What are the key features and challenges of the proposal?

## LEGAL BASIS FOR SOCIAL OBJECTIVES

The Draft Report considers a wide range of legal sources ranging from established international law standards to soft law standards. Established international norms include authoritative legal sources such as fundamental human rights standards (Universal Declaration of Human Rights; the International Covenant on Economic, Social and Cultural Rights, the International Covenant on Civil and Political Rights or the

### Integration of EU Social Taxonomy



**E**

**Activity-based approach:**  
 “environmentally sustainable investment” requires economic activity in identified sectors

- Substantially contribute (SC) to one or more of six environmental objectives
- Technical screening criteria
- DO not significantly harm (DNSH)
- Social minimum safeguards test

**S**

**Social Taxonomy combined entity-level & activity-level approach:**  
 socially sustainable investments (not defined) have horizontal and vertical dimension

<p><b>Horizontal Dimension</b></p> <ul style="list-style-type: none"> <li>• Entity-level requirement</li> <li>• Process-related integration of social and human rights objectives in business model and processes</li> <li>• Three horizontal stakeholder-centric objectives for                             <ul style="list-style-type: none"> <li>(i) employees,</li> <li>(ii) customers and</li> <li>(iii) communities</li> </ul> </li> <li>• All sectors</li> </ul>	<p><b>Vertical Dimension</b></p> <ul style="list-style-type: none"> <li>• Activity requirement</li> <li>• Social objective: “Adequate Irving standard” with two sub-objectives and related topics:                             <ul style="list-style-type: none"> <li>(i) improved access to basic human needs products/services with topics (a) water, (b) food, (c) housing, (d) healthcare and (e) education</li> <li>(ii) improved access to basic economic infrastructure with topics (i) transport, (ii) (iii) telecommunications and internet, (iv) clean electricity, (v) financial inclusion, (vi) waste management.</li> </ul> </li> <li>• Substantially Contribute (SC) with criteria based on AAAQ-Framework</li> <li>• Do not significantly harm (DNSH)</li> <li>• Environmental minimum safeguards test</li> <li>• Defined sectors (see above)</li> </ul>
---	---

**G**

**Additional proposals for “G” Governance included in Draft Report Social Taxonomy:**

- Entity-level requirement
- Process-related integration of two key governance objectives in business model and processes
- Good sustainable corporate governance
- Transparent and non-aggressive tax planning

© Heiland/Glander – ESG integration and the notion of the “S”: Social Taxonomy Developments in the EU Sustainable Finance Framework, Butterworths Journal of International Banking and Financial Law, Sep 2021

## Feature

### Biog box

Dr Oliver Heiland is Head of Business Solutions & Partnerships at Finance in Motion, and involved in delivering impact investing and sustainable finance products for institutional investors, international financial institutions and philanthropic investors.

Email: [o.heiland@finance-in-motion.com](mailto:o.heiland@finance-in-motion.com)

European Convention on Human Rights) and fundamental labour and social standards adopted by the International Labour Organisation. The Draft Report also takes into account soft law instruments such as conduct-based frameworks (eg the OECD GM) and major industry-led initiatives based on voluntary self-commitment (eg the UNPRI), which reflects the diversity of the relevant legal sources for ESG integration (see also Heiland, 'Transition to hard law: ESG integration and the EU framework on sustainable finance' (2020) 8 JIBFL 553).

### SYSTEMATIC PERSPECTIVE: RELATIONSHIP BETWEEN THE GREEN TAXONOMY AND A SOCIAL TAXONOMY

One obvious, but complex, question is that of the relationship between the Green Taxonomy and a Social Taxonomy and how a Social Taxonomy could be implemented in the EU Sustainable Finance Framework. The Draft Report raises the question but leaves it unanswered (Draft Report, p 60). It is therefore possible that there could be an integrated solution whereby the current Green Taxonomy would be expanded to include social objectives to form one single taxonomy with economic activities which are both socially and environmentally sustainable. The Draft Report, however, voices concerns that such a model would require measuring an economic entity's combined social and environmental sustainability, which could pose practical problems. In addition, an integrated solution requiring re-opening of the Green Taxonomy to include a set of new social objectives alongside developing the next four environmental objectives (see Art 9 (c)-(f) Green Taxonomy) could also add unnecessary complexity and confusion to the application of the law already in force.

A further option is a *stand-alone Social Taxonomy* following the model and structure of the Green Taxonomy. This could allow for a cleaner sequenced approach, leaving time to develop those elements and criteria specific to the Social Taxonomy alongside further parallel work on the Green Taxonomy. However, the Draft Report also points out that the extension of the Green Taxonomy is not free from controversy amongst members of the PSF. The consultation will help to understand the more fundamental concerns of stakeholders against introducing a Social Taxonomy. It is therefore currently not certain whether a Social Taxonomy will be realised at all.

### STRUCTURAL PERSPECTIVE: HORIZONTAL AND VERTICAL DIMENSIONS AND AAAQ-FRAMEWORK

The Draft Report's principal proposal is that the Social Taxonomy follows the model of the Green Taxonomy to the extent possible. However, one fundamental conceptual difference to the Green Taxonomy is that the Social Taxonomy does not designate objectives but rather so-called dimensions as overarching categories. As opposed to "environmentally sustainable investments", for which a set of six different environmental objectives were identified based on science, the Draft Report argues that because the inherent nature of respecting human rights requires avoiding and addressing adverse impacts of any economic activity, a different conceptual approach is required. This approach therefore distinguishes, as a starting point, between a *horizontal* and a *vertical dimension of the Social Taxonomy*.

The horizontal dimension of the Social Taxonomy refers to *respect and support for human rights and applies at entity-level* (eg the company or fund). Since in the horizontal dimension, any activity may have an impact, it is consequently unlimited in scope and applies across all sectors. The *vertical dimension*, on the other hand, refers to *products and services* and would consequently address the *activity-level* (ie economic activities carried out by an economic entity).

The concept of horizontal and vertical dimension is transferred from the human rights context, where the realisation of human rights does not only depend on a State's principal duty to promote and protect individual human rights in the relationship between State and individual (vertical dimension), but increasingly on the respect of human rights obligations amongst individuals and corporations (horizontal dimension). Adapted for the purposes of the Social Taxonomy to distinguish between entity-level (horizontal dimension) and products and services-level (vertical dimension), there are similarities to the SFDR. The SFDR also looks both at company-level (eg integration of ESG factors in business processes and disclosures at company-level) as well as at product-level (eg integration of ESG factors in the investment value chain). From a structural perspective, the approach is consistent and also reflects the Draft Report's understanding of the EU Taxonomy and the SFDR as interrelated measures of a "structured ESG framework" (see

Draft Report, p 8). The concept of horizontal and vertical dimensions reflects the EU Sustainable Finance Framework's approach to hold financial market participants accountable for the transition towards a society and economy which is not only environmentally, but also socially, sustainable. Consequently, the horizontal dimension of the Social Taxonomy continues the principal understanding of the EU Sustainable Finance Framework that human rights duties are placed on private actors (see eg the EU Taxonomy's social minimum safeguards test or the SFDR's adverse impact statement on company-level). With a view to making this dimension measurable in practice, the horizontal dimension identifies, as key stakeholder groups, employees, customers and communities, for which negative impacts must be identified and avoided (the so called "stakeholder-centric" approach). Consequently, the Draft Report suggests the following three objectives as forming part of the horizontal dimension: (i) ensuring decent work; (ii) promoting consumer interests; and (iii) enabling inclusive and sustainable communities.

For the vertical dimension, on the other hand, the *promotion of adequate living standards* has been proposed as the main social objective (Draft Report, p 28). But what does the term "adequate standard of living" mean? It has been shaped and interpreted over time in the context of core international human rights treaties, foremost the United Nations International Covenant on Economic, Social and Cultural Rights (ICESCR). The legal basis for the term "adequate standard of living" is Art 11 (1) ICESCR and it serves as an umbrella term encompassing the right to adequate food, water, housing and clothing, as well as the right to health and education. For the purposes of the Social Taxonomy, the term has been modified to include two sub-objectives relating to products and services and basic infrastructure. These *two sub-objectives* are: (i) improved accessibility of products and services for basic human needs (eg accessibility of water, food, housing and other products and services pertaining to basic human needs); and (ii) the improvement of accessibility to basic economic infrastructure (eg transport, clean electricity, financial inclusion).

Both sub-objectives will be assessed at the level of the respective economic activity. For that assessment, the Social Taxonomy follows

**Biog box**

Dr Harald Glander is a partner at Simmons & Simmons in Frankfurt/Main, Germany, and involved in regulatory work for clients operating in the financial services sector. Email: [harald.glander@simmons-simmons.com](mailto:harald.glander@simmons-simmons.com)

the Green Taxonomy's four step-approach to test substantial contribution with technical screening criteria, "DNSH" and compliance with minimum safeguards. Reflecting the Draft Report's preference for a stand-alone Social Taxonomy, the minimum safeguards test under the Social Taxonomy would consequently be cross-referencing environmental objectives (ie as an environmental minimum safeguards test).

At this stage, the Draft Report does not define criteria for substantial contribution and "DNSH" and proposes the use of a methodical framework, which has been developed in the human rights context of the ICESCR. This Availability, Accessibility, Acceptability and Quality (AAAQ) Framework already supported the implementation and reportability of the right to health and the right to water (Arts 11 and 12 ICESCR) and distinguishes four elements:

(i) **Availability:** Availability refers to the existence of facilities, goods and services, in each case in sufficient quantity; (ii) **Accessibility:** Are facilities, goods and services accessible, with access being understood as on a non-discriminatory basis, requiring physical and economical (ie affordable) access accompanied by adequate information; (iii) **Acceptability:** Is specific to the social objective, but also includes ethical considerations and cultural appropriateness; and (iv) **Quality:** Are facilities, goods and services of good quality and scientifically appropriate.

The Draft Report proposes to use this framework as a starting point for the development of a more granular understanding of what rights contribute to the realisation of the respective topics under the sub-categories (ie basically human rights such as the right to water, health, education) or to identify respective obstacles. While the Draft Report emphasises the AAAQ-Framework's international recognition as an approach to test implementation and fulfilment of basic human rights (see Draft Report, p 29), the transfer from human rights context to the financial system will require appropriate modification and time to build understanding and acceptance. Modifications will need to reflect intrinsic differences between States as sovereign actors on the one hand and financial market participants as legal subjects on the other. It will be a particular challenge to reflect that financial market participants, as opposed to a State with responsibility for its sovereign territory, are

active across multiple jurisdictions and operate across heterogenous legal systems, societies and contexts. Considering that the application of the EU Taxonomy is not limited to economic activities carried out in the European Union, financial market participants will require specific guidance on how to apply criteria in varying circumstances. Another challenge will be to balance intrinsic conflicts between the delivery of basic human need products and services in a market-based economy with access to basic human needs such as, eg the human right to water or the human right to health. While the Draft Report only provides possible outlines of the Social Taxonomy, it is apparent that the realisation of the Social Taxonomy will include a material step-up for financial market participants from respecting human rights to taking a more active role in the realisation of human rights.

### OUTLOOK FOR FINANCIAL MARKET PARTICIPANTS AND FINANCIAL PRODUCT DESIGN

With the inception of the EU Sustainable Finance Framework, the design of financial products has already been materially reshaped, in particular by the SFDR and the interrelated provisions of the EU Taxonomy (see Glander/Lühmann, 'Overview on new European ESG disclosure requirements for asset managers' (2020) 11 JIBFL 763). The new framework provides for principally two types of ESG financial products, being impact products and sustainability-promoting financial products. At one end, an impact product under Art 9 SFDR will need to demonstrate that it has sustainable investment as an objective and it will need to clarify whether EU Taxonomy aligned "environmentally sustainable investments" are made or not. One level below, for Art 8 SFDR, on the other hand, it is sufficient that a financial product merely promotes sustainability characteristics. Article 8 SFDR products, however, allow three sub-categories, being: (i) products that intend to invest (partially) in EU Taxonomy aligned "environmentally sustainable investments" (ie without the financial product necessarily intending this as its primary investment objective); (ii) products that intend to invest (partially) in "sustainable investments" as defined under the SFDR; and (iii) those products that do not match the criteria under (i) and (ii) above, but otherwise promote sustainability characteristics.

The interplay between the SFDR and

certain provisions of the EU Taxonomy has created a new financial product pyramid, which requires ESG financial products and strategies to increasingly consider, promote or pursue as its main investment objective, defined ESG criteria. Yet, from a practical perspective, the exact classification of financial products remains challenging and is subject to the development of further guidance from regulatory authorities. It is worth noting that the EU Commission has raised concerns about the classification of products under the SFDR being used as a "label" for marketing purposes. However, in the EU's Sustainable Finance Framework, ESG financial products will increasingly constitute the "standard". Nevertheless, because of the EU Taxonomy's present restriction to environmental objectives, "social impact" products can follow the highest standard as an impact product under Art 9 SFDR despite having a clear framework for "socially sustainable investments" and not environmentally sustainable ones.

Given the holistic approach of the EU Sustainable Finance Framework, both investment firms offering financial products and investors will therefore require clarity about social objectives. This is not only because of the progressive integration of sustainability considerations into investment and disclosure processes, but also because of the integration into related advisory processes. In this regard, recent regulatory developments under the Market of Financial Instruments Directive (MiFID) introduced the new concept of "sustainability preferences", which will accelerate the investor demand for ESG financial products including those that focus on the "S". Under this new concept, it will be a requirement at the point of sale to ask investors about their sustainability preferences including social considerations. As the demand for social bonds financing projects with positive social outcomes, eg in the housing or educational sector, already shows, investors will increasingly require comparable standards for socially sustainable financial products to prevent "Social Green Washing", ie the concern that social considerations are unduly used for marketing purposes, can be avoided and the policy target of the EU's renewed Sustainable Finance Strategy addressing the concerns of re-directing investments into socially sustainable investments would be further promoted. ■