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Deutsches Institut für
Entwicklungspolitik

German Development
Institute

Discussion Paper 29/2021

What is Social Finance?

Definitions by Market Participants, the EU Taxonomy for Sustainable Activities, and Implications for Development Policy

Sören Hilbrich

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Bonn 2021

Discussion Paper / Deutsches Institut für Entwicklungspolitik
ISSN (Print) 1860-0441
ISSN (Online) 2512-8698

Die Deutsche Nationalbibliothek verzeichnet diese Publikation in der Deutschen Nationalbibliografie; detaillierte bibliografische Daten sind im Internet über http://dnb.d-nb.de abrufbar.
The Deutsche Nationalbibliothek lists this publication in the Deutsche Nationalbibliografie; detailed bibliographic data is available on the Internet at http://dnb.d-nb.de.

ISBN 978-3-96021-172-3 (printed edition)

DOI:10.23661/dp29.2021

Printed on eco-friendly, certified paper

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Published with financial support from the Federal Ministry for Economic Cooperation and Development (BMZ)

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Acknowledgements

I am very grateful to Kathrin Berensmann, Clara Brandi, Paul Marschall und Ulrich Volz for comments on earlier versions of this paper. Adrian Glaz and Monja Rinderle provided valuable research assistance.

Abbreviations

ADB	Asian Development Bank
ACMF	ASEAN Capital Markets Forum
ASEAN	Association of Southeast Asian Nations
CICETE	China International Center for Economic and Technical Exchanges
DNSH	do no significant harm
ESG	environmental, social and governance
ETF	exchange-traded funds
EU	European Union
FfD	Financing for Development
GDP	gross domestic product
ICMA	International Capital Market Association
ILO	International Labour Organization
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPSF	International Platform on Sustainable Finance
MSME	micro, small and medium enterprises
NFRD	Non-Financial Reporting Directive
NGO	non-governmental organization
OECD	Organisation for Economic Co-operation and Development
SDG	Sustainable Development Goal
UN	United Nations
UNDP	United Nations Development Programme
USA	United States of America
WWF	World Wide Fund for Nature

Executive summary

The market for social financial instruments is rapidly growing. The issuance of social bonds, for instance, reached $149.4 billion in 2020, showing an extraordinary growth of 720% compared to 2019 (ADB, 2021, p. 14). By providing capital for certain types of investments associated with positive social impacts, these instruments are intended to close funding gaps that hamper the realisation of social goals, as laid down, for instance, in the 2030 Agenda for Sustainable Development. In addition, social finance might set incentives for enterprises to engage in more sustainable business models that would give them access to social financial instruments potentially associated with a lower cost of capital. However, the magnitude of the potential contribution to society of social finance is a matter of debate. One reason for this is that, due to the fungibility of money, it usually cannot be ensured that social financial products mobilise *additional* resources.

This paper focuses on another important challenge for social finance – one that concerns the plurality of existing definitions of social investments. It provides an overview of the definitions followed by market participants, describes the European Union (EU) taxonomy for sustainable activities as a potential standard in this context, and discusses implications for development policy.

Until now, market participants have worked with very different definitions of social investments. Some agents have focused on the social impacts of goods or services. Others have focused on process-related impacts, such as those related to working conditions of employees.

There is also considerable variety in the procedure for selecting eligible investments. Some issuers of social financial products positively identify specific sectors as being eligible; others merely exclude some sectors. Other agents use so-called best-in-class procedures and consider a fixed share of firms in each industry that score highest in respect of social indicators as eligible. Finally, minimum criteria that all eligible firms have to meet are also often used in identifying potential investment projects. Partly depending on the different foci and selection procedures, there are also great differences in the level of ambition of the various definitions.

The plethora of definitions of social investments in economic practice is detrimental to positive societal impacts. Heterogeneous definitions increase transaction costs because investors have to spend resources on researching what definition is being applied by the issuer of a specific social financial product, and they can facilitate deceptive practices and even lead to adverse selection. Social finance can thus only realise its full potential if common definitions for social financial products are established.

While, many efforts to develop standards for definitions of social investments have been made by private agents such as the International Capital Market Association (ICMA), the European Union (EU) is currently preparing a comprehensive taxonomy for sustainable activities. A proposal for this taxonomy, developed by the EU Platform on Sustainable Finance, suggests that the taxonomy should combine a number of the different approaches used by market participants to identify social activities. The details of this classification system with respect to the social dimension and its level of ambition have not yet been

determined. In developing the taxonomy, it will be important to ensure that economic activities have to meet sufficiently demanding criteria to be considered sustainable.

The EU taxonomy will probably exert a major influence on the global sustainable finance markets as, for instance, all agents wanting to sell financial products in the EU will have to disclose the extent to which the proceeds of these products finance activities that are aligned with the taxonomy. Because of the likely global repercussions, impacts on non-EU and, in particular, poorer countries should be carefully assessed and taken into account in the development of the taxonomy. Of direct relevance to these countries is, for instance, how working conditions and local externalities in global supply chains will be taken into account.

International efforts to further develop the governance of social finance (and more generally sustainable finance) as they are currently undertaken by, for instance, the G20, will remain important (in spite of the influence exerted by the EU taxonomy). It is crucial that representatives from poorer and smaller countries are able to participate in shaping the governance of social finance to improve the chance that future rules will meet the interests of the population of these countries. Social finance should thus also be on the agenda of more inclusive processes, such as that of the United Nation’s Financing for Development process.

1 Introduction

A number of financial instruments are available on the market that are labelled as “social”, “ethical”, “sustainable”, as “social responsible investment” or as “impact investment”. Increasingly, sustainable finance instruments focus not only on environmental issues but take into account social objectives (alternatively or additionally). While social finance is still in its infancy, financial products such as social bonds and social equity funds show extraordinary growth rates. In addition, social finance has reached the international political agenda. The European Union (EU) is currently developing a comprehensive taxonomy for sustainable activities that will also include social objectives. The G20 transformed (and upgraded) its Green Finance Study Group to a Sustainable Finance Working Group that also addresses social issues. In addition, organisations such as the World Bank, the United Nations Development Programme (UNDP), the Asian Development Bank (ADB), and the Organisation for Economic Co-operation and Development (OECD) have taken up the topic, compiling studies and facilitating dialogue on market development and governance (e.g. ADB, 2021; OECD and UNDP, 2020), or issuing their own social bonds.

In general, social finance should help to close the funding gaps for investments that are necessary to achieve social goals such as those included in the 2030 Agenda for Sustainable Development. By influencing the cost of capital, social finance might also set incentives for firms to pursue business models that are better aligned to social objectives. However, to what degree social finance is able to live up to these promises has yet to be proven.

One of the main challenges for the further development of the social finance market concerns its often opaque conceptual underpinnings. There is no widely shared and reasonably concrete understanding of what social finance is, let alone uniform and binding criteria applied to financial products that are sold as “social”.[1] A lack of common definitions can hamper further development of a well-functioning social finance market by, for instance, increasing transaction costs. (Investors need to devote resources to figuring out and comparing the criteria that issuers of social financial products apply in selecting investment projects.)

Due to the important role of definitions, it is surprising that a comprehensive assessment of sustainable finance definitions that focuses specifically on social finance is still lacking in the literature.[2] To fill this lacuna, this paper analyses the plethora of existing definitions and distinguishes different foci and selection procedures. In addition, it discusses the most prominent comprehensive effort by a public institution to establish a common classification system: the ongoing work on the EU taxonomy for sustainable economic activities. As the

1 To some degree this holds true not only for the social dimension but for all three dimensions of sustainable finance that are commonly distinguished: the environmental, social, and governance dimensions (ESG) (Migliorelli, 2021, p. 15).The distinction between environmental, social, and governance dimensions of sustainable finance differs from the distinction between environmental, social, and economic dimensions of sustainability commonly applied in the discourse on sustainable development. The reason why no economic dimension figures prominently in the concept of sustainable finance is arguably that there is no need for institutional changes to push market participants to take economic consideration into account because the economic viability of investments has, obviously, always been a major concern of investors. The governance dimension differs from the environmental and the social dimension because it has a mainly instrumental role in the realisation of the other two dimensions.

2 For a review of frameworks of sustainable finance in general, see Migliorelli (2021).

prospective governance of social finance, in general, and the EU taxonomy, in particular, will have considerable global repercussions, the paper also discusses implications for development policy.

The remainder of this paper is structured as follows: Section 2 sketches the potential for, and limitations of, social finance to contribute to social improvements. Section 3 gives an overview of the very heterogeneous definitions of social investments adopted by market participants. Section 4 argues that in light of the great diversity of definitions, efforts to establish common standards for definitions are crucial. Section 5 deals with the EU taxonomy for sustainable activities as a potential standard in this area. Finally, section 6 discusses policy implications, in particular for development policy.

2 The relevance of social finance

Many important social goals, as they are described, for instance, in the 2030 Agenda for Sustainable Development, can only be achieved if the financial system is aligned with these goals and substantial financial resources are mobilised to finance the necessary investments. The Covid-19 pandemic has shown once again that great funding gaps exist in many social sectors, such as health. In addition, the pandemic has caused substantial setbacks with respect to many social goals, for instance by increasing unemployment and poverty. At the same time, available financial resources for the implementation of these goals have decreased in many countries. For instance, the EU assumes that the tax revenue of its member states declined by 4% in 2020 (European Commission, 2021, p. 18). The International Monetary Fund (IMF) estimates that the general government revenue as share of GDP of "low-income developing countries" declined from 15% in 2019 to 13.2% in 2020 (IMF, 2021, p. 85). The Covid-19 pandemic has thus brought about the unfavourable combination of "declining resources [and] increasing needs" (OECD & UNDP, 2020, p. 5).

Social financial instruments are meant to contribute to closing the funding gaps associated with many social goals. Compared to green financial instruments, the market for social financial products took off relatively late. In 2015, for instance, 303 green bonds and only three social bonds were issued (ADB, 2021, p. 19).[3] Since then, though, the market for social financial products has rapidly developed.[4] For instance, the issuance of global social bonds rose by 27% from 2017 to 2018, 44% from 2018 to 2019, and an extraordinary 720% from 2019 to 2020 (ADB, 2021, p. 14).[5] According to Morningstar, the number of sustainable

3 That green financial products gained relevance first can partly be explained by the fact that it is – at least sometimes – easier to measure impact with respect to environmental than to social issues (for instance, by using straightforward and quantifiable measures such as greenhouse gas emissions) (ADB, 2021, p. 18).

4 In this paper, I focus on social financial products. Measures to align financial markets with social objectives can (and should), obviously, also make use of regulations concerning financial flows that are not labelled as social. In addition, social finance is often understood as also including capital flows, such as grants given by foundations or methods of crowdfunding that do not necessarily require any form of repayment (Nicholls & Emerson, 2015, p. 2). This paper, though, focuses on social financial products, such as social bonds or social equity funds, which should allow investors to invest purposefully in projects that are in line with social goals while also generating financial returns.

5 It is worth noting that the growth in 2020 was driven by the EU SURE social bonds issued by the EU to mobilise resources for its member states to deal with the impacts of the Covid-19 pandemic.

funds, which often also take into account social aspects, available in the USA had reached 392 in 2020, equals 20% more than in 2019 (Morningstar, 2021, p. 2). While annual net capital flows to sustainable funds available in the USA were about $5 billion in 2016, 2017 and 2018, the funds attracted an additional $21.4 billion in 2019 and $51.1 billion in 2020 (Morningstar, 2021, p. 12).

Social financial products might improve the availability of capital for investments necessary for the transformation towards sustainability and, by altering the supply, influence the cost of capital for socially sustainable and unsustainable investment projects. In fact, a few studies show that, for instance, green bonds are associated with a somewhat lower cost of capital than conventional bonds with similar characteristics; investors seem to be willing to pay a "greenium" – a premium for green financial products (Gianfrate & Peri, 2019; Löffler, Petreski, & Stephan, 2021). Such cost advantages might also arise for social financial products. If sustainable financial products can bring about substantial changes in cost of capital, this could make sustainable projects economically viable and worsen the profitability of unsustainable economic activities. However, the cost advantages of sustainable financial products seem to have been rather small until now.

Investors can have different motivations for purchasing social financial products. They might be moved by a genuine concern for social sustainability (instead of focusing exclusively on the financial outlook of their investments). Investors might also hope that social investments can improve their reputation and attract customers, or help with the recruitment of qualified staff. Or they might believe that regulatory measures or changes in consumer preferences might hurt the future business case for potential investment projects that do not meet criteria of social sustainability.[6] In the latter case, social financial products will only be purchased if investors see credible steps in the direction of tighter regulations or changes in consumer preferences. The success of social finance depends, then, on changes that concern the real economy. Social financial products might play a role, though, in pulling forward the effects of future developments to the present.

However, social finance also faces important challenges, and the magnitude of its potential contribution to the transformation towards sustainability is subject to controversy. For instance, on a general level, the so-called problem of additionality – as it is often described, for instance, with respect to green bonds (Bracking, 2015; Hilbrandt & Grubbauer, 2020; Schneeweiß, 2019) – constitutes a major challenge for most sustainable financial products. Even if the capital raised through these products finances genuinely sustainable projects, because of the fungibility of money this does not lead necessarily to *additional* funds for such projects. If, for instance, a sovereign issues a social bond, the capital raised has to be invested in projects that conform to predefined social criteria. That does not mean, though, that the government would not have invested in these projects anyway. The capital raised through social bonds makes up only a tiny fraction of the entire financial resources of states. As long as the state would have made, in any case, *some* investments that are eligible for

6 Maltais and Nykvist investigate what attracts investors in and issuers to the green bond market by conducting interviews with Swedish market participants. They find that "[r]espondents largely frame their incentives for investing in green bonds in terms of the non-financial business case rather than financial incentives" (Maltais & Nykvist, 2020, p. 9). Advantages of green bonds that are mentioned include "attracting customers and staff, mainstreaming sustainability into internal operations, and broader signalling effects" (Maltais & Nykvist, 2020, p. 14). However, the study's exclusive focus on green bonds and Swedish market participants gives it a rather limited scope.

the social bond, the conditions attached to the bond do not necessarily change anything with respect to the overall investment decisions taken.

Some argue, therefore, that the benefits of products such as green bonds are associated more with general shifts in financial practices than with directly redirecting capital flows. These products might, for instance, raise awareness of sustainability issues on financial markets, advance discussions on the nature and identification of green or social economic activities, and improve the dialogue between issuers and investors on sustainability issues (Cripps, 2018). However, whether such potential "cultural change[s] and new standards of practice" (Jones, Baker, Huet, Murphy, & Lewis, 2020, p. 56) are effectively catalysed by sustainable financial products and can in the end make a substantial contribution to the realisation of sustainability objectives is highly unclear. The limited existing research on the impact of sustainable financial products does not, therefore, allow a definitive verdict on the magnitude of the potential societal benefits of social financial instruments.

3 Definitions of social finance by market participants

No common understanding of the "social" in social finance has yet emerged. A great diversity of definitions is used by market participants and informs the design of social financial products. In general, two different foci and four different selection procedures can be distinguished.[7]

The two different foci concern the kind of causal linkages that are taken into account.[8] On the one hand, economic activities can have an impact on the realisation of social goals by producing certain goods or services. Obviously, the production of certain goods or services, such as medicines or educational services, are essential for the realisation of social goals, while other goods or services do not have any impacts on these goals, and still others are even harmful. Many definitions of social investments refer to these social impacts of the goods or services produced.

On the other hand, economic activities also have direct process-related impacts on social goals that have nothing to do with the nature of the goods or services produced. Unsafe working conditions are, for instance, an important social issue, regardless of whether these conditions are present in sectors that produce socially beneficial goods or services or in other sectors. These impacts related to the process of an economic activity can also be positive. For instance, local communities might benefit from taxes paid by a company. Definitions of social investment often take into account such process-related issues.

Irrespective of the question of which of these two causal connections a definition of social finance focuses on, four different selection procedures for social investments can be

7 I mostly focus in the following on how these approaches are applied to investments in the private sector. However, investments in the public sector are often identified as social in a similar way.

8 The draft report of the Platform on Sustainable Finance on the EU social taxonomy includes a similar distinction between vertical and horizontal objectives (Platform on Sustainable Finance, 2021). In addition, the Global Reporting Initiative and the United Nations Global Compact refer in a guide on corporate reporting on the SDGs to this distinction as "entry point A" and "entry point B" (Global Reporting Initiative & United Nations Global Compact, 2018, p. 7).

distinguished: positive selection of sectors, sector exclusion, best-in-class procedures, and minimum criteria. The first selection procedure specifies a number of sectors, such as the health or education sector, and consider all investments in these sectors as eligible for social financial products (*positive selection*). In the second procedure, a number of sectors are excluded, such as the production of military weapons and the gambling industry (*exclusion*). In the third, a specified share of all firms from each sector that do best in terms of some social indicators is considered as being eligible (*best-in-class*). In the fourth, all investment projects that meet certain *minimum criteria*, such as the payment of statutory minimum wages, are considered as social.

The distinction between two foci and four selection procedures yields eight different approaches. Definitions of social investment usually combine a number of these approaches in the identification of social investments (see Table 3). One might, for instance, select a number of sectors because of the impacts of the goods and services produced in these sectors (e.g. the housing sector) and use additional minimum criteria to ensure that eligible firms from these sectors do not engage in some process-related harmful practices, such as tax evasion or corruption.

In the following, I describe for two categories of financial products – social bonds and social equity – which of the described approaches are widespread among financial market participants. I will focus on the general approaches used in the definitions and will touch only in passing on issues related to reporting or verification. In addition, as the approaches distinguished above leave open what is considered as relevant social goals, the following sections will also sketch what social issues are typically taken into account.

3.1 Social bonds

Social bonds are bonds the proceeds of which have to finance certain social activities. Most private and public issuers of social bonds follow the guidelines included in the Social Bond Principles, which were developed by a committee of investors, issuers and underwriters, hosted by the International Capital Market Association (ICMA) (ICMA, 2020a).[9] The ICMA is a Zürich-based trade organisation of capital market participants. The Social Bond Principles include recommendations with respect to the use of proceeds, the process of project evaluation and selection, the management of proceeds, and the reporting.[10]

With respect to the use of proceeds, the Social Bond Principles do not concretely specify for what kinds of projects the proceeds of social bonds should be used. They only state, first, that issuers should disclose in the legal documentation of the bond for what the proceeds are used. The principles state, secondly, that proceeds should finance projects that mitigate or address social issues, and should be directed especially towards specific target populations, such as people who live below the poverty line, people with disabilities, migrants or elderly people. The positive social impact could arguably be caused by the

9 See Table A1 in the annex for a summary of the ICMA Social Bond Principles.

10 The ICMA Social Bond Principles are not the only existing guideline for social bonds. For instance, the Nasdaq stock exchange also developed criteria that bonds have to meet to be listed on one of Nasdaq's Sustainable Debt Markets (Nasdaq, 2021). The ICMA Social Bond Principles, though, are by far the most influential guideline for social bonds.

production of certain goods or services, or be constituted by process-related impacts. The examples mentioned, such as affordable housing or employment generation, suggest that the principles recommend a *positive selection* of social projects.

In general, the ICMA Social Bond Principles provide only a very general framework. Issuers that follow the principles still have a lot of leeway to develop their own definitions of social investments that can have rather different levels of ambition. When issuing a social bond, issuers usually publish a so-called social bond framework that specifies more concretely their definition of social finance. To obtain information on the social issues the proceeds of social bonds should most often address, I searched for publicly available documents on the social bonds listed in the ICMA sustainable bonds database. Information on the use of proceeds by 71 bonds was available. These bonds include those issued by private institutions (just under half) and public institutions such as the EU or the Asian Development Bank (ADB). Table 1 summarises the main sectors in which the proceeds of social bonds are invested. Categories of investment projects that are most often considered eligible for social bonds include health, housing, education, micro, small and medium enterprises (MSMEs), employment creation, and the socio-economic advancement of women.

Table 1: Eligible investment projects of 71 social bonds (projects categories most often mentioned)

Eligible investment projects	Share of social bonds
Health	37%
Housing	35%
Education	31%
Micro, small and medium enterprises (MSME)	25%
Employment creation	21%
Socio-economic advancement of women	21%
Basic infrastructure (e.g. sanitation, transportation, drinking water, electricity, sewers, internet)	17%
Socio-economic advancement of disadvantaged groups (e.g. disabled, elderly, youth, immigrants, refugees)	13%
Financial services	11%
Support after natural disasters	8%
NGO financing	7%
Food security	6%

Source: Author’s compilation based on publicly available documents provided by the bond issuers

Social bonds, the proceeds of which have to be used for certain investments, should not be confused with social impact bonds or sustainability-linked bonds. Social impact bonds usually involve a service provider receiving capital from an investor to implement an intervention. If this intervention achieves a certain predefined social impact, a (usually public) institution pays the investor a return. Sustainability-linked bonds are “any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined Sustainability/ESG [environmental, social and governance] objectives” (ICMA, 2020b, p. 2). An investor might, for instance, agree to receive lower coupons if the issuer achieves certain sustainability targets, in order to incentivise the issuer to improve the sustainability of its activities. As with green and social bonds, the ICMA has developed voluntary process guidelines for sustainability-linked bonds (ICMA, 2020b). However, the guidelines leave much room for different sustainability targets, allowing for different understandings of social (or environmental) investment.

3.2 Social equity and sustainability ratings

Social finance is increasingly playing a role on equity markets. For instance, equity funds – taking the form either of actively managed funds or of exchange-traded funds (ETFs) – that claim to offer the opportunity of a social investment have rapidly increased in number in recent years. Sustainable ETFs replicate sustainable business indices, such as one of the MSCI SRI Indexes or the Dow Jones Sustainability Indices. Such indices cover a subset of the companies of a parent index that are selected for their sustainability performance.[11]

Various combinations of the approaches distinguished above are used in the selection procedures of actively managed funds or the compilation of sustainable business indices. For instance, many sustainable equity funds *exclude* some sectors, such as the production of military weapons, due to the kind of goods produced from their investment universe. This is often combined with a *best-in-class procedure*, or the application of *minimum criteria* that might also concern process-related impacts. Other funds use a *positive selection* of social sectors.

The definitions of social sustainability employed by sustainable equity funds have very different levels of ambition. In addition, many funds are not very transparent about the exact selection procedure of stocks and the sustainability criteria employed in these procedures. In general, in spite of the great number of financial products in this area, so far no common definitions or standards for social equity have emerged.

Sustainable equity funds often rely in their investment decisions at least partly on ESG data provided by sustainability rating agencies. Agencies such as MSCI, Refinitiv, or ISS-oekom assign corporations a rating according to sustainability criteria, and often provide additional ESG data. ESG ratings are typically relative to industry peers (MSCI, 2020, p. 4). Therefore, investment decisions based on sustainability ratings can be described as employing a kind of *best-in-class procedure*. Rating agencies usually focus predominantly on process-related issues, but often also consider to some extent the impacts of the goods and services produced.

Criteria related to the social dimension of sustainability that are part of the rating processes often concern, for instance, the situation of the workforce, product liability and engagement with local communities. Table 2 summarises what social categories are taken into account by four exemplary rating providers. On the level of general categories there is a rather high degree of overlap among different rating providers. However, as detailed methodologies of rating agencies are not always made publicly available, the precise understanding of the social dimension of sustainable finance implicit in their ratings is often unclear. In addition, sustainability ratings of different agencies have been shown to diverge to a substantial extent (Dorfleitner, Halbritter, & Nguyen, 2015). In general, the meaning and trustworthiness of

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11 For an analysis of a number of sustainable business indices, see Fowler and Hope (2007).

ESG data provided by these agencies is subject to debate (Berg, Koelbel, & Rigobon, 2019; Busch, Bauer, & Orlitzky, 2016; Cash, 2018; Widyawati, 2020).

Table 2: Social categories taken into account in ESG ratings by exemplary providers

	FTSE Russell	**MSCI**	**Refinitiv**	**S&P Global**
Social categories (terms used by the respective rating agency)	• Labour standards • Human rights and community • Health and safety • Costumer responsibility	• Human capital • Product liability • Stakeholder opposition • Social opportunities	• Workforce • Human rights • Community • Product responsibility	• Workforce and diversity • Safety management • Customer engagement • Community

Author's compilation based on FTSE Russell (2020), MSCI (2020), Refinitiv (2021), and S&P Global (2020)

4 The importance of common definitions

The discussion of definitions of social investments widespread on financial markets in the previous section revealed how heterogeneous understandings of social finance are. Great differences exist with respect to foci, selection procedures, and how demanding the criteria are.

In principle, there might be nothing wrong with having social financial products that follow different definitions. A diversified market can, for instance, allow investors who put much weight on social concerns to purchase products that are meant to make a clear positive contribution. Other investors who are less motivated by social concerns might at least be motivated to purchase financial products that take some minimal social criteria into account. In addition, financial products can be designed to align with values of specific population groups, such as certain religious communities.

However, if all providers can label financial products as social according to their own definition, this opens up opportunities for deceptive practices, such as "social washing". Social washing can be understood as analogous to greenwashing, which refers to exaggerated (or false) claims made by firms that mislead customers or investors about the impact of their business practices on the environment (Gregory, 2021, p. 1). The consequences of social washing are twofold: financial products that are labelled as "social" but are little different from conventional financial products cannot have a positive societal impact (or rather no impact that is different from the impact of other financial products) and potential investors are likely to be deterred from investing in social financial products (Migliorelli, 2021).

More generally, as is often argued with respect to standards and definitions concerning green bonds (Berensmann, 2017; Shishlov, Morel, & Cochran, 2016), a lack of harmonisation increases transaction costs because investors have to assess, in each case, what approaches are applied by the respective providers in the selection of social investment projects. Increased transaction costs lower the financial returns of social financial products compared to other products, and can thereby reduce market size.

A lack of common definitions and transparency could even lead to adverse selection due to asymmetric information. If consumers of sustainable financial products cannot easily distinguish between financial products that meet ambitious social standards and products that apply only loose standards or are even merely advertised as social but do not differ from conventional financial products, this can drive suppliers of financial products that conform to ambitious standards out of the market. If the level of ambition cannot easily be identified by investors, they might set their reservation price (i.e. the maximum price they would be willing to pay) lower than the price they would be willing to pay for products that meet high social standards. Suppliers that are only willing to provide their financial products at a higher price leave the market. Common standards are thus crucial to enable social finance to realise its potential in supporting the transformation of the economy towards sustainability. This holds true not only for standards on the definition of social investments but also for other kinds of standards for social financial products, such as standards on reporting or monitoring. In this paper, though, I focus exclusively on issues associated with defining what counts as a social investment.

5 The need for public governance and the EU taxonomy for sustainable activities

As a lack of common definitions can lead to social washing, increased transaction costs and adverse selection, social finance can only make a substantial contribution to the transformation towards sustainability if standards on definitions are developed. Such standards can, in principle, be established by private agents, such as associations of market participants and multi-stakeholder organisations, and by public agents, such as national governments and international organisations.

In general, private governance is sometimes able to achieve some harmonisation without issuing legally binding rules (Kawabata, 2020; Thistlethwaite, 2014). As described above, the ICMA as a private agent has established guidelines that are followed by many issuers of social and green bonds (and even by public institutions that issue such bonds). However, these guidelines remain on a very general level and do not include a sufficiently concrete definition of social investments.

Moreover, to establish *any* common definition is, obviously, not sufficient. Adequate definitions that ensure that social finance realises its potential in contributing to the transformation towards sustainability need to set, for instance, sufficiently ambitious criteria. The commercial interests of market participants, as they are organised in associations such as the ICMA, do not necessarily favour the definitions that would do best in terms of sustainability goals. In addition, the systematic exclusion of affected groups in decision-making raises issues of legitimacy if rules made by private agents become prevalent.[12]

12 For instance, the ICMA, in common with many institutions that provide private governance in the global sphere (Dingwerth, 2008), is dominated by agents from high-income countries. For a discussion of the shortcomings that can be associated with a strong role of private actors in global monetary and financial governance – focusing on the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO) – see Underhill and Zhang (2008).

Despite these shortcomings, private governance might still have a role to play in establishing standards for social finance. In the absence of public regulations, guidelines and principles of private association can constitute second-best solutions. In addition, private governance can provide opportunities for experimentation and serve as an "idea incubator" (Green & Auld, 2017, p. 271) for public actors. However, due to the described deficits, efforts of public institutions to develop common standards on the definition of social investments that, at least, complement forms of private governance in this area, are to be welcomed.

One of the first comprehensive efforts by a public institution to define sustainable economic activities is currently undertaken by the EU in developing a taxonomy for sustainable activities. The EU taxonomy is not the first effort to establish a public definition of social investments. However, attempts such as the ASEAN Social Bond Standards (ACMF, 2018) or the SDG Finance Taxonomy (Qing & Nedopil Wang, 2020) developed by United Nations Development Programme (UNDP) China and the China International Center for Economic and Technical Exchanges (CICETE) have remained rather general and have not exercised the same degree of influence on the markets as can be expected with respect to the EU taxonomy.[13]

The EU taxonomy should be used in a number of ways. Financial market participants will probably be obliged to disclose to what extent the proceeds of their financial products finance activities that are in line with the EU taxonomy. This disclosure requirement will apply to all agents that sell financial products in the EU, irrespective of where they are based. The EU taxonomy will thus also be of considerable importance to global markets and definitions of social investment followed by financial market participants from non-EU countries.

Not only financial market participants, but also large companies of all sectors that fall under the scope of the Non-Financial Reporting Directive (NFRD) will probably have to report on the proportion of their turnover, capital expenditure, and operating expenditure that is associated with economic activities that are sustainable in the sense laid out by the taxonomies.[14] In addition, the EU sustainable taxonomies should be used as definition of sustainable economic activities for all public labels for sustainable financial products that might be developed by the EU or the member states. This is relevant, for instance, to the EU Green Bonds Standard or the EU Eco Label for financial products currently being developed.

A green taxonomy has already been presented, in 2020. Green economic activities have to substantially contribute to at least one of six environmental objectives defined in the taxonomy (*positive selection*) and to do no significant harm (DNSH) to the realisation of

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13 The ASEAN Social Bond Standards and the SDG Finance Taxonomy are included in the overview in the Annex (table A1). Public taxonomies that focus on the green dimension are somewhat further developed. For an overview of green finance definitions and taxonomies, see OECD (2020).

14 However, the members of the Platform on Sustainable Finance that is preparing the EU taxonomies voice scepticism over whether it will be possible to calculate the proportion of turnover, capital expenditure, and operating expenditure for all objectives that are suggested for inclusion in the social taxonomy (Platform on Sustainable Finance, 2021, p. 33).

the other five.[15] Delegated Acts by the European Commission establish technical screening criteria for these objectives. In addition, the green taxonomy includes minimum social safeguards (*minimum criteria*).

A taxonomy of social activities that will probably have a rather similar structure is currently under development.[16] In preparing the sustainability taxonomies, the EU Commission is advised by the Platform on Sustainable Finance, a group of experts from private sector, civil society, and public institutions. In July 2021, the Platform published a draft report on the social taxonomy (Platform on Sustainable Finance, 2021).[17] The recommendations included in the report are interesting because they might provide a foretaste of what the prospective social taxonomy of the EU will look like.

The report emphasises that the social taxonomy should refer in its criteria to international agreements, such as the International Bill of Human Rights and the International Labour Organization (ILO) core labour norms. The members of the platform believe that, unlike in the case of the green taxonomy, it is often not possible to derive social criteria directly from scientific knowledge. The reference to “international authoritative standards” (Platform on Sustainable Finance, 2021, p. 4) is seen as a suitable alternative basis for the social taxonomy. In addition, the reference to international agreements is meant to avoid infringing on national sovereignty if these agreements are accepted by all EU member states.

The report suggests including five social objectives in the social taxonomy: improving accessibility of products and services for basic human needs, improving accessibility to basic economic infrastructure, ensuring decent work, promoting consumer interests, and enabling inclusive and sustainable communities. For each of these topics the fully worked out taxonomy would have to specify criteria for a “substantial contribution” and for “doing no significant harm” (the current report of the Platform on Sustainable Finance includes only examples of potential criteria). An economic activity would have to make a substantial contribution to one of the five objectives (*positive selection*) and to do no significant harm to the other four (*minimum criteria*) to count as socially sustainable.[18]

The first two objectives – referred to in the report as “vertical objectives” – relate to the impacts of goods and services on the realisation of social goals. The other three,

15 The six environmental objectives are: climate change mitigation, climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems.

16 How the green and social taxonomy will be related to each other is not yet clear. The Platform on Sustainable Finance describes two models in this regard. According to the first model, sustainable economic activities have to conform either to the green or to the social taxonomy and meet only some minimum safeguards with respect to the other dimension. According to the second model, there will basically be only one taxonomy. Sustainable activities would then have to make a substantial contribution to one of the objectives (green or social) and meet all green and social DNSH-criteria (Platform on Sustainable Finance, 2021, pp. 52-57).

17 For an earlier comprehensive proposal for the EU social taxonomy by a representative of a German NGO that is also member of the Platform on Sustainable Finance, see Schneeweiß (2020).

18 The EU green taxonomy is applied to economic activities. The report of the Platform on Sustainable Finance on the social taxonomy states, though, that it might not be possible to link social issues in all cases to economic activities. Instead, for some issues, such as tax transparency, it might make more sense to focus on economic entities (Platform on Sustainable Finance, 2021, p. 4).

"horizontal", objectives are process-related and can, in principle, be met by economic activities that produce all kinds of goods or services. The report suggests, though, excluding some economic activities as "significantly harmful activities", such as the production of tobacco and of certain kinds of weapons, because of the negative impacts of the goods produced (*exclusion*). According to the proposal of the Platform on Sustainable Finance, the EU social taxonomy would thus combine many of the approaches to identifying social economic activities described above (see Table 3).

Table 3: Overview of approaches used in the EU Social Taxonomy, the ICMA Social Bonds Principles, and definitions of social investments that build on ratings of sustainability rating agencies

	Impact of goods or services produced on social goals	**Process-related impacts on social goals (e.g. working conditions)**
Positive selection of sectors (or certain types of activities)	EU Social Taxonomy ICMA Social Bonds Principles	EU Social Taxonomy ICMA Social Bonds Principles
Exclusion of sectors (or certain types of activities)	EU Social Taxonomy	
Best-in-class procedures	Sustainability rating agencies	Sustainability rating agencies
Minimum criteria	EU Social Taxonomy	EU Social Taxonomy

Author's compilation, based on Platform on Sustainable Finance (2021) and ICMA (2020a)

6 Implications for development policy

In the previous sections, I argued that social finance could contribute to closing the funding gaps for social investments and setting incentives for the transformation of the economy towards sustainability (although the magnitude of its potential contribution is unclear). I also described the plethora of definitions of social investments on the markets, and explained how this plurality of definitions increases transaction costs and facilitates deceptive practices. For this reason, I argued that standards for the definition of social investments are necessary to allow social finance to realise its potential. The EU taxonomy for sustainable activities as a comprehensive classification system may well set such a standard.

The efforts of the EU to establish a comprehensive taxonomy for sustainable activities could, thus, in principle, be highly beneficial. In accompanying the process of developing the taxonomy, the German governments should seek to ensure that the taxonomy has a sufficient level of ambition and is not subsequently watered down in response to lobbying activities. As business actors are strongly represented in the Platform, this might be a real threat. Several NGOs, including the World Wide Fund for Nature (WWF), have also reported experiencing lobbying by EU member states in favour of specific commercial interests in the development of the green taxonomy. They suspended their participation in the Platform for Sustainable Development in April 2021 because they considered the taxonomy rules concerning bioenergy and forestry as being too weak, and were critical of lobbying activities that had led to these rules (WWF, 2021a), only resuming their work after the EU Commission proposed steps to increase the independence of the Platform (WWF, 2021b).

As described in the previous section, the adoption of the EU taxonomy for sustainable activities will have a great influence on global financial markets and the further development of standards for social financial products. Due to these global impacts, it is necessary to carefully assess consequences of the taxonomy regulation for non-EU countries, consult with representatives of these countries on potential impacts, and take these impacts into account in the design of the taxonomy.

The EU taxonomy could have impacts on poorer countries even if the amount of capital that is channelled to these countries in the near term through taxonomy-aligned dedicated sustainable financial products remains limited.[19] After all, the report of the Platform on Sustainable Finance on social taxonomy emphasises the importance of human rights due diligence that encompasses the entire value chain (Platform on Sustainable Finance, 2021, p. 32). Ambitious criteria with respect to international supply chains could potentially provide additional incentives for large companies to implement measures that improve working conditions and address local externalities of production processes abroad. However, the report does not yet specify exactly how requirements with respect to supply chains should be reflected in the taxonomy.

Supply chains are relevant for two of the social objectives included in the current proposal for the taxonomy, namely "ensuring decent work" and "ensuring inclusive and sustainable communities". To be able to set effective incentives, criteria for these objectives with respect to supply chains (in particular the criteria for "substantial contributions") must go much further than the legal obligations that are already enacted by national legislation or will be included in the EU due diligence law currently being prepared. Criteria should, for instance, not only concern immediate suppliers but the entire supply chain, and should go beyond requiring merely risk analyses.

While the EU taxonomy will arguably play a crucial role in setting standards for social finance and sustainable finance in general, activities of international organisations to monitor developments and work towards harmonisation in the area of social finance will remain relevant. Countries such as China or Mexico have, in the past, to some degree established their own standards in the area of sustainable finance, for instance with respect to green bonds. It is questionable whether they will simply adopt the definition of social activities set by the EU taxonomy for sustainable activities. While it can be beneficial if definitions are adapted to national circumstances, different standards will, as described above for the definitions of social investments followed until now by market participants, increase transactions costs. International cooperation on sustainable finance regulations has, in the past, been facilitated, for instance, by the OECD, the World Bank and the G20. It is crucial, though, that regulatory questions concerning sustainable finance are also discussed in more

19 Until now, markets for sustainable financial products have developed rather slowly in many economically poor countries. It has been argued that barriers to the development of, for instance, green bond markets in these countries include currency risks, requirements of international institutional investors to purchase only financial products with high credit ratings, minimum size requirements, limited technical capacity, and high transaction costs (Banga, 2019; Jones et al., 2020). It is plausible that these barriers also apply to markets for social financial products.

inclusive processes, such as the Financing for Development (FfD) process of the United Nations (UN).

In 2018, the EU launched, together with a number of relevant authorities from non-EU countries, the International Platform on Sustainable Finance (IPSF).[20] Today, the platform includes 17 members, including countries such as China, India, Japan and Kenya. It is meant to facilitate the exchange between its members and promote best practices with respect to sustainable finance policies.[21] For instance, the platform is working “toward a ‘Common Ground Taxonomy’ highlighting the commonalities between existing taxonomies” (International Platform on Sustainable Finance, 2020, p. 6). In general, the German government and the EU should encourage discussion of issues related to social finance in inclusive fora, and support poorer or smaller countries in actively participating in decision-making with respect to the governance of sustainable finance.

20 The IPSF should not be confused with the Platform on Sustainable Finance mentioned above, which is an expert group that advises the EU with respect to its sustainable finance policies.

21 However, the IPSF seems to have focused until now mainly on the green dimension of sustainable finance.

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Annex

Table A 1: Overview of eligible activities and target populations specified in social taxonomies and social bond principles			
	Function	**Eligible activities**	**Target groups**
EU Social Taxonomy (Proposal of the Platform on Sustainable Finance 2021)	Classification system for all economic activities	• Improving accessibility of products and services for basic human needs • Improving accessibility to basic economic infrastructure • Ensuring decent work • Promoting consumer interests • Enabling inclusive and sustainable communities	(no target groups specified)
SDG Finance Taxonomy (developed by UNDP China and CICETE)	Classification system for all economic activities to enable "users to navigate sustainable project finance", developed for the Chinese context	• Basic infrastructure • Affordable housing • Health • Education, technology, and culture • Food security • Financial services	• Unemployed/underemployed people • Underserved (e.g. people living in remote areas) • Undereducated people • Migrants and displaced persons • People with disabilities • Vulnerable groups (e.g. children, senior citizen, and pregnant women) • Excluded/marginalised populations • People living below the poverty line
ICMA Social Bond Principles (The **ASEAN Social Bond Standards** are – with respect to the categories described in this table – identical to the ICMA Social Bond Principles.)	Guidelines for Issuers of Social Bonds	• Affordable basic infrastructure • Access to essential services • Affordable housing • Employment generation • Food security and sustainable food systems • Socio-economic advancement and empowerment (Only meant as examples)	• Living below the poverty line • Excluded and/or marginalised populations and /or communities • People with disabilities • Migrants and /or displaced persons • Undereducated • Underserved, owing to a lack of quality access to essential goods and services • Unemployed • Women and/or sexual and gender minorities • Aging populations and vulnerable youth • Other vulnerable groups, including as a result of natural disasters (Only meant as examples)
Author's compilation based on Platform on Sustainable Finance (2021), Qing & Nedopil, Wang (2020), ICMA (2020), ACMF (2018)			

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