International
Capital
Market
Association

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ICMA's response to the call for feedback on the Platform on Sustainable Finance's draft report on a Social Taxonomy

The International Capital Market Association (ICMA) welcomes the opportunity to provide feedback on the draft report on a social taxonomy.

ICMA is a membership association, headquartered in Switzerland, committed to serving the needs of its wide range of members. These include private and public sector issuers, financial intermediaries, asset managers and other investors, capital market infrastructure providers, central banks, law firms and others worldwide. ICMA currently has around 600 members located in over 60 countries. See: www.icmagroup.org. ICMA's transparency register number is 0223480577-59.

The International Capital Market Association (ICMA) promotes well-functioning cross-border capital markets, which are essential to fund sustainable economic growth. More specifically, ICMA represents the global debt capital market and provides the standards underpinning the sustainable bond market with the Green and Social Bond Principles (GBP and SBP), the Sustainability Bond Guidelines (SBG) and the Sustainability-linked Bond Principles (SLBP).

This feedback is given on behalf of ICMA and its constituencies primarily in this case with the input from the Executive Committee of the Principles (Green, Social, Sustainability-Linked Bond Principles and Sustainability Bond Guidelines) and its Social Bonds Working Group.

Yours faithfully,

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Response to the call for feedback on the Platform on Sustainable Finance's draft report on a Social Taxonomy

The focus on environmental issues, and especially climate change, through the work on the EU Taxonomy to date in effect tackles issues that can also be defined as social issues, given the existential threat they create for society. Nevertheless, there are a range of social issues that fall outside the environmental purview, or may be deemed intertwined in a different way, such as the pandemic, which has highlighted the connection between environmental degradation and social issues, including how crises exacerbate pre-existing disparities in healthcare provision and outcomes, as well as in access to good employment, education and housing.

We think that a well-conceived and usable Social Taxonomy could become a useful and complementary tool in the sustainable bond market to help assess and benchmark the social objectives and targets incorporated in social, sustainability (mix of social and green) or even sustainability-linked bonds. It could help investors determine what are robust and meaningful social activities and projects/investments to guide them in directing their money to companies and investments that make a difference.

From a regulatory perspective, a Social Taxonomy would also further connect the dots with for example investors' disclosure obligations under SFDR which already contain social factors.

The responses below focus on the points in the consultation that are most relevant to ICMA members and to participants in the sustainable bond market. <u>We concentrate especially on assessing the potential of the proposed Social Taxonomy as a resource for participants in the sustainable bond market rather than its potential broader use as a classification tool for investment portfolios for all types of securities including equities.</u>

1. **Preliminary remarks: the overall approach of the EU Social Taxonomy**

In the same way that the Environmental Taxonomy is intended to identify and promote activities, projects and investments that have a significant positive environmental impact, the Social Taxonomy should be designed to do the same in relation to those activities, projects and investments that make a significant positive social contribution, including through highlighting baselines, benchmarks, qualitative and quantitative impact metrics. Also, in the same way as the Environmental Taxonomy, inclusion in the Taxonomy neither seeks to address overall entity-level reporting on Environmental, Social and Governance ("ESG") or Corporate Social Responsibility ("CSR") issues, except to the extent envisaged by elaborated Do No Significant Harm ("DNSH") criteria.

The current suggested approach appears likely to muddle positive social impact with minimum social safeguards and standards of social responsibility. This may in turn serve to identify as positive those undertakings that should more generally be seen as minimum standards (or "business as usual") rather than making a significant positive social impact.

Indeed, the highlighting in the report of child labour and forced labour among the sub-objectives seems to reflect the very low bar that may be set for what could be construed as a positive social contribution. Providing guidance on ESG/CSR criteria and reporting is of great importance when focusing on sustainability but is also a significant undertaking that should be addressed separately and would greatly benefit from coordination with such internationally recognised standards as GRI and SASB.

We therefore recommend looking solely at elaborating what may be considered as meaningful social contributions (i.e. the vertical criteria) and highlight any relevant DNSH and minimum social safeguards to be incorporated in the Social Taxonomy.

DNSH criteria and/or processes should be able to be defined, and not, as proposed in the draft Report, impose unclear and subjective criteria, such as the requirement for cultural acceptability.

It is important that the benchmarks proposed are easily translatable into corporate and/or project objectives and do not narrowly entrench the approach taken by the SDG's, which are primarily designed by and for governments.

In the existing social and sustainability bond market, and as reminder, the SBP aim to resolve the difficulties in making social themes investible by using three important conceptual filters:

- Firstly, rather than activities, the SBP focus on eligible social projects and related high-level categories (such as "affordable basic infrastructure" and "affordable housing", among others).
- Secondly, the SBP expect issuers to identify a "target population" for which the social project is being designed.
- Finally, the SBP require annual reporting to demonstrate measurable positive social outputs/outcomes for which guidance on metrics is provided.

As expressed in our comments below, it is not clear at this stage that the proposed Social Taxonomy will necessarily provide a usable and complementary approach in the sustainable bond market compared to this existing methodology.

2 Concerns with the proposed vertical approach of the Social Taxonomy

The proposed Social Taxonomy aims to introduce social criteria both "vertically" (activities for social products and services) and horizontally (processes in a company).

Regarding the vertical dimension, the proposal is to borrow from the methodology of the EU Taxonomy and to seek to determine economic activities that are deemed socially beneficial based on two key objectives that are (i) improving accessibility of products and services for basic human needs and (ii) improving accessibility to basic economic infrastructure. "Social" economic activities are then to be identified through NACE codes as in the existing EU Taxonomy. It is further proposed to then identify social "substantial contribution" criteria referencing an Availability Accessibility Acceptability Quality (AAAQ) framework and in relation to 10 identified social objectives.

From the perspective of the sustainable bond markets, it is important to underline that because the vertical dimension of the proposed Social Taxonomy is based on economic activities rather than projects, it will raise the same considerable usability challenges as those being experienced with the existing EU Taxonomy which takes the same approach.

At a conceptual level, compared to their use for identifying environmental or sustainable economic activities in the EU Taxonomy, NACE codes provide very little specificity on the "social" benefits of an economic activity (as illustrated by proposed codes in the consultation such as *F41 - Construction of buildings* or A1.2 - Growing of perennial crops). Arguably, the difficulty is further compounded when considering the identification of economic activities that are deemed "socially harmful" with proposed NACE codes such *as G46.1.6 - Agents involved in the sale of textiles, clothing, fur, footwear and leather goods* or *O84.2.2 – Defence activities*.

Consequently, the actual identification of "beneficial" or "harmful" social activities will really take place through the filter of the AAAQ framework and the 10 social objectives. We would therefore question the value of using NACE codes in this context (beyond design consistency with the structure of the current EU Taxonomy) considering the complexity of the task and the resources required to do it.

Indeed, were NACE codes to be used to describe the activities that make a significant positive social contribution, we believe that it would hamper usability for projects and investments without sufficient translation. Furthermore, it would be possible and preferable to elaborate a threshold for material positive social contribution without tying it to any specific activity. By articulating DNSH criteria/processes, it would be possible to exclude social projects that may undermine or create significant risks to other social and/or environmental objectives.

The vertical criteria should rather be an elaboration of the threshold for what may be deemed a material positive social contribution together with processes to ensure that any risks or harms to other social or environmental objectives are identified, monitored and mitigated. Construction of roads, for instance, may be vital in ensuring economic inclusion, and depending on where they are sited, may serve to reduce emissions and pollution for local populations, and increase climate resilience. It is, after all, not the roads themselves that are any more negative for climate change than railways, but rather the transportation that will use them.

It is also very important to focus on the usability challenges that may arise from the AAAQ framework. For example, the definition of what is "culturally acceptable" may prove essentially subjective and/or controversial, and impossible to define accurately in an investment context. Considerable scrutiny and reflection will therefore be required to ensure the suitability of this framework as a tool for sustainable finance.

The proposed 10 social categories under the two overarching objectives will otherwise need to be refined to avoid excessive overlap with primarily environmental categories such as "clean electricity" and perhaps "water including wastewater management".

3 Usability problem with horizontal approach of the Social Taxonomy

In addition, the proposed Social Taxonomy further builds on the precedent of the EU Taxonomy by seeking to develop Do No Significant Harm ("DNSH") criteria through a "horizontal" approach. This is to be built around three overarching objectives: (i) ensuring decent work, (ii) promoting consumer interests and (iii) enabling inclusive and sustainable communities. We know from the ongoing feedback from the sustainable bond market (see ICMA's response to the EU GBS consultation in October 2020), that DNSH criteria in the existing EU Taxonomy raise the greatest usability issues notably because of unproven methodologies, data shortfalls and concerns on potential liability issues. It is likely that DNSH in the proposed Social Taxonomy will also lead to similar conundrums.

Specifically, we do not agree with the approach of highlighting objectives for DNSH in the horizontal dimension, as we believe that it muddles positive social impact with minimum social safeguards and standards of social responsibility. This may in turn serve to identify as positive those undertakings that should more generally be seen as minimum standards (or "business as usual") rather than making a significant positive social impact. For instance, training one's staff and measures to promote health and safety in the workplace should be seen as business as usual, and part of minimum CSR standards.

Training of marginalised populations to facilitate employment, and projects that incorporate significant capital expenditures to improve the health and safety of people, especially in challenging sectors and/or underserved populations and/or parts of the world may be deemed a meaningful positive social contribution.

Alternatively, we believe that the Taxonomy could reference OECD guidelines, or the equivalent, as minimum safeguards that should be assessed at entity level.

Above all, we recommend that usability issues are addressed in parallel with the creation of social DNSH criteria and not subsequently when the root causes of difficulties can no longer be resolved or mitigated.

4 Maintaining separate Environmental and Social Taxonomies for the time being

Relatedly with the points made above, it is very likely that seeking at this stage to integrate fully a new Social Taxonomy as currently conceived into the existing EU Taxonomy would multiply the level of difficulties at a practical level especially from a usability perspective. Asking participants in the sustainable bond market to address, for example, DNSH from an environmental and social perspective for all types of sustainable projects in order to align with an integrated future Taxonomy may simply be impractical at this stage. The two taxonomies should therefore remain separate (Model 1) for the time being.

It is however understood that at a later stage Model 2 which tries to ensure that no significant harm is done to both environmental and social objectives would make the most sense. To give an example, if you are building a windfarm on wetland this could do significant harm to the environmental objective of biodiversity but what if that windfarm is built on land belonging to indigenous people? Model 2 would protect both. Model 2 is however contingent on resolving the conceptual and usability challenges of integrating both environmental and social criteria into DNSH. As indicated above, we believe that social criteria could reference minimum safeguards such as the OECD guidelines that include governance factors.

5 Other points

While a social taxonomy by its nature should not interfere with things like national regulations or a social partners' autonomy, an unintended consequence could be that it may be perceived as a quasi-regulation, thereby affecting decision making by issuers and investors. And with respect to minimum safeguards and other criteria, we recommend flexibility to account for activities that are financed outside of the EU and suggest looking to safeguard standards such as those set by multilateral development banks or the equivalent.

While good governance is critical and providing guidance on ESG/CSR criteria and reporting is of great importance for sustainability, it is a significant piece of work that should be addressed separately and would greatly benefit from coordination with internationally recognised standard-setters such as GRI and SASB. It must also be clear that capital market participants are already investing significant resources in reporting and disclosure requirements of existing market standards and that the regulation's disclosure requirements would neither align nor replace existing reporting requirements stretching resources and budgets and affecting smaller companies and public sector entities disproportionately. Relatedly, there seems to be a lack of recognition of the public sector role in the provision of social services and channelling of funds to support social sustainability. While public sector issuers may not be the direct subject of reporting requirements, they will nonetheless need to provide information to EU investors and fund managers who buy their bonds.

We would further note that good governance is of equal importance in environmental activities, projects and investments, and was nonetheless excluded from the approach to establishing the Environmental Taxonomy. We recommend the same initial approach with developing the Social Taxonomy.