A reality test for the European definition of sustainable investment

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How should a "sustainable" financial investment be defined? The European Responsible Investment Framework, including the 2019 Sustainable Finance Disclosure Regulation (SFDR) and the 2020 Environmental Taxonomy, draws three fundamental principles:

(i) "contribute to" (a sustainability goal),
(ii) "do no harm" (to any other sustainability goal), and
(iii) "comply with" (good governance practices).

This European process, clarifying what constitutes sustainable investment, is obviously welcome. Implementing and interpreting the SFDR has not been easy, however. The concerns are twofold: lack of access to data to account for sustainability risks and confusion over definitions of terms, including the definition of sustainable investing.

The current European reporting framework for companies is not fit for purpose. The upcoming implementation of the CSRD Directive, as reviewed by the European Commission in June 2023, falls short of expectations and will not necessarily solve the problem of data. As for the definition of "sustainable investment", in practice the implementation of principles "contribute to" and "do no harm" is very uneven and fragile to say the least.

This is particularly true for the social chapter, which is clearly under-represented, if not neglected. There is no Social Taxonomy equivalent to Environmental Taxonomy. As for sustainability indicators, a brief overview shows the imbalance between the environment on the one hand, and the social and governance on the other.

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The European framework

How should a "sustainable" financial investment be defined? That is, a financial investment that makes a net contribution to a given sustainable development goal without undermining other sustainable goals. The European Framework on Responsible Investment has one, based upon the Sustainable Finance Disclosure Regulation (SFDR) of 2019 and the Environmental Taxonomy adopted in 2020:

- The SFDR Regulation (2019 and delegated version 2022) provides a three-tier reporting framework for asset managers and the funds they manage on behalf of investors: "Article 6" funds (no consideration of ESG criteria), "Article 8" (promoting social and/or environmental characteristics) and "Article 9" (financing "sustainable investments"). For Article 8 and 9 funds, the SFDR requires reporting on at least 18 indicators related to "Principal Adverse Impact" (PAI), listed in Annexes I (mandatory) and II (optional).

- The Environmental Taxonomy (2020 and delegated version 2023) among others identifies six categories of environmental contribution qualifying for sustainable investment status: (i) mitigation and (ii) adaptation to climate change, (iii) sustainable use and protection of aquatic and marine resources, (iv) transition to a circular economy, (v) pollution prevention and reduction and (vi) protection and restoration of biodiversity and ecosystems.

Definition

Bringing the SFDR and Taxonomy definitions of sustainable investment together, we land with three fundamental principles: (i) "contribute to" (a sustainable development goal), (ii) "do no harm" (to any other sustainable development goal and) (iii) "comply with" (good governance practices).

In a more elaborate version, and based on Articles 2(17) of the SFDR and Articles 3, 9 and 18 of the Taxonomy, sustainable investing is defined as follows:

Is sustainable, an activity that:
- Contributes to a sustainable development goal,
    - one of the 6 objectives of the Environmental Taxonomy; or
    - a social objective to be defined (and in the absence of a Social Taxonomy)
- Does no harm to any other sustainable development goal, including by

    - reporting on sustainability risks, by way of the mandatory indicators on Principal Adverse Impact (PAI), and
    - ensuring compliance with (i) the OECD Guidelines for Multinational Enterprises, (ii) the UN Guidelines on Business and Human Rights, (iii) the eight core ILO conventions and (iv) the UN Charter on Human Rights;

and whose investee company complies with good governance practices, including:

- sound management structures,
- industrial relations and staff remuneration, and
- tax compliance.

This definition applies to the level of an asset held by a company ("an activity") with respect to the first two principles ("contribute to" and "do no harm"). On the other hand, the third principle ("to comply with") is at the level of the investee company.

Regulatory uncertainty persists

This European effort to clarify what constitutes sustainable investment is obviously to be welcomed. Unfortunately, the devil is in the details and the implementation and interpretation of the SFDR regulation as a whole has not been too easy. In December 2022, the Financial Services Commissioner, Mairead McGuinness, acknowledged difficulties in interpreting the fundamental concepts of the SFDR. The concerns are twofold:

- lack of access to data to report on sustainability risks through the PAI indicators, and
- confusion over the definitions of the terms being used, including the definition of sustainable investment.

In response to this regulatory uncertainty, and in a context of increased concerns about greenwashing, some EUR 195 billion of assets were "downgraded" during 2022 by the asset managers themselves, from "Article 9" status (the most ambitious in terms of sustainable investment) to "Article 8". Initiatives to clarify and streamline the process have also increased, such as:

- In June 2022, Eurosif published a proposal to revise the three categories of SFDR funds;
- In September 2022, the three European Financial Supervisory Authorities (including ESMA, European Securities and Markets Authority) challenged the European Commission on the interpretation of the SFDR, in particular on the definition of sustainable investment;
- In January 2023, ESMA discussed guidelines on the use of responsibly related terms, a project that is effectively akin to a European labelling initiative;
- In February 2023, the French Autorité des marchés financiers proposed an overhaul of the minimum criteria for SFDR funds.

Data collection is indeed problematic for the 18 mandatory PAI indicators, not to mention the other 46 in option. ESG reporting by companies is supposed to feed the data. Yet the current European reporting framework is not fit for purpose. This problem should normally be solved by the CSRD Directive on reporting by companies and its new ESRS technical standards. Unfortunately, the delegated version proposed by the European Commission in June 2023 falls short of expectations, leaving too much room for manoeuvre to companies to choose the format of reporting and therefore the scope of the data to be reported.

Confusion over the terms of definition

Confusion over the definition of “sustainable investment” is the other sticking point in the implementation of SFDR.

It is certainly the case with respect to the first principle on the “contribution” to sustainable development. In a report published in December 2022, French Novethic examines the documentation published by 195 SFDR funds. Regarding the definition of sustainable investment, “*in many cases, it is simply mentioned that the fund has an objective within the meaning of Article 9 of the SFDR Regulation, which is to say that its sustainable investment objective is sustainable investment*”. When a more precise definition is given, a minority of cases, it is most often about green bonds and emission trajectories compatible with the Paris Agreement. In a handful of cases, it is about contributions to the Sustainable Development Goals, or more specific objectives – energy transition, access to water, access to education.

The implementation of the second principle (“do no harm” and PAIs) is equally heterogeneous. While the SFDR requires the consideration of at least 18 mandatory indicators, in reality we are far from the target. According to the Novethic study, the most common practice is to report exclusion policies (tobacco, controversial weapons, coal phase-out, etc.). The other practice is to substitute an ESG best in class rating for PAI indicators without any assurance that the PAIs themselves are actually taken into account. Practices are changing, of course. For example, the French subsidiary of Allianz reports in some detail on almost all indicators for its entire portfolio.

The social dimension left aside

The social dimension of the European definition of sustainable investment is also under-represented or even neglected. This is clearly the case with respect to the first principle on contribution: there is no Social Taxonomy equivalent to the Environmental Taxonomy, nor is there a process in development. To be sure, a fairly extensive and detailed report of February 2022 makes concrete proposals (including adding 3 objectives of “social contribution” to the 6 objectives of the Environmental Taxonomy: (i) decent work, (ii) the well-being of users and consumers and (iii) inclusive communities). Unfortunately, the process as a whole was put on hold by the European Commission end of 2022.

Regarding the second principle “do no harm”, it should be first emphasized that the concept itself comes from humanitarian aid and environmental law and is alien to the long history of human rights and social rights standards. For instance, it appears nowhere in the UN Guiding Principles or in the OECD Guidelines. As for the PAI indicators, a brief overview of the composition of the indicators (annexes I and II) shows the imbalance between the environment on the one hand, and the social and governance aspects on the other. If such balance in representation more or less is respected when we look at all the indicators, mandatory and optional, the environment domination is clear when focussing on mandatory indicators only. The vast majority of social indicators are indeed “optional”. And one can question how basic social indicators, such as those relating to occupational health and safety, could possibly be considered “optional” (see annex II, the indicators “Accident rate” and “Number of days lost due to injury, accident, death or illness”).

PAI indicator for enterprises	Mandatory	Optional
Environment	9	16
Social	3	14
Governance	2	3

Source : SFDR 2022

In addition, the list of social indicators contains a misinterpretation regarding compliance with the instruments referenced by the SFDR, namely: (i) the OECD Guidelines for Multinational Enterprises, (ii) the United Nations Guidelines on Business and Human Rights, (iii) the eight ILO core conventions and (iv) the United Nations Charter on Human Rights. Yet, the two corresponding mandatory social indicators, n°10 & 11 (see Annex I), requires reporting on the OECD Guidelines and on... the Global Compact. While the Global Compact is a UN-sponsored initiative, it is distinct and, on substance, very different from the United Nations Principles on Business and Human Rights. This error speaks volumes about the level of understanding of social and human rights instruments. Even if we were to be satisfied with a reporting on the OECD Guidelines, such reporting is today of little effect in the absence of a consensus on an open source methodology on its conformity.

In this context, the proposal to revise the PAIs in April 2023 by the three European financial supervisory authorities is much welcome, as it aims at increasing the number of social and human rights indicators for the sake of consistency with the ESRS standards (see Annex III), but also at rectifying the gross confusion between the Global Compact and the United Nations Principles. It has yet to be seen if this proposal will be taken on board.

As for tax compliance, despite being spelled out in Article 2(17) of the SFDR, it is entirely ignored in practice.

This imbalance between the environment on the one hand and the social aspects on the other, mirrors the current state of the ESG agenda which, in a zero-sum game, is saturated by climate and biodiversity, leaving little room for social issues. Investor initiatives on climate, and now on biodiversity, are numerous and visible: Climate Action 100+ , Net-Zero Asset Owner Alliance & Net-Zero Asset Manager Initiative, Institutional Investors Group on Climate Change, Finance for Biodiversity. On human and social rights on the other hand, it is hard to find comparable initiatives, even if a handful of initiatives have recently gained momentum such as the UN PRI Advance initiative and the Investor Alliance for Human Rights.

Annex I : Mandatory Principal Adverse Impact indicators

coverage	Chapter	PAI indicator
Business	Environment	1. GHG emissions
Business	Environment	2. Carbon footprint
Business	Environment	3. GHG intensity of investee companies
Business	Environment	4. Exposure to companies active in the fossil fuel sector
Business	Environment	5. Share of non-renewable energy consumption and production
Business	Environment	6. Energy consumption intensity per high impact climate sector
Business	Environment	7. Activities negatively affecting biodiversity-sensitive areas
Business	Environment	8. Emissions to water

Business	Environment	9. Hazardous waste and radioactive waste ratio
Business	Social	10. Violations of UN Global Compact principles and Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises
Business	Social	11. Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines for Multinational Enterprises
Business	Social	12. Unadjusted gender pay gap
Business	Governance	13. Board gender diversity
Business	Governance	14. Exposure to controversial weapons (anti-personnel mines, cluster munitions, chemical weapons and bio logical weapons)
Sovereign	Environment	15. GHG intensity
Sovereign	Social	16. Investee countries subject to social violations
Real estate	Environment	17. Exposure to fossil fuels through real estate assets
Real estate	Environment	18. Exposure to energy-inefficient real estate assets

Source : SFDR 2022

Annex II : Optional Principal Adverse Impact indicators

coverage	Chapter	PAI indicator
Business	Environment	1. Emissions of inorganic pollutants
Business	Environment	2. Emissions of air pollutants
Business	Environment	3. Emissions of ozone-depleting substances
Business	Environment	4. Investments in companies without carbon emission reduction initiatives
Business	Environment	5. Breakdown of energy consumption by type of non-renewable sources of energy
Business	Environment	6. Water usage and recycling
Business	Environment	7. Investments in companies without water management policies
Business	Environment	8. Exposure to areas of high water stress
Business	Environment	9. Investments in companies producing chemicals
Business	Environment	10. Land degradation, desertification, soil sealing
Business	Environment	11. Investments in companies without sustainable land/agriculture practices
Business	Environment	12. Investments in companies without sustainable oceans/seas practices
Business	Environment	13. Non-recycled waste ratio
Business	Environment	14. Natural species and protected areas
Business	Environment	15. Deforestation
Business	Environment	16. Share of securities not issued under Union legislation on environmentally sustainable bonds
Sovereign	Environment	17. Share of bonds not issued under Union legislation on environmentally sustainable bonds
Real estate	Environment	18. GHG emissions
Real estate	Environment	19. Energy consumption intensity
Real estate	Environment	20. Waste production in operations
Real estate	Environment	21. Raw materials consumption for new construction and major renovations
Real estate	Environment	22. Land artificialisation
Business	Social	1. Investments in companies without workplace accident prevention policies
Business	Social	2. Rate of accidents
Business	Social	3. Number of days lost to injuries, accidents, fatalities or illness

Business	Social	4. Lack of a supplier code of conduct
Business	Social	5. Lack of grievance/complaints handling mechanism related to employee matters
Business	Social	6. Insufficient whistleblower protection
Business	Social	7. Incidents of discrimination
Business	Social	8. Excessive CEO pay ratio
Business	Social	9. Lack of a human rights policy
Business	Social	10. Lack of due diligence
Business	Social	11. Lack of processes and measures for preventing trafficking in human beings
Business	Social	12. Operations and suppliers at significant risk of incidents of child labour
Business	Social	13. Operations and suppliers at significant risk of incidents of forced or compulsory labour
Business	Social	14. Number of identified cases of severe human rights issues and incidents
Business	Governance	15. Lack of anti-corruption and anti-bribery policies
Business	Governance	16. Cases of insufficient action taken to address breaches of standards of anti-corruption and anti- bribery
Business	Governance	17. Number of convictions and amount of fines for violation of anti-corruption and anti-bribery laws
Sovereign	Social	18. Average income inequality score
Sovereign	Social	19. Average freedom of expression score
Sovereign	Social	20. Average human rights performance
Sovereign	Governance	21. Average corruption score
Sovereign	Governance	22. Non-cooperative tax jurisdictions
Sovereign	Governance	23. Average political stability score
Sovereign	Governance	24. Average rule of law score

Source : SFDR 2022

Annexe III : Proposal of additional PAI indicators by the European Supervisory Authorities

	Mandatory	
Governance	Amount of accumulated earnings in non-cooperative tax jurisdictions	Amount of accumulated earnings by undertakings where the consolidated revenue on their balance sheet date exceeded for each of the last two consecutive financial years a total of € 750 million at the end of the relevant financial year in jurisdictions that appear on the revised EU list of non- cooperative jurisdictions for tax purposes
Social	Exposure to companies involved in the cultivation and production of tobacco	Share of investments in investee companies involved in the cultivation and production of tobacco
Social	Interference in the formation of trade unions or election of worker representatives	Share of investments in investee companies without commitments on its non-interference in the formation of trade unions or election of workers' representatives.
Social	Share of employees earning less than the adequate wage	Average percentage of employees in investing companies earning less than the adequate wage
	Optional	
Social	Excessive use of non- guaranteed-hour employees in investee companies	Average share of non- guaranteed hours employees as share of total employees

Social	Excessive use of temporary contract employees in investee companies	Average share of own employees with a temporary contract as share of total employees
Social	Excessive use of non- employee workers in investee companies	Average share of non-employee workers as share of total employees
Social	Insufficient employment of persons with disabilities within the workforce	Average share of persons with disabilities amongst the workforce of investee companies
Social	Lack of grievance/complaints handling mechanism for communities affected by the operations of the investee companies	Share of investments in investee companies without grievance or complaints handling mechanism for stakeholders materially affected by the operations of the investee companies
Social	Lack of grievance/complaints handling mechanism for consumers/end-users of the investee company	Share of investments in investee companies without grievance/ complaints handling mechanism for consumers or end users of the investee companies

Source : Joint consultation on the review of SFDR Delegated Regulation, Avril 2023