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ESG Integration and SRI Strategies in the EU

Challenges and Opportunities for Sustainable Development

Edited by Luca Spataro
Maria Cristina Quirici · Gabriella Iermano

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Luca Spataro · Maria Cristina Quirici · Gabriella Iermano
Editors

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Preface

In recent years the European Union (EU) has firmly established itself as an international leader in promoting sustainable financial growth, pushing for concrete policy actions and regulatory frameworks to address the negative effects of climate change and to pursue the Sustainable Development Goals of the 2030 Agenda of the United Nations. Starting with the European Commission (EC)'s *Action Plan on Financing Sustainable Growth* in March 2018 and then, in December 2019, with the Green Deal, the European Union has set itself some ambitious goals on these issues, including a reduction of 55% of greenhouse gas emissions by 2030, and become a fully conditionally neutral continent by 2050. To facilitate the achievement of these objectives, in January 2020 the EC published a *Sustainable Finance Plan*, with the aim of systematising the economic and environmental policies and encouraging sustainable investment; subsequently, in June 2020, the EU published a Regulation on the *Taxonomy* of environmentally sustainable economic activities (852/2020/EU), as well as a new *European Standard for Green Bonds*. Finally, the EC recently approved *Regulatory Technical Standards* for disclosure by financial market participants of sustainability-related information under the *Sustainable Finance Reporting Regulation*, known as SFDR (2088/2019/EU).

The analysis of the effects of these ambitious policy measures is at the core of the present volume. In particular, the volume provides a multidisciplinary insight into economic, financial, and legal issues concerning

Sustainable and Responsible Investments, green finance and the growing ESG factors integration at European and international levels.

The editors of this book have been working together on these issues since 2015, the year in which they established an international network involving researchers from various fields, in the belief that only a multi-disciplinary approach can provide effective means to examine these issues correctly. In particular, this volume collects some of the contributions presented at the Final International Conference of the Jean Monnet Project *Assessing EU strategy on green finance and ESG Factors*, held in Pisa on 16–17 June 2022, funded by the European Union.[1]

We hope that this volume will contribute to deepening the issues related to SRI and ESG integration, as they have emerged around the world in recent decades, and, in particular, in the European Union in recent years. In particular, we hope to persuade the reader that a multi-disciplinary approach is an effective and correct means to address these issues.

At the end of this Preface, we would like to thank all the participants in the Research Project, in the Final Conference held in Pisa and, finally, the Publisher, for its kind support.

Pisa, Italy
April 2023

Luca Spataro
Maria Cristina Quirici
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[1] The research group, coordinated by Luca Spataro, has received two grants on competitive calls from the European Union within the Jean Monnet projects action in 2016 and 2020: "Development and Harmonization of Socially Responsible Investment in the European Union", (project code 574998-EPP-1-2016-1-IT-EPPJMO-PROJECT) and "Assessing the EU Strategy on Green Finance and ESG factors (AEU_GF)", (project code 620016-EPP-1-2020-1-IT-EPPJMO-PROJECT). The details of the research activity of the latter project can be retrieved at https://agreenfin.ec.unipi.it/.

Praise for *ESG Integration and SRI Strategies in the EU*

"This book is an essential resource for anyone looking to gain greater insight into how the EU is approaching sustainable development and how the integration of ESG strategies is transforming this space. With an in-depth analysis of the ESG framework, SRI strategies, and their connection to sustainable development, this book is an indispensable resource for policy-makers, regulators, educators, and the corporate world. Highly recommended for all those interested in European development."

—Scheherazade S. Rehman, PhD, *GW Deans Professorial Fellow of International Finance, Professor of International Finance (GWSB) & Professor of International Affairs (ESIA), The George Washington University, USA*

"In the past decade EU leadership has been clearly established in ESG and SRI strategies. By contrast in the United States, the field has been increasingly met with politically motivated backsliding. This book is the antidote to skepticism and resistance. It is an essential overview, covering the full spectrum of topics for practitioners and policymakers alike, demonstrating in a clear and compelling fashion why ESG integration and SRI has been, and will continue to be, a powerful force for sustainable development."

—Laura Berry, *Mutual Fund Director, Foundation Trustee and Shareholder Advocate, New York City, U.S.*

"Driven by a multidisciplinary approach this book is about systematizing the economic and legal framework and policies of the Sustainable Development Goals. The authors provide valuable insights on how to enable stakeholders from small island states up to strong European economies to enable financing sustainable growth."

—Viola Heutger, *Rector Magnificus, University of Aruba*

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CHAPTER 1

Introduction

Luca Spataro, Maria Cristina Quirici, and Gabriella Iermano

The challenges of the globalization process, such as climate change and the waste of natural resources, together with the consequences of the recent economic and financial crises triggered, on the one hand, by the Covid-19 pandemic and, on the other, by energy supply problems caused by international geopolitical tensions, have provided new impetus to both the public sector and the private financial industry towards socially responsible economic behaviour and choices.

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As regards the initiatives promoted by international organizations, it is worth mentioning the launch of the *United Nations Principles for Responsible Investment* in 2006 (UN PRI), the issue of climate bonds (i.e. green and themed) by multilateral organizations since 2007, the publication of the 17 *Global Sustainable Development Goals* (SDGs) by the United Nations in 2015, the Agreement of Paris on climate change in the same year, the *Climate Task Force of the Financial Stability Board* (FSB), the initiative relating to financial disclosure (TCFD) in the European Union of 2016.

As far as the financial industry is concerned, it is worth highlighting that financial and political liberalization has attributed an increasing role to financial markets in tackling environmental sustainability problems, and that, in particular, the international crisis that began in 2007 has produced a greater demand for higher standards and transparency from financial organizations on their governance structures, risk management strategies and practices. As a result, in recent years institutional investors have begun to include environmental, social and governance (ESG) responsibility factors in their investment decisions, giving rise to the well-known phenomenon of socially (or, sustainable) responsible investments (SRI). In particular, institutional investors use their influence to affect the choices of the companies in which they invest and are calling for corporate governance reforms to address the sustainability issues that come from society. Such investors, under the influence of the general public and young generations, invoke ESG criteria being incorporated in management, investment decision-making or shareholder activities, thus aiming to generate both significant financial returns and positive social impacts.

As a result, since the 1980s the SRI industry has evolved from an activity carried out by a very limited number of investment funds—with negligible economic impact—to an investment philosophy that, by incorporating ESG factors into its investment selection and decisions processes embraced by a growing share of investor institutions, has become an important part of the International Asset Management Capital Market.

The Global Sustainable Investment Alliance report highlights that in 2020, global SRI assets amounted to USD$35.3 trillion, with an increase of 55% since 2016. This amount represented 35.9% of all professionally managed assets in the world.

On one hand, proponents argue that SRI can play a crucial role in influencing companies to address Corporate Social Responsibility

issues, deliver "dual yields"—both economic and social—stabilize financial markets, and finance modern forms of welfare state or social policies. However, opponents argue that SRI strategies may have lower returns, entail higher expenses, and reduce the degrees of freedom of a full-choice market spectrum and risk diversification possibilities. Some authors also doubt the effectiveness of divestment strategies from "bad" companies compared to other strategies, such as customers' boycotts or shareholder voting. The lack of universally agreed taxonomy of SRI practices and regulations raises concerns about so-called companies' "greenwashing" behaviour. Moreover, while economic and financial studies of SRI have primarily concentrated on its profitability in comparison to traditional investment, only recently have theoretical models been proposed to incorporate environmental externalities and results are still sparse. Finally, the debate about which approach to be adopted—i.e. hard law or soft law—is still on the public agenda.

Furthermore, in recent years the European Union (EU) has implemented strict regulatory measures and set ambitious goals to foster sustainable economic growth, reduce carbon emissions, and mitigate climate change, also through promoting green finance (among the most recent steps, it is worth recalling the Taxonomy Regulation, the Sustainable Finance Disclosure Regulation (SFDR), Low Carbon Benchmarks Regulation, the Non-Financial Reporting Directive, the Green Bond Standard). The EU has also set up a range of financial mechanisms and institutions, including the European Investment Bank (EIB) and the European Green Deal Investment Plan, to support the transition to a more sustainable economy. However, critics argue that it is important to strike a balance between regulatory measures and market-based solutions while ensuring effective implementation and enforcement across all member states.

These are only but a few issues on the role and the effects of SRI, ESG practices and European Regulation that are at the core of the present volume. Given the breadth and complexity of the problems at stake, the volume aims to analyse them by adopting a multidisciplinary point of view, thus collecting the contributions of scholars of economics, finance, law and economic history.

More precisely, the volume is divided into four Sections, each containing three chapters, which reflect the multidisciplinary approach of the research project:

1. “Theoretical and empirical issues on SRI and ESG Integration”;
2. “Corporate Governance, SRI and ESG Integration”;
3. “ESG Integration: Valuation, Products and Risks”;
4. “Legal and Regulatory Issues on SRI and ESG Integration”.

As for the first Section, Chapter 2 by Marsiliani, Naga, Renström and Spataro provides a review of the economic theoretical literature on SRI. In particular, the authors argue that standard neoclassical models of preferences cannot fully explain SRI and, in particular, how individuals incorporate ESG factors into their investment decisions. The authors note that in order to comprehend SRI, it is important to consider the significance that the investor assigns to their actions and the ethical or societal advantages they receive from supporting ESG factors, even regardless of the outcomes of their contribution. This shift of focus moves away from the consequentialist viewpoint of value, pursued by the neoclassical approach, and towards a deontological perspective, where investors assign value to their actions (Kantian ethics). Moreover, the authors argue that their analysis proposes an agenda for future research to answer two key questions: Would non-standard preferences enable an efficient equilibrium whereby externalities from production are internalized? If government intervention is needed, what is the nature of this intervention under these non-standard preferences? Answering these questions, the authors argue, could guide the efficient design of policy to promote SRI.

In Chapter 3, Gianmoena and Spataro provide a review of empirical literature on the performance of SRI compared to traditional investments. In particular, the authors analyse the main findings from literature examining the performance of SRI mutual funds and SRI portfolios compared with non-SRI investments, bringing out the different theories supporting the possible outcomes. The research suggests that SRI investments do not result in worse returns and seem to perform as well as standard assets, with less volatility, especially during times of crisis. However, the question of whether SRI strategies outperform traditional investment strategies remains still open, due to methodological issues in estimating the full financial and non-financial returns of SRI investments. The authors conclude that future research should aim to scrutinize the overall value of SRI, not just its financial returns, by providing new measures that consider both the economic and social value of SRI.

Chapter 4 by Quirici reviews the evolution of the concept of SRI, from "Ethical Finance" to "Sustainable Responsible Investment". The author highlights the main features of SRI, which involves research, analysis and selection of investments based on ESG criteria and emphasizes how this concept has been incorporated into recent European ESG Regulatory Frameworks, specifically the EU Taxonomy and the Sustainable Finance Disclosure Regulation. The author also discusses a new possible "Classification Scheme" for sustainable investments and the necessity of aligning definitions related to the concept of "sustainable investment" in all the considered EU regulations to avoid "greenwashing".

In Chapter 5 of Section II, Iermano and Schittenhelm address a fundamental question: is the shift towards sustainability driven solely by ethical concerns or do legal and financial factors also play a role? The article takes an interdisciplinary approach to address this complex question and examines the increasing relevance of sustainability from both the corporate and financial law perspectives. In particular, the authors evaluate the extent to which modern legal systems are moving towards higher sustainability standards and consider the potential economic benefits and costs of complying with these standards. The authors conclude that sustainability should be viewed from a project perspective, and propose a differentiated approach to profit and risk assessment that takes into account the sustainability of investments and businesses.

Recently, the European Commission proposed a Directive on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 on February 23, 2022. The proposal seeks to create a corporate sustainability due diligence obligation to combat negative human rights and environmental impact and harmonize existing national or voluntary regulations on due diligence. Latella, in Chapter 6, argues that the proposed Directive on corporate law centres on the triple duty of businesses to respect human rights, the natural environment, and good governance. The legislation would apply to large and listed companies, potentially having a pervasive impact. According to the author, the new discipline could face criticisms for its vagueness and new duties imposed on companies, but a cultural shift towards sustainable finance may alleviate concerns of competitive disadvantage for European companies. The proposed reform indirectly affects corporate law, specifically on the duties and responsibilities of directors and controlling shareholders. The general "duty of care" for directors to pursue the corporation's interests with reasonable diligence and prudence is now specified into a concrete duty

of adopting due diligence policies, taking into account stakeholder and civil society input, and integrating due diligence into corporate management systems. Directors would be responsible for both the lack of such policies and procedures and their inadequacy.

In Chapter 7, Della Tommasina examines the impact of sustainability factors on the Italian insurance market, particularly in promoting ESG objectives in the non-life sector. The paper suggests contractual solutions that can promote sustainability goals by deviating from the legal framework in the Italian Civil Code. The placement of insurance products is also discussed from two perspectives: individual customer relationships and the packaging of the product for a distribution strategy that promotes ESG preferences. The chapter also considers the role of product oversight and governance in promoting ESG objectives for large-risk insurance, as well as the manufacturer's influence on distributor relationships and the internal corporate governance policies of the insurance company.

In the Third Section, Chapter 8 contains an analysis by Fasano, Guardabascio and Stanghellini aimed at investigating the impact of compliance with ESG factors on credit ratings of European companies. The authors use mediation analysis to separate the direct and indirect effects of standard balance sheet indicators and ESG ratings on credit ratings. In particular, the authors consider the three aspects of the ESG score separately and find that only Governance has an impact. More precisely, they find that only Governance has a significant indirect effect on credit ratings, although the effect is relatively small.

In Chapter 9, Quirici investigates the emerging Blue Economy, particularly in Europe, and its potential for sustainable development. She highlights the need for a new Blue Economy Framework to pursue Goal 14 of the UN's 2030 Agenda, which involves conserving and sustainably using marine resources. The author discusses the recent EU Blue Economy Reports and the commitment of policy-makers and private institutions to the Blue Economy, especially from a regulatory and financial perspective. The author highlights the need for regulation in relation to Blue Bonds and concludes by suggesting further research in this area.

In Chapter 10, Quirici and Giurlani show that the EU has positioned itself as a global leader in promoting sustainable finance and has the lion's share (82%) of sustainable fund assets, with the US having 12% of sustainable fund assets. The EU has implemented an ESG regulatory framework, including the *Sustainable Finance Roadmap 2022–2024* by ESMA, which aims to integrate sustainability into the single rulebook, build common

approaches for incorporating ESG factors, monitor market developments, and improve transparency on the role of ESG factors. However, there are concerns regarding the implementation of the EU SFDR, particularly in the definition of sustainable investment and product classification, which could lead to fragmentation in the European investment market and compromise cross-border distribution of sustainable products. The authors conclude that urgent regulatory interventions are needed to address these concerns and reduce the risk of greenwashing.

In Chapter 11 Nelemans argues that a multi-level approach is needed for ESG objectives, with some lending themselves well to self-regulation and soft law. The EU has expanded its financial supervision law to include sustainability and green finance, but challenges remain, including combating greenwashing and anticipating conflicts with pre-existing laws. The author suggests that feedback and reporting from markets and institutions could impact standard-setting and subsequent integration of ESG into institutions' operations and culture.

Chapter 12 discusses the use of private law as a last safety net to influence the policies of governments and companies when government and administrative law fail to realize the goals set in the ESG criteria. The author, van der Velden, argues that, however, recent developments have challenged the trias politica, where courts are forced to interfere in issues where policy-making should set the standard. The author notes that innovative climate policy from the government is the most important route to change, but private law is also starting to play a role in promoting ESG.

Chapter 13 by Martini analyses the language used by the EU from 2002 to 2022 to refer to socially/sustainable responsible investments, mainly in legal and regulatory contexts. The author uses corpus linguistics software to measure changes in the meaning of the acronym SRI over time and determine the EU's influence in guiding this process. The results show that the EU has significantly contributed to the shifting of the concept of SRI to a mainly environmentally related issue.

The authors of this volume have taken on the challenge of addressing some of the most pressing issues that the EU and the world as a whole are facing. The transition towards a more sustainable and resilient society is indeed an arduous journey, and it requires the concerted effort of all stakeholders. We believe that the analyses and the solutions proposed by the authors can indeed serve as useful compasses to guide the next steps towards achieving this ambitious goal.

PART I

Theoretical and Empirical Issues on SRI and ESG Integration

CHAPTER 2

Theory of Socially Responsible Investment: A Review

Laura Marsiliani, Lucy Naga, Thomas I. Renström, and Luca Spataro

2.1 Introduction

Socially responsible investment (SRI) is a "long-term oriented investment approach, which integrates environmental, social and governance (ESG) factors in the research, analysis and selection process of securities

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within an investment portfolio" (Eurosif, 2016, p. 9). Socially responsible investors employ strategies of positive or negative investment screening, shareholder advocacy, impact and community investing in order to identify and invest in companies that meet certain standards of ESG factors (GSIA, 2020 for more details).

According to the latest Global Sustainable Investment Alliance report (GSIA, 2020), across regions covered in the report[1] USD$35.3 trillion was invested in SRI funds in 2020, equating to 35.9% of all professionally managed assets across those regions. The report records a growth of SRI, with funds growing 15% since 2018 and 55% since 2016. Research by OnePlanetCapital (Green, 2022 *Unbiased*), a new sustainability-driven investment house, has found that 85% of investors now view climate change as the greatest long-term threat, and many have begun to move their investments in response. 12% plan to transfer into ESG funds this year and a further 17% plan to move in the next few years. These statistics suggest that investors value ESG factors and that the growth of SRI will continue. This finding emphasises the importance of gaining an economic understanding of SRI, the motivating factors driving it, and the economic, environmental, and social consequences of it.

The empirical literature presents mixed evidence regarding the financial return to SRI (see Chapter 3). Many studies find that financial returns on ESG funds tend to fall below conventional funds (Baker et al., 2022; Barber et al., 2021; Bolton & Kacperczyk, 2021; Hong & Kacperczyk, 2009; Jones et al., 2008; Pástor et al., 2021; Zerbib, 2019). However, studies also find that in times of economic or environmental crisis, ESG funds have been found to outperform conventional funds (Pástor & Vorsatz, 2020; Pástor et al., 2021; Varma & Nofsinger, 2014).

Given the empirical evidence, it appears that whilst ESG practises may be desirable to improve the environmental and social impact of the firm, they do not directly contribute to financial performance. This suggests that socially responsible investors are willing to accept lower financial returns from firms engaging in ESG practices. Economists seeking to model such socially responsible preferences argue that investors are motivated by preferences for non-pecuniary attributes (Lewis & Cullis, 1990), pro-environmental preferences (Zerbib, 2019), and preferences for social

[1] In its fifth edition, the biennial Global Sustainable Investment Review 2020 maps the state of sustainable and responsible investment of major financial markets globally, combining regional data from the United States, Canada, Japan, Australasia and Europe.

impact (Barber et al., 2021). This implies that they not only value the cash flows from their investments but also how those cash flows are generated (Dam & Heijdra, 2011), deriving benefits from investing in ESG factors.

Whilst ESG practises are not explicitly priced within the market, investors display a willingness to pay for the positive externalities ESG practises entail, implying that the standard neoclassical model of independent, egoistic, risk-adjusted-returns-maximising investors cannot explain observed patterns of SRI.

On the other hand, the studies finding that ESG funds can outperform conventional funds in particular scenarios suggest that even independent, egoistic, risk-adjusted-returns-maximising investors have some incentive to engage in SRI. Pástor et al. (2021) suggest that in times of bad climate news green stocks become a hedge against climate change risks in the market. Bad climate news encourages a growth in green consumerism and environmental legislation which favour ESG firms. Other arguments suggest that ESG factors may improve returns due to reduced costs of conflict (Renneboog et al., 2008), attracting more motivated workers (Brekke & Nyborg, 2008; Grolleau et al., 2012; Nyborg & Brekke, 2004), reduced pressure from lobbyists (Baron, 2001), reduced agency costs (Barnea & Rubin, 2010), or due ESG factors signalling more competent managers and therefore better management and higher financial returns.

Overall, given that there is no concrete empirical evidence of higher financial returns to SRI funds, we are led to conclude that conventional models of investor behaviour fall short of explaining why a set of investors would commit to SRI. In a multi-country survey, Williams (2007) finds that investors' attitude towards social issues is likely to be a key driver of SRI. Bollen (2007) suggests that a multiple-attribute utility function incorporating a set of personal and societal values alongside standard risk-adjusted financial values would be a more suitable model of investor preferences. Renneboog et al. (2008) claim that if investors do have a multiple-attribute utility, then we should expect two things. Firstly, we should expect SRI to continue to grow even if the risk-adjusted financial returns on socially responsible funds are lower than conventional funds. Secondly, we should expect money flows to be less sensitive for socially responsible funds. Whilst there is mixed evidence on the returns of SRI funds, Bollen (2007) and Renneboog et al. (2011) find that volatility in SRI fund flows is lower than the volatility of conventional fund flows. Furthermore, they find that flows are less responsive to poor returns than

to high returns, suggesting socially responsible investors value financial returns, but that they also have a greater commitment and loyalty towards socially responsible firms who may have lower returns.

Within this review, we will be focusing on how non-standard preferences have been incorporated into models of investor behaviour.[2] We will first focus on warm-glow preferences (Andreoni, 1990), their role in investor behaviour (Dam, 2011), and their policy implications (Dam & Heijdra, 2011; Renström et al., 2019, 2021). We will then draw on the literature on public good provision and green consumerism to enrich the warm-glow concept with moral preferences. We will pose two key questions for future research. Firstly, would these non-standard preferences enable an efficient equilibrium to be achieved whereby externalities from production are internalised? Secondly, if government intervention is needed, what is the nature of this intervention under these non-standard preferences?

2.2 Socially Responsible Investors with Warm-Glow Preferences

2.2.1 Why Does the Neoclassical Model Fall Short?

The neoclassical model of agent behaviour was constructed within the framework of a perfectly functioning market, where information is complete, competition is perfect, and markets are complete such that there are no externalities. In such a market, the egoistic consequentialist framework of the neoclassical model is an adequate conception of agent behaviour, since the agent has complete information about the consequences of their actions, prices are set at marginal costs and as such are a reliable signal of value, and markets are complete with all consequences appropriately priced. If just one of these assumptions does not hold, the neoclassical model of behaviour diverges from observable behaviour. Even Edgeworth, who stated that 'the first principle of Economics is that every agent is actuated only by self-interest' (Edgeworth, 1881) recognised this principle was appropriate for agents engaging in 'economical calculus' (exchange in a perfectly competitive market), yet it was perhaps fundamentally mistaken about general human behaviour. If economic decisions take place within imperfect, incomplete markets, the motivation driving

[2] We also provide a summary of the main literature in a table in the Appendix.

human behaviour diversifies beyond self-interest. Arrow (1973) states that 'a close look reveals that a great deal of economic life depends for its viability on a certain limited degree of ethical commitment. Purely selfish behaviour of individuals is really incompatible with any kind of settled economic life'. This suggests that social norms, community values, and moral rules which guide non-economic behaviour have an important role to play in much of economic life.

In the context of SRI, we observe investors who are willing to accept lower returns in order to invest responsibly in firms that promote ESG factors. These ESG governance factors represent a form of positive externality which is not adequately accounted for within the market, therefore the assumptions behind the first principle of economics fail to hold. Subsequently, we see a divergence between observed behaviour and neoclassical representations. We must draw on human dimensions of behaviour to understand investors' behaviour in such imperfect markets.

2.2.2 *Warm-Glow Model of Socially Responsible Investors*

A first step has been made towards modelling the non-standard preferences of socially responsible investors. Dam (2011) claims that socially responsible investors care not only about the cash flows of their investments but also about how these cash flows are generated. Graff Zivin and Small (2005) and Dam (2011) model investors with 'warm-glow' preferences. The concept of a 'warm-glow' preference was introduced by Andreoni (1990) to explain why agents would voluntarily contribute to the provision of a public good. Andreoni suggested that agents derive a private benefit from the act of contributing which is separate from the benefit derived from the public good itself. Graff Zivin and Small (2005) suggest that socially responsible investors perceive the firm's managers to act on their behalf, and thereby investors experience this 'warm-glow' payoff from the act of contributing to public goods through holding securities issued by socially responsible firms. Similarly, in the context of environmental externalities, Dam (2011) models socially responsible investors as feeling partly responsible for the pollution generated by firms in which they hold shares, and therefore deriving a private 'warm-glow' benefit from investing in 'clean' firms. In Dam's (2011) model, socially responsible investors limit their investment opportunities or accept lower returns from ESG equity due to the private benefit they derive from investing in 'clean' firms.

Within Dam's (2011) model, investors can invest in 'clean' government bonds or in 'dirty' corporate shares. He models investor utility to depend upon consumption, environmental quality, and a warm-glow payoff. This warm-glow payoff depends upon the agent's shareholdings in dirty firms, along with either the total stock of environmental quality or the flow of pollution. Both the stock and flow models demonstrate higher warm-glow benefits from clean investment portfolios where the agent has lower 'dirty' stockholdings. Henceforth, the agent will have a preference for clean assets and will require a pollution premium on dirty assets. This corresponds with the empirical findings of Hong and Kacperczyk (2009), where investors require higher returns on 'sin' stocks which exhibit externalities.

Dam (2011) suggests that SRI creates a role for the stock market to deal with intergenerational externalities. The pollution premium required by investors on dirty stocks pushes up the necessary marginal product of capital which reduces the level of capital for these firms and lowers pollution. Dam finds that the size of the pollution premium depends upon how the warm-glow is formalised. Where the warm-glow depends on the stock of pollution, the premium is the discounted sum of pollution premia for all future generations. Whereas, where the warm-glow depends on the flow of pollution, the premium is only the current generation's pollution premium and is therefore much lower. Therefore, the former representation has a larger effect on pollution and is able to internalise a greater extent of the environmental externalities, whilst the latter has a much smaller effect.

Similar models of warm-glow preferences have been employed to investigate how SRI interacts with environmental policy (Dam & Heijdra, 2011; Renström et al., 2019, 2021).

2.2.3 Policy Implications of SRI

Dam and Heijdra (2011) introduce warm-glow preferences of socially responsible investors into a continuous time dynamic growth model. They consider how SRI interacts with fiscal policy in the form of a public abatement program financed through lump-sum taxation. Within their model, warm-glow preferences result in investors requiring higher returns from polluting firms, this pollution premium implies an implicit tax on the value of the polluting firm, increasing their cost of capital and discouraging investment. Public abatement policies will reduce the

level of pollution at every level of capital stock. Such policies are funded through lump-sum taxation; thus, they will reduce resources available for consumption. Lower private consumption reduces the marginal rate of substitution between the environment and private goods, implying a reduction of the implicit tax from warm-glow preferences. This reduces the costs of capital for polluting firms leading to larger capital stock and higher pollution. Dam and Heijdra argue that SRI behaviour partially offsets the positive effects on the environmental quality of public abatement policies. This is because, in the absence of warm-glow preferences, consumption will fall due to an increased lump-sum tax, but since there is no implicit tax on polluting firms, this implicit tax cannot be reduced, and capital stock will not increase. However, it is important to note that pollution will always be lower under SRI behaviour.

Conversely, Renström et al. (2019, 2021) find that SRI can reduce the need for environmental policy and has the potential to increase its effectiveness. Firstly, Renström et al. (2019) investigate the impact of SRI on optimal pollution taxes. They show that pollution taxes reduce the marginal productivity of capital, shrinking the level of capital invested in by firms, and lowering the overall production levels, consequently reducing total pollution emissions. This works in a similar way to the effect of warm-glow preferences which impose an implicit tax by requiring a pollution premium from dirty firms. Renström et al. (2019) find that in the presence of socially responsible investors, the optimal pollution tax will be smaller since firms will be faced with both the pollution tax charged by the government and the pollution premium required by investors. Both of these wedges will improve environmental quality at the cost of economic output. Since a lower pollution tax will be more politically feasible, SRI can help to fill the gap to further internalise environmental policies. They also conclude that public intervention is always needed, as SRI can never fully solve the externality problem.

Secondly, Renström et al. (2021) investigate the impact of SRI on subsidies to abatement. In this paper, the authors seek to resolve the conflict between environmental quality and economic performance. We have seen that pollution taxes reduce pollution by reducing installed capital, reducing production, and reducing per capita consumption. They investigate whether subsidies on abatement could reconcile this conflict and study the influence of socially responsible investors in this scenario. Subsidies to abatement would reduce firms' cost of production thereby increasing investments in capital and in abatement activity. On the one

hand, increased capital would increase production and increase pollution. On the other hand, increased abatement activity would make production cleaner and would decrease pollution per unit. Therefore, subsidies have the potential to reduce pollution without harming the economy, and may even increase steady-state consumption, but their influence is ambiguous. Renström et al. (2021) argue that the effect of the abatement subsidy hinges on the pollution premium for socially responsible investors. If there is no warm-glow, then the firm will always have higher profits from engaging in zero abatements unless they are subsidised >100%, therefore the subsidy would not be effective. With a warm-glow, the firm must equate the marginal cost of abatement after the subsidy to the marginal pollution premium, henceforth given a pollution premium, an increase in the subsidy will lower the abatement cost below the pollution premium and thus increase abatement. Consequently, they suggest that subsidies are a more politically feasible instrument of environmental policy, and the case for subsidies is strengthened by the presence of socially responsible investors with warm-glow preferences.

Whilst public abatement (Dam & Heijdra, 2011) and subsidies to private abatement (Renström et al., 2021) cause an increase in steady-state capital, they have different effects on steady-state consumption. Public abatement always causes a reduction in steady-state consumption, whilst subsidies to private abatement may cause a consumption increase. The reason is that the abatement subsidy to firms is more efficient, and consequently, the lump sum tax to implement it is lower.[3]

[3] It should be noticed that there is a difference in the respective representation of firms. Renström et al. (2021) model firms as engaging in abatement activity which reduces their output of pollution, henceforth, when faced with a higher cost of capital through the pollution premium required by socially responsible investors, firms have an incentive to engage in abatement activities to lower their pollution and therefore lower the cost of capital. Given this feature of the model, we can see why SRI improves the effectiveness of subsidies, because SRI investors give them an incentive to clean up their production. On the other hand, Dam and Heijdra (2011) model government abatement and use a constant parameter to capture the pollution content of production.

2.3 Beyond Warm-Glow Preferences

2.3.1 Moral Mechanisms Driving Warm-Glow Payoffs

The warm-glow concept claims that the more one contributes to the public good, the better one will feel. Andreoni et al. (2017) claim that 'the concept of the warm-glow is a placeholder for more specific models of individual and social motivations'. Nyborg (2018) argues in favour of enriching the concept of the warm-glow and the mechanisms underlying it. She suggests, from a moral perspective, the warm-glow should depend upon other factors as well, such as the agent's beliefs about the social importance of the cause and their perceived moral obligation to do something about it. Furthermore, from a social perspective, it should depend upon the prevalent social norm and the observability of their actions. Henceforth, more is not always better from moral and social perspectives. Understanding the mechanisms underlying the warm-glow is important to understand and predict investor behaviour and to designing effective environmental policy.

In the previous section, we highlighted how the neoclassical model of behaviour failed to represent SRI due to the market failures brought about by the positive external effects of ESG practices which are not appropriately priced within the market. Understanding the nature of these positive external effects can help to understand the social and moral motivations underpinning them. Firstly, the utility of agents becomes interdependent when external effects exist. Secondly, when there is interdependence, egoism is no longer an appropriate model of human behaviour.

On the one hand, the investor may value the positive environmental and social externalities in themselves, deriving benefit from a cleaner environment (Zerbib, 2019) and gaining joy from others' well-being due to altruistic preferences. In view of this, the investor may place value on these consequences and be willing to contribute towards them. On the other hand, in many cases the effect of an individual investor's contribution to promoting ESG practises will be negligible, therefore, even if they value the marginal effect of their contribution, this is not sufficient to cover the cost of accepting a lower financial return. Therefore, to explain SRI we must think about the value that the investor is placing on the action itself and the moral or social benefits they derive from contributing to ESG factors, regardless of the consequences of their contribution. This

draws attention away from consequentialist theories of value and towards a deontological view, whereby investors place value on their actions.

The term 'socially responsible investment' is often used interchangeably with 'ethical investment'. This metonym offers a moral interpretation of investor behaviour. Brooks (1989, p. 32) defines ethical investors as those who 'believe that all investments they make have an ethical dimension, that they can and should apply their ethical standards to potential investments… they look for an investment vehicle with both ethical and financial quality'. Brook's conception of the role of morality in investment mirrors Laffont's (1975) claim that 'every economic action takes place in the framework of a moral or ethics', and Arrow's (1973) earlier statement that 'a great deal of economic life depends for its viability on a certain limited degree of ethical commitment'. Economics is not exempt from the moral constructs which hold society together, distinguish right from wrong, and assign rights and duties. Etzioni (1987) argues that 'the role of moral commitments and the factors that shape them must be taken into account in studying economic behaviour'. He proposes that an integration of social factors (of which he focuses on moral ones) and economic factors should be used to predict and explain behaviours.

2.3.2 Moral Considerations

Given the context of externalities and interdependent agents, the concept of morality in economics must be expanded beyond the egoistic consequentialist represented within neoclassical models. One way this has been done in the literature is to draw on Kantian economics. This form of deontological reasoning not only broadens the scope of morality beyond the individual, but it moves the focus from the value of the expected consequences to the rightness or wrongness of actions themselves. A socially responsible investor therefore cares about doing the right thing or about being a good person and thus puts their money where their values lie.

Under Kantian morality, individuals contemplate Kant's golden rule of the categorical imperative. This states that one should "Act only according to that maxim whereby you can, at the same time, will that it should become a universal moral law" (Kant, 1785, 4:421 as in Korsgaard, 2012, p. 34). This can be interpreted as setting out a logical relation that one should only engage in an action if they can consistently wish that others do the same thing if they were in the same situation.

Laffont (1975) demonstrates Kantian reasoning through his beer can on the beach example. In this example, an individual considers whether to dispose of their beer can or to leave it on the beach. The neoclassical agent would contemplate the Nashian counterfactual, holding the actions of all other agents constant, in this case, the cost of disposal exceeds the aesthetic cost of a single additional piece of litter. The Kantian agent would contemplate the Kantian counterfactual, assuming all agents perform the same action as themselves, in this case, the cost of disposal is far outweighed by the aesthetic cost of a beach full of litter. Henceforth, the Kantian agent would internalise externalities from their own actions by seeking to internalise the externalities imposed upon them by other agents.

Several economists have investigated whether Kantian moral preferences are evolutionarily conceivable for economic agents (Alger & Weibull, 2013, 2016; Alger et al., 2020; Bergstrom, 1995; Caparrós et al., 2010; Curry & Roemer, 2012). Alger and Weibull (2013) employ an evolutionary game-theoretic model of agent–agent interaction whereby the preferences of agents guide their behaviour and generate fitness payoffs. The fittest agents survive to pass on their preferences, through genes or culture, to the next generation. They find that whilst Nashian agents outperform Kantian agents in one-on-one interactions through free-riding, Kantian-Kantian interactions bring sufficiently higher payoffs to sustain survival of such preferences. Alger and Weibull follow this survival-of-the-fittest logic to find that a degree of Kantian morality can be sustained within the general population if there is assortative matching such that agents are more likely to interact with others of the same type. They coin the 'homo moralis' as a moral agent who places weight both on material and Kantian moral preferences, concluding that the weight placed on morality is closely related to the assortativity index. They find that a similar argument holds in the context of group interactions (Alger & Weibull, 2016), and in a paper with Lehmann (Alger et al., 2020) demonstrate how the structure of populations influences the optimal degree of morality.

Empirical literature investigates whether individuals are observed to exhibit moral preferences within economic scenarios (Czajkowski et al., 2017; Caparo & Rand, 2018; Elias et al., 2016; Miettinen et al. 2020; Van Leeuwen & Alger, 2021). Miettinen et al. (2020) and Van Leeuwen and Alger (2021) use experimental games to elicit preferences of players, and subsequently investigate how well different formulations of utility

functions represent individual behaviour. Both papers find evidence of moral preferences alongside both selfish and other-regarding preferences. Evidence of a generalised moral preference is also found by Caparo and Rand (2018), he finds that, when faced with a trade-off between an efficient and an equitable trade-off, pro-social individuals will tend to choose the option which is labelled as 'moral'.

Within the theoretical literature on public goods and green consumerism, Kantian morality has been introduced into choice of economic agents. This has been done in various ways, both for identical consumers and heterogeneous consumers, both directly and indirectly through self-image payoffs.

When individuals are identical, the Kantian counterfactual would posit that all agents perform the same action as the decision-maker. Within this literature, the utility of agents is interdependent, therefore under the Kantian counterfactual, the decision-maker would consider the external effects which others would impose upon them if others were to perform the same action. Alger and Weibull (2013) model the homo moralis, as having a utility function which is a convex combination of material utility and moral utility, where material utility employs the Nashian counterfactual, and moral utility employs the Kantian counterfactual. Brekke et al. (2003) also employ Kantian reasoning, modelling identical agents to calculate the Kantian moral ideal by maximising the utilitarian social welfare function assuming all agents perform the same action. They then proceed to derive a self-image payoff which depends upon how close their action is to the moral ideal. The utility is a weighted sum of material utility and their self-image payoff.

When individuals are heterogeneous, the Kantian counterfactual must be adjusted because individuals have different preferences, or endowments, or income, implying that the 'same maxim' would result in a variety of different actions. Henceforth, Roemer (2010) suggests that the Kantian equilibrium is where 'no player would like all players to alter their contributions by the same multiplicative factor' (p. 1). In this case, 'same thing' is interpreted as the same deviation. Roemer proceeds to model perfectly Kantian agents, who optimise through this form of Kantian reasoning. His model has been adopted by Van Long (2021), who has sought to represent partially Kantian moral agents, who trade-off material utility against moral utility. Van Long implements Brekke et al.'s

(2003) framework of a self-image payoff, employing Roemer's conception of Kantian morality to calculate the moral ideal for heterogeneous agents.

Kantian morality has been introduced into the agents' choice problem in two ways. One way suggests that the moral individual cares about doing the right thing, and thus places value directly on the hypothetical moral payoff (Alger & Weibull, 2013; Eichner & Pethig, 2022). The alternative suggests that the moral individual cares about being a good person, and thus places value on a self-image payoff of how close their action is to the moral ideal (Brekke et al., 2003; Van Long, 2021).

An extension of this literature considers how moral and non-moral agents interact. Van Long (2016, 2017, 2019; Grafton et al., 2017) has explored interactions between perfectly Kantian agents and non-Kantian agents who maximise their material utility. Within these papers, Van Long distinguishes between inclusive Kantians and exclusive Kantians. Inclusive Kantians would consider all agents, Kantian and non-Kantian, to be hypothetical 'co-movers' who all deviate by the same multiplicative factor. Henceforth, the presence of non-Kantian agents does not influence their behaviour. Exclusive Kantians would only consider the subset of Kantian agents to be hypothetical co-movers, meanwhile, they would take the actions of non-Kantian agents as given. Van Long (2019) considers a continuum of inclusivity between these extremes, whereby non-Kantians deviate by some fraction of the multiplicative factor. He finds that whilst non-Kantians outperform Kantian agents, the payoff of both agents is increasing in both the share of Kantian agents and their degree of inclusivity, whilst the size of the externality is decreasing in these parameters.

This literature provides us with a framework for capturing the behaviour of moral investors. Investors also have the ability to generate externalities from their investment portfolios, whether investors directly care about their morality, or whether they are conscious of their self-image, considering the morality of their investments an important aspect of the decision-making process.

2.3.3 Policy Implications of Moral Motivation

External policy interventions alter the economic environment in which economic decisions are made and henceforth can change behaviour. The investment literature on warm-glow preferences demonstrates that when

socially responsible investors with warm-glow preferences are present, optimal pollution taxation will be lower than corrective Pigouvian taxation meanwhile subsidies to abatement may be more effective (Renström et al., 2021). Now that the warm-glow is enriched further to consider the moral mechanisms underpinning it, it is important to consider how external policy influences effect moral motivation.

Frey and Stutzer (2008) highlight the potential for external policy interventions to crowd out intrinsic motivations. Self-determination is key for Kantian individuals to derive moral value from their actions. However, if an external policy is perceived to control their behaviour such that the right action coincides with the utility-maximising action, then their moral preferences are crowded out. On the other hand, if a policy is perceived as supportive, such as information about the consequences of action, then the policy can crowd in moral incentives. This highlights the importance of understanding the mechanisms underlying decision-making.

When integrating moral preferences into public good games and models of green consumerism, different recommendations have been made with regard to the optimal policy intervention. Roemer (2010) defines the Kantian equilibrium and represents players as optimising in a Kantian manner. He demonstrates that where all agents are perfectly Kantian, the Kantian equilibrium achieves the Pareto-efficient outcome amongst feasible allocations. This is because the Kantian thought-experiment forces each agent to internalise the externalities arising from their behaviour. Henceforth, there would be no need for corrective environmental policy in this case. Roemer (2017) embeds his Kantian model for cooperation within general equilibrium models to demonstrate that introducing Kantian optimisation in one market suffices to internalise externalities.

Naga et al. (2022) introduce Kantian agents into a model of optimal commodity taxation with dirty goods which exhibit environmental externalities. They find that when all agents are perfectly Kantian, all externalities are perfectly internalised, and thus corrective Pigouvian taxes are zero in the first best. However, they find that moral preferences reduce the elasticity of demand for dirty goods, suggesting that in a system of second-best commodity taxation, it would be optimal to levy higher taxes on them.

Other economists have recognised that, for the majority of agents, morality is just one preference within a multi-attribute utility function.

Alger and Weibull (2013) represent moral preferences as a convex combination of material utility and Kantian utility. Eichner and Pethig (2022) adopted their framework extending it to allow for heterogeneous degrees of utility throughout the population. Eichner and Pethig investigate how moral preferences influence the level of efficient emissions taxation. They find that where the degree of morality differs across the population, the first-best optimal emissions taxation would need to be consumer-type specific, such that consumers placing a higher weight on morality face a smaller emissions tax, and that this tax will always be smaller than the Pigouvian tax which is equal to the marginal cost of the emissions externality. Since this is infeasible to implement, they calculate the second-best uniform emissions tax, which also undercuts the Pigouvian tax. This demonstrates that agents are partially internalising environmental externalities, reducing the need for external intervention.

Dasgupta et al. (2016) find that when agents have different degrees of morality, the only policy which can achieve the social optimum is a Pigouvian tax equal to the cost of the externality. This suggests that moral preferences will be crowded out for many agents, but that overall higher social welfare is achieved.

Brekke et al. (2003) argue that it is important to take into account the endogenous nature of moral preferences. Within their model, an individual's self-image pay-off depends upon the morally ideal level of consumption. They recognise that any policy which affects the moral ideal will influence agent behaviour. In terms of optimal tax policy such as green taxes, Brekke et al. (2003) argue that the effect will depend upon how the tax is perceived by consumers. On the one hand, if the taxes are perceived as prices which cover the social cost of the externality, then the tax gives moral justification for being a utility maximiser. Brekke et al. argue that there is no problem with this crowding out of moral motivation if perceptions are correct because the social optimum is still achieved. However, if perceptions are incorrect, and the tax does not cover the full social cost, then this crowding out of moral motivation could bring the equilibrium further from the social optimum, reducing welfare. On the other hand, if taxes are perceived as a punishment symbolically reminding that such behaviour is harmful, then it is possible that the tax could crowd in moral motivation. Since such a tax is not perceived as sufficient to internalise external effects, consumers are still endowed with a degree of moral responsibility. Providing information regarding the

harmful effects of an externality can stimulate and enhance moral motivation within people. This supports Frey and Stutzer's (2008) argument regarding the role of self-determination in endowing moral responsibility to agents, but emphasises the role of consumers' perception of policy.

Nyborg (2011) builds on the importance of information in the context of moral motivation. She argues that moral responsibility is a heavy burden, therefore morally motivated agents may strategically avoid information to reduce the weight of this burden. She suggests that in this case, information campaigns can be an effective means of increasing contributions by providing unwanted information and stimulating moral motivation to do the right thing. This argument is supported empirically by Andreoni et al. (2017) who find that many generous people 'avoid the ask' of charitable giving. They suggest that this is likely to be because generous people are aware that if they are asked then they will donate. However, they are also aware that they cannot reasonably donate to every charitable cause. To avoid the cost of not giving when asked, they avoid being asked at all.

Whilst information can increase the feeling of moral responsibility, Asheim (2010) argues that where there is asymmetric information about an environmental problem, morally motivated agents would rationally feel sceptical with regard to the information which is provided to them. He claims that the government knows that morally motivated consumers are likely to contribute morally to the environment, but that since not all agents are perfectly moral this will not be enough to achieve the social optimum. Henceforth, they have the incentive to strategically select the information they convey to exaggerate the magnitude of environmental damage in order to increase contributions from the morally motivated. However, rational moral agents foresee this and become sceptical of the information provided to them. Therefore, whilst information provision can be a powerful policy tool in the presence of moral consumers, the government must be able to make credible commitments to convey all information.

2.4 Outlooks

The theoretical literature on SRI has sought to represent investment behaviour through warm-glow preferences, whereby the more investors contribute to socially responsible firms, the higher their private warm-glow payoff. Within this review, we have investigated the case for going beyond warm-glow, such as Kantian morality.

Firstly, would these non-standard preferences enable an efficient investment equilibrium to be achieved whereby externalities from production are internalised?

Within the literature on moral consumers, we find that where all agents optimise in a Kantian manner, the Pareto optimum can be achieved (Roemer, 2010). However, this is likely to be an unrealistic representation of behaviour. The majority of papers have represented moral consumers by placing a weight both on material utility and on Kantian morality and trading the two off against each other. In this form, moral preferences would partially internalise external effects, thereby moving the market equilibrium closer to a socially optimal level.

This implies that even with morally motivated socially responsible investors government intervention is still needed to target ESG practises by firms, since not all investors will have moral preferences, and moral investors will vary in their degree of morality.

Secondly, if government intervention is needed, what is the nature of this intervention under these non-standard preferences?

We can see that, in the case of the warm-glow effect, there was a simple relationship between utility and socially responsible contributions such that a higher contribution implied a higher warm-glow benefit. We saw within the investment literature that this meant that warm-glow investors would accept lower returns from ESG firms, whilst requiring higher returns on polluting firms. Optimal pollution taxes were lower due to the warm-glow adding an additional implicit tax on polluting firms. In terms of abatement subsidies, we saw conflicting effects, depending on whether the model allowed firms to reform.

If this warm-glow payoff was developed to unpack the moral mechanisms underlying it, we might expect different forms of government intervention to be optimal. With regard to pollution taxes, the perception of these taxes is important to determine whether they crowd out or crowd in moral motivation. Where agents only experience a warm-glow from contributing more, it would not matter if the externality was perceived

to be fully internalised by public policy, the individual would still derive private benefit from contributing and therefore their warm-glow could not be crowded out.

Furthermore, moral preferences introduce an important role in information campaigns. Williams (2007) finds that those individuals who are concerned about social issues as consumers tend to extend this behaviour into their portfolio strategies. McLachlan and Gardner (2004) find that socially responsible investors exhibit important differences in their beliefs about the importance of moral intensity, their investment decision-making style, and their perceptions of moral intensity. Henceforth, providing information to demonstrate the environmental, social and governance impacts of different investment decisions endows such investors with valuable details which help them to align their market actions with their values. As Nyborg (2011) suggests, moral investors may not seek out this information themselves due to the burden of moral responsibility that it entails, therefore information provision can be key to endowing awareness of consequences and activating moral preferences (Schwartz, 1968).

Appendix

See Table 2.1.

Table 2.1 Theoretical papers, key equations and conclusions

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Graff Zivin and Small (2005)	Investor (Atomistic)	warm-glow Altruism	$u(x, y)$ *where* $x = n_A + (1-\gamma)n_B - m$ $y = k_i \gamma n_B + m$	x material consumption y warm-glow from donating to charity n_A shares in traditional firm A n_B shares in firm B who also engages in charity γ social policy of firm B, reduces share pay-out m direct charitable giving k_i preference for corporate charity over direct charity	If corporate charity and direct charity are perfect substitutes, share prices and aggregate donations are insensitive to corporate social policy. If imperfect substitutes, they *are* sensitive. If non-negative share of investors prefer corporate giving, then share prices will be maximised at strictly positive level of corporate giving	warm-glow investor preferences encourage CSR

(continued)

Table 2.1 (continued)

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Dam (2011)	Investor (Atomistic)	warm-glow	$u(c_{t+1}, g_{t+1}, E_{t+1})$ *where* $g_{t+1} = \Gamma(E_{t+1}, P_{t+1}) * n_t$	c_{t+1} consumption g_{t+1} index of environmental impact caused by firms which consumer owns shares of (warm-glow) E_{t+1} stock of environmental quality P_{t+1} flow of pollution Γ strength of warm-glow effect n_t corporate shares (polluting)	If warm-glow depends on *stock* of environmental quality, pollution premium accounts for all future damages. warm-glow preferences, $g_{t+1} = \gamma E_{t+1}, 0 < \gamma < 1$ partially internalise these damages. Where $\gamma = 1$ full internalisation is possible If warm-glow depends on *flow* pollution, the pollution premium accounts for next period damages, partially internalise damage, can never fully internalise intergenerational externalities. warm-glow helps resolve intergenerational conflict of environmental externalities	warm-glow investor preferences generate pollution premium on dirty firms

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Dam and Heijdra (2011)	Investor (Atomistic)	warm-glow	$U[c, p, Q] \equiv lnc - \beta lnln(1+p) + \zeta lnQ$ *where* $p = \frac{e}{\underline{E}} \frac{\gamma Y}{Q}$	c consumption p index of the flow of pollution caused by firms that the household holds shares in Q stock of environmental quality e number of shares the household possesses $\underline{E}$ total number of outstanding firm shares γ constant parameter capturing the notion that production generates undesirable side effects Y aggregate output	The warm-glow motive results in socially responsible investment in the equity market, which imposes an implicit tax on the value of the polluting firm Public abatement policy reduces resources available for consumption, which lowers the implicit tax, leading to larger capital stock and higher pollution Find that socially responsible investment behaviour by households partially offsets the positive effects on environmental quality of public abatement policies, via the implicit tax mechanism	warm-glow investor preference generate pollution premium, acts as implicit tax on polluting firm

(continued)

Table 2.1 (continued)

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Renström et al. (2019)	Investor (Atomistic)	warm-glow	$U(0) = \int_0^{\infty} e^{-\rho t} u(c(t), l(t), p(t), Q(t))dt$ where $p(t) \equiv \sum_{j=1}^{J} \frac{e^j(t)}{\underline{E}^j} \underline{p}^j(t)$ and $\underline{p}^j(t) \equiv \underline{p}\left(x^j(t); X(t), F(t), Q(t)\right)$	c consumption l labour p warm-glow Q stock of environmental quality e^j number of shares of firm j owned by individual $\underline{E}^j$ number of total shares of firm j $\underline{p}^j$ the 'pollution content' of firm j as perceived by the individual x^j flow of pollution produced by jth firm X aggregate flow of pollution F aggregate gross production of the homogenous good	The presence of warm-glow preferences yields lower first-best pollution taxes, since firms will be faced with both the pollution tax charged by the government and the pollution premium required by investors	warm-glow preferences generate pollution premium, lower the optimal level of pollution tax

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Renström et al. (2021)	Investor (Atomistic)	warm-glow	$U(0) = \int_0^\infty e^{-\rho t} u(c(t), p(t))dt$ $p(t) \equiv \sum_{j=1}^{J} \frac{e^j(t)}{E^j} \underline{p}^j(t)$ $\underline{p}^j(t) = \gamma * x^j(t)$	c consumption p warm-glow e^j number of shares of firm j owned by individual E^j number of total shares of firm j $\underline{p}^j$ the 'pollution content' of firm j as perceived by the individual x^j flow of pollution produced by jth firm γ positive parameter	The effect of an abatement subsidy hinges on the pollution premium required by socially responsible investors. If no warm-glow, firm always better off with no abatement, with warm-glow firm trades off cost of abatement against cost of pollution premium	warm-glow preferences generate pollution premium, can increase effectiveness of abatement subsidies
Andreoni (1990)	Consumer (Non-atomistic)	warm-glow	$U_i = U_i(x_i, G, g_i)$	x_i private good consumption G aggregate public goods g_i contribution towards private good	Impure altruism increases voluntary contributions to the public good. Income transfers to more altruistic individuals will increase overall provision of the public good	warm-glow preferences increase voluntary contributions to public goods
Alger and Weibull (2013)	Consumer (Non-atomistic)	Moral, identical individuals	$u_\kappa(x, y) = (1 - \kappa) * \pi(x, y) + \kappa * \pi(x, x)$	κ degree of morality x decision maker's strategy y opponent's strategy π pay-off function/ fitness increment	With assortative matching, homo moralis preferences are evolutionarily stable. The coefficient of morality will align with the index of assortativity	Homo moralis preferences are evolutionarily stable

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Table 2.1 (continued)

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Brekke et al. (2003)	Consumer (Non-atomistic)	Moral self-image, identical individuals	$U_i = u(x_i, l_i, G, I_i)$ $I_i = -a\left(e_i - e_i^*\right)^2, a > 0$	x_i consumption of private goods l_i leisure G a pure public good I_i individual's self-image as a socially or morally responsible person a positive parameter e_i^* morally ideal effort from individual, calculated by maximising social welfare subject to constraints, assuming that everyone performs the same action	An agent's self-image preferences improved by acting in accordance with what they believe to be morally right. Trade-off gains to self-image against costs to material utility. Increase contributions to public goods, but not enough to achieve social optimum	Morally grounded self-image preferences increase voluntary contributions to public goods
Roemer (2010)	Consumer (Both atomistic and non-atomistic)	Moral, heterogeneous individuals	$(\forall i = 1, \ldots, n)(\forall \alpha \geq 0)\left(V^i\left(\widehat{L}\right) \geq V^i\left(\alpha\widehat{L}\right)\right)$	$\widehat{L} = \left(\widehat{L}^1, \ldots, \widehat{L}^n\right)$ Kantian equilibrium effort α multiplicative deviation $i = 1, \ldots, n$ individuals in population	At the Kantian equilibrium, where 'no player would like all players to alter their contributions by the same multiplicative factor', the Pareto efficient, cooperative outcome is achieved	Moral preferences can achieve Pareto efficiency

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Van Long (2021)	Consumer (Non-atomistic)	Moral self-image, heterogenous individuals	$U_i = M_i + v_i$ $v_i = A_i - \theta_i^{\mu}\{0, (e_i - e_i^K)\sigma\}$ $M_i = f_i(e_i, E_{-1} + e_i) - g_i(e_i)$	M_i material wellbeing v_i self-image function A_i positive constant e_i actual exploitation of common resource e_i^K exploitation that Kantian would dictate $\sigma > 0$ objective severity of the effect of overconsumption $\theta_i^{\mu} > 0$ subjective loss of self-esteem associated with excessive exploitation $f_i(e_i, E_{-1} + e_i)$ harvest as a function of own and aggregate exploitation level $g_i(e_i)$ effort cost of harvesting	Excessive exploitation of the commons can be avoided if agents are concerns about tier self-image as a person imbued with Kantian morality. In each generation, parents have an interest in the collective provision of moral education for their children	Morally grounded self-image preferences prevent excessive exploitation of the commons

(continued)

Table 2.1 (continued)

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Eichner and Pethig (2022)	Consumer (Atomistic)	Moral, Identical individuals	$U(y,z,\theta) = B(y,\theta) + z - H\left(m\underline{y}\right)$ $V(y,z,\theta) = B(y,\theta) + z - H(my)$ $W(y,z,\kappa,\theta) = (1-\kappa)U(y,z,\theta) + \kappa V(y,z,\theta)$	$U(y,z,\theta)$ material utility $V(y,z,\theta)$ moral utility $W(y,z,\theta)$ 'homo moralis' utility $B(y,\theta)$ private gross utility derived from consuming the dirty good y quantity of dirty good consumed z quantity of clean good consumed m population size $\underline{y}$ average consumption of dirty good $H\left(m\underline{y}\right)$ harm from aggregate emissions in material utility, assume constant $H(my)$ moral hypothetical harm from aggregate consumption when all other agents consume the same as the decision maker κ degree of morality θ preference parameter	Moral agents will deliberately reduce their emissions beyond the level consistent with utility/profit maximisation. With heterogenous moral consumers, this implies that cost-effective policies may require agent-specific prices	Moral preferences result in voluntarily lower emissions. Optimal tax rates smaller than Pigouvian rates

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Van Long (2017)	Consumer (Non-atomistic)	Moral, Nash	$Nashians:$ $V_{Nj}(S_t) =$ $\{u_j(y_{jt}) + \beta V_{Nj}(S_{t+1})\}$ $where$ $S_{t+1} = F\left(S_t, y_{jt} + \sum_{h\in N-\{j\}}\psi_h(S_t) + \sum_{f\in K}\theta_f(S_t)\right)$ $Kantians:$ $Kantian\ ideal\ x^*_{jt} = \theta_i(S_t) satisfies:$ $1 = argmax_\lambda\{u_i(\lambda x^*_{it}) + \beta V_{Ki}(S_{t+1}(\lambda))\}$ $where$ $S_{t+1}(\lambda) =$ $F\left(S_t, \lambda x^*_{jt} + \sum_{h\in N}\psi_h(S_t) + \sum_{f\in K-\{i\}}\lambda\theta_f(S_t)\right)$ $Hence\ Kantian\ utility\ is:$ $V_{Kj}(S_t) = u_i(\phi_i(S_t)) + \beta V_{Ki}(S_{t+1})$	N number of Nashian agents y_{jt} exploitation effort by Nashian agent S stock of the natural asset β discount factor $V_{Ni}(S_{t+1}(\lambda))$ Nashian's value function K number of Kantian agents x_{it} exploitation effort by Kantian agent λ Kantian deviation $V_{Ki}(S_{t+1}(\lambda))$ Kantian's value function	When there are both Kantian and Nashian agents, in the Kant-Nash equilbrium Nashians will free-ride and earn higher individual payoffs, yet social welfare will increase with the share of Kantians	Higher proportion of population with moral preferences, the higher the level of social welfare

(continued)

Table 2.1 (continued)

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Grafton et al. (2017)	Countries (Non-atomistic)	Moral, Nashian	$V_i(x_i, Q_{-1} + x_i)$ Profile x is a Nash equilibrium iff $(\forall i)(\forall x_i\prime \in R_+^m)(V_i(x_i, Q_{-1} + x_i) \geq V_i(x_i\prime, Q_{-1} + x_i\prime))$ Profile x is a Kantian equilibrium iff $(\forall i)(\forall \lambda \geq 0)(V_i(x_i, Q_{-i} + x_i) \geq V_i(\lambda x_i, \lambda Q_{-1} + \lambda x_i))$ Profile x is a generalised Kant-Nash equilibrium for a co-move structure S iff $(\forall i)(\forall \lambda_i \geq 0)\left(\begin{array}{l} V_i\left(x_i, \sum_{j \notin C(i)} x_j + \sum_{j \in C(i)} x_j\right) \\ \geq V_i\left(\lambda_i x_i, \sum_{j \notin C(i)} x_j + \sum_{j \in C(i)} \mu_{ji}(\lambda_i) x_j\right)\end{array}\right)$	$M = 1, \ldots m$ countries x_i country's emission level, proportional to public good consumed $x = (x_1, \ldots, x_m)$ profile emission levels Q public bad, which is the sum of emissions V_i utility depends on private and public good λ Kantian deviation S co-mover structure determines which agents deviate with the Kantian agents and by how much $C(i)$ set of co-movers for agent i $\mu_{ji}(\lambda_i)$ deviation by co-mover j dependent on i's deviation	When there are both Kantian and Nashian agents in the economy, in the Kant-Nash equilibrium Kantians will emit less than Nashians	The more moral countries there are the closer the economy will be to social optimum
Roemer (2017)	Consumer (Atomistic)	Moral, heterogenous consumers	$V^i\left(E^i, E^S\right) = u^i(x, E) = u^i\left(\frac{E^i}{E^S} G(E^s), E^i\right)$ Kantian equilibrium: $\forall i, \frac{d}{dr}\vert_{r=1} u^i\left(\frac{rE^i}{rE^S} G\left(rE^S\right), rE^i\right) = 0$	x fish consumed E efficiency units of labour expended fishing $G(E^s)$ production function of the lake where people fish	Kantian agents internalise environmental externalities from their actions and achieve cooperative solutions which make everyone better off	Perfectly moral consumers can achieve social optimum

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Dasgupta et al. (2016)	Consumer (Atomistic)	Moral	$W = \varphi(z) + (y + t\underline{z}) - (q + t)z - d(M\underline{z}) + \alpha S$ $L(z) = \{\varphi[\tilde{z}(p)] - p\tilde{z}(p)\} - [\varphi(z) - pz]$ $HMB(z) = \{\varphi(z) - pz - d(Mz) + aM[\varphi(z) - qz - d(Mz)]\}\{-\varphi(\tilde{z}) - p\tilde{z} - d(M\tilde{z}) + aM[\varphi(\tilde{z}) - q\tilde{z} - d(M\tilde{z})]]\}$ $\mu HMB(z) - (1 - \mu)L(z)$	W well-being of a typical individual z dirty good consumption $\varphi(z)$ benefit from dirty good $x = y - pz = y + t\underline{z} - (q + t)z$ expenditure on all other goods $\underline{z}$ average dirty good consumption M total population $d(M\underline{z})$ damage function from total emissions, where each unit of dirty good generates 1 unit of emissions S social welfare $\alpha > 0$ degree of altruism $L(z)$ direct loss from choosing level of dirty good consumption which differs from Marshallian demand $\tilde{z}(p)$ $\tilde{z}(p)$ Marshallian demand, maximises material utility subject to constraints	Moral preferences bring consumption closer to the social optimum, however do not full internalise environmental externalities. Due to varying degrees of morality, the full pigouvian tax will be needed to achieve the social optimum	Moral consumers consume closer to social optimum, but not fully correct externality

(continued)

Table 2.1 (continued)

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
				$HMB(z)$ hypothetical moral benefit to themselves and everyone else from everyone choosing the same level of consumption z		
Nyborg (2011)	Consumer (Atomistic)	Moral self-image, heterogeneous individuals	$U_i = u(x_i) + \alpha_i G + S(g_i)$ $S(g_i) = g(g_i, g_i^*)$ $g_i^* = g^*(m\beta)$	x_i consumption of private goods g_i contribution to public good α_i characteristic determining i's benefits from a public good G $S(g_i)$ individual's benefits of maintaining a good self-image, depends on contribution to the public good g_i^* i's view of the ideal contribution, an increasing function of the social value of contributions	If moral responsibility is a burden then agents have an incentive to avoid facing such responsibility. Show that duty-oriented consumers are willing to pay to avoid information	Moral preferences consume closer to social optimum when fully informed

Article	*Investors/ Consumer Behaviour*	*Preference type*	*Optimisation Problem*	*Variables*	*Paper conclusion*	*Impact of Preference*
Asheim (2010)	Consumer (Non-atomistic)	Moral self-image, identical individuals	$u(e_i, e_{-i}; e^*, \hat{e}) = 1 - e_i + e^* ln ln\left(\sum_{j=1}^{n} e_j\right) - a\lvert\hat{e} - e_i\rvert$ $e^* = argmax_e u(e, (e, \ldots, e), e^*, e^*)$	e_i voluntary contribution of effort to environmental public good $(1 - e_i)$ private consumption $\sum_{j=1}^{n} e_j$ total provision of public good $\hat{e}$ effort level believed to be socially optimal by the individual-drives their moral motivation e^* effort which, if made by all, would maximise utility that each individual	Moral individuals will consume closer to social optimum. When individuals have moral preferences, information may be used strategically to change behaviours. However, agents may expect this and not trust information, hence social welfare reduces Need to make sure information is reliable and transparent	Moral preferences encourage individuals to consume closer to social optimum

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CHAPTER 3

The Performance of Socially Responsible Investing: A Review

Lisa Gianmoena and Luca Spataro

3.1 Introduction

The profitability of socially responsible investment (SRI) has attracted considerable academic interest over the past 20 years, with largely mixed results attributable mainly to the methodology and the quality of the data.

In this chapter, we present a review of the main empirical studies on the profitability of SRI, from the earliest contributions to the most recent ones. In doing so, we try to bring out both their theoretical grounding and the main differences in terms of the sample periods, methodology and characteristics of the economy under analysis. Indeed, despite the SRI phenomenon having existed for at least 30 years, the characteristics and the definition of social responsibility over the years have undergone

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profound changes (see Chaps. 4 and 13), which, in turn, have modified and expanded the boundaries of analysis at both the methodological level, thus requiring new methods of estimation, and the geographical level, by engaging developed and emerging economies towards new forms of investment that are more sensitive to ethical, social and environmental issues (Wimmer, 2012).

Much of the debate in the SRI literature revolves around their profitability. Hamilton et al. (1993) and Goldreyer and Diltz (1999) can be considered the early studies on the performance of SRI funds. The results, obtained by estimating a single-factor model (i.e., CAPM) for a sample of 49 and 32 US funds, respectively, show no significant difference in performance from that of conventional funds. The main reason for this result is to be ascribed to the methodology adopted in these early studies. Indeed, as shown by subsequent contributions, a single-factor model cannot take properly into account specific aspects of individual funds, like the dimension of firms (Brooks & Oikonomou, 2018; Liang & Renneboog, 2017) or the possible effect of external/growth shocks (Becchetti et al., 2015; Glode, 2011; Leite & Cortez, 2015 and Nofsinger & Varma, 2014). Therefore, more advanced multifactor techniques have been implemented as more appropriate to measure funds' performance, such as the Fama–French three-factor model (1993) or the Carhart four-factor model (1997).

On the capacity of SRI to produce better or worse investment returns, Hamilton et al. (1993), Angel and Rivoli (1997) and Derwall et al. (2011) review the theoretical arguments and clearly identify different hypotheses behind the debate on the financial returns of SRI, so that they can (i) *underperform*, (ii) *outperform* or (iii) *perform similarly* to conventional funds or portfolios. In this view, many studies have attempted to assess the performance of sustainable investments worldwide. In this chapter, we are mainly concerned with reviewing the work done so far in terms of analysis of the performance of SRI Funds (see Table 3.1) and SRI portfolios (see Table 3.2), by maintaining the tripartition concerning the hypotheses on their performance mentioned above. As already anticipated, the results emerging from the literature should be interpreted cautiously and broadly, as they may be specific to the country/market analysed, investor characteristics, periods and methodological choices. However, we can say that empirical evidence, while still mixed, seems

more oriented towards supporting the neutrality hypothesis or better performance of SRI with respect to traditional funds.

Table 3.1 Summary of studies on financial performance of SRI funds

Author	*Geographic Markets*	*Period*	*Significant difference?*
Bauer et al. (2005)	Germany, UK and US	1990–2008	NO
Kreander et al. (2005)	EU	1995–2001	NO
Scholtens (2005)	Netherlands	2001–2003	NO
Bauer et al. (2006)	Australia	1992–2003	NO
Bauer et al. (2007)	Canada	1992–2003	NO
Jones et al. (2008)	Australia	1986–2005	Yes −
Fernandez-Izquierdo and Mattalin-Saez (2008)	Spain	1998–2001	NO
Magnier et al. (2008)	EU, North America	2006–2008	NO
Renneboog et al. (2008)	Australia, Asia EU, US, UK, Asia–Pacific	1991–2003	Yes − (FR, SE, JP − NO)
Gil-Bazo et al. (2010)	US	1997–2010	Yes +
Cortez et al. (2009)	EU, US	1996–2008	NO (EU) Yes − (US)
Climent and Soriano (2011)	US	1987–2009	Yes − (NO 2001–2009)
Cortez et al. (2012)	US, Europe,	1996–2008	NO
Nofsinger and Varma (2014)	US	2000–2011	Yes +
Leite and Cortez (2015)	France	2001–2012	Yes ±
Lean et al. (2015)	North America, EU	2011	Yes +
Becchetti et al. (2015)	Global, North America, EU, Asia	1992–2012	Yes +
Nakai et al. (2016)	Japan	2002–2010	Yes +
Leite et al. (2018)	Sweden	2002–2012	NO
Reboredo et al. (2017)	Europe and US	2010–2016	Yes −
El Ghoul and Karoui (2022)	US	2010–2017	Yes +

Table 3.2 Summary of studies on the financial performance of SRI portfolios

Author	*Geographic Markets*	*Period*	*Significant difference?*
Schröder (2004)	The United States, Germany and Switzerland	1990–2002	NO
Derwall et al. (2005)	The United States	1995–2003	Yes +
Van de Velde et al. (2005)	Europe	2000–2003	NO
Brammer et al. (2006)	United Kindom	2002–2004	Yes −
Kempf and Osthoff (2007)	The United States	1992–2004	Yes +
Galema et al. (2008)	The United States	1992–2006	NO
Derwall et al. (2011)	The United States	1992–2008	Yes +
Borgers et al. (2013)	The United States	1992–2009	Yes +
Lee et al. (2013)	The United States	1998–2007	NO
Brzeszczynski and Mc Intosh (2014)	United Kindom	2000–2010	NO
Humphrey and Tan (2014)	The United States	1996–2010	NO
Mollet and Ziegler (2014)	The United States and Europe	1998–2009	NO
Halbritter and Dorfleitner (2015)	The United States	1991–2012	NO
Auer (2016)	Europe	2004–2012	Yes +
Auer and Schuhmacher (2016)	The United States, Europe, Asia	2004–2012	NO
Trinks and Scholtens (2017)	The United States	1991–2012	Yes −
Badía et al. (2020)	North America, EU, Asia, Japan	2003–2017	Yes ±

3.2 The Underperformance Hypothesis of SRI

From a theoretical point of view, the lower performance of SRI is supported by the classic portfolio theory, in which additional monitoring costs due to screening activities[1] can lead to an additional "*ethical penalty*" on the return from investment.

[1] We recall that fund managers mainly adopt three screening methods to identify SRI: negative screening (exclusion), positive screening (inclusion) and best in class (best performer in relation to the financial, social and environmental performance of each sector). Negative screening excludes companies involved in sectors that might be harmful to the environment or the society. Positive screening promotes companies with best ESG practices. Finally, the "best in class" screening selects those companies in a specific sector

In its theoretical framework, the classical theory of investments views screening activities as actions that may limit the investment portfolio's size, leading to lower diversification and investment returns. In this view, the "barriers" imposed by screening actions and the related monitoring costs exert the final effect to hurt investors' decision which is often too short-term focused, preventing them from realising the potential longer-term benefits of SRI. From this perspective, the perceived underperformance of SRI can be easily detected considering three possible explanations, known in the economic and financial literature as the s*hunned-stock hypothesis, the limited optimisation argument*, and the *overvaluation hypothesis* (Derwall et al., 2011; Hong & Kacperczyk, 2009; Sievänen, 2013).

The *shunned-stock hypothesis* posits that non-SRI stocks may have superior returns because ethical investors, using negative screening approaches in their investment portfolio strategy, screen out non-SR investments, which leads to an overall decreasing demand for the latter and pushes prices of non-SRI funds below those of responsible stocks. The shunned-stock hypothesis is based on the work of Hong and Kacperczyk (2009), who states that since "sin stocks" are neglected by institutional investors, these stocks would be relatively cheap. Building on Hong and Kacperczyk (2009), the contribution of Derwall et al. (2011) developed further this argument by pointing out that if investors do not invest in controversial firms, then they create a shortage of demand for these sin stocks, so that the number of investors for those firms decreases with a reduction of the risk-sharing opportunities as well. Sin stocks are therefore ignored by investors and are traded marginally because fewer investors follow them and, as a consequence, their prices get lower (Hong & Kacperczyk, 2009).

On the other hand, the *limited optimization hypothesis*, which found its root in the traditional *portfolio theory*, suggests that restriction in investor's choice due to SRI screening activity negatively affects investment performance because, from the mathematical point of view, a constrained optimisation problem cannot deliver a superior result than

that demonstrate the best ESG credentials in their area of business. In some cases, companies identify a hybrid screening process considering all, or part of, the three methods mentioned above. (Capelle-Blancard & Monjon, 2014; Erragraguy & Revelli, 2015; Leite & Cortez, 2015; Chap. 4).

an unconstrained one. Indeed, a central point in finance is that diversification decreases investment risk inducing a reduction in expected returns (Markowitz, 1959). Thus, investment in a diversified portfolio provides the optimal risk/return trade-off, and any restriction in the investable universe leads to a worse trade-off. In such a case, it is easy to expect that the screening-out activities could have the final effect of reducing portfolio diversification/efficiency and, therefore, its profitability.

Finally, the *overvaluation hypothesis* finds its root in different views. First, investors would consciously accept to pay financial costs for excluding so-called sin stocks, even when they have higher expected returns than otherwise comparable stocks (Edmans, 2011; Herzel et al., 2012; Hong & Kacperczyk, 2009). Consequently, it might be expected that SRI investors are willing to pay a higher price (i.e., the "ethical price") for investing according to their social or personal values, accepting a lower financial return for a non-financial payoff of upholding and inspiring socially responsible practices (Herzel et al., 2012). Second, the overvaluation could be associated with a "*market failure*", where the expected/potential positive financial benefits of ESG practices are not well priced in the market, and, thus, a mismatching between the positive financial benefits of ESG actions and future financial performance occurs (Flammer, 2015). This case can be referred to as *errors-in-expectations*, which captures the situation where ESG factors do not significantly improve firm performance, so the benefits are lower than expected, and the final effects should result in negative excess returns for SRI because of the market's difficulty in valuing such intangible aspects.

Consistent with the fact that investors pay a *price for ethics*, Renneboog et al. (2008) show how SRI funds in many European and Asia–Pacific countries strongly underperform domestic benchmark portfolios. Their analysis shows that the number of social screens significantly reduces financial performance, while the number of ethical and environmental screens does not seem to have a significant impact. Precisely, these authors find that SRI funds in the United States, the United Kingdom and many continental European and Asia–Pacific countries underperform their national benchmarks by between -2.2% and -6.5%. In contrast, for some countries such as France, Japan and Sweden, the risk-adjusted returns of SRI funds do not appear to be statistically different from those of conventional funds.

In line with *the limited optimization hypothesis*, Jones et al. (2008) analyse 89 ethical funds in Australia over the period 1986–2005. Estimating a multifactor CAPM model, they find that SRI funds underperform the key market benchmarks by between 3 and 5% over their sample period.

Climent and Soriano (2011) consider the US market, paying particular attention to green funds and comparing them with conventional funds in the period 1987–2009. Their results show that green funds underperformed their conventional counterparts during the entire period. However, in a different subperiod, 2001–2009, no significant differences emerge in risk-adjusted financial performance between green and conventional mutual funds.

Slightly different is the contribution of Reboredo et al. (2017). The authors investigate alternative energy mutual funds for 2010–2016 and compare them with conventional funds. They conclude that renewable-energy funds' performance is lower than conventional funds, supporting the idea that investors pay a premium to be green.

An alternative approach to evaluate SRI's financial returns is the analysis of the performance of portfolios based on firms' social characteristics. From Table 3.2, we can conclude that most studies find that considering ESG factors in the portfolio selection process does not decrease portfolio performance.

Looking at an international sample of more than 1,600 stocks, Trinks and Scholtens (2017) investigate the impact of negative screening on a market portfolio. Their findings suggest that negative screening significantly affects the size of the investment universe and risk-adjusted return performance. Indeed, investing in sin stocks seems, in many cases, to guarantee higher risk-adjusted returns, whereas excluding them generates a loss in terms of financial performance.

Brammer et al. (2006) examine the relationship between social performance and stock returns within the United Kingdom. In doing so, the authors use screens for the environment, employment and community activities, finding lower returns for SRI, confirming the "*Efficient Market Hypothesis*" as "*removing some stocks, sectors, or even whole countries on ethical grounds from the investable universe of securities…reduces portfolio efficiency*" (Brammer et al., 2006, p. 97).

Mixed results emerge in the contribution of Badía et al. (2020), who performed a complete analysis of the performance of synthetic stock portfolios based on CSR criteria at the global level and in four

geographical regions: North America, Europe, Japan and Asia-Pacific and for different periods. Their results show that SRI performance highly depends on geographic factors, the period under consideration and the specific ESG screening strategy used. In particular, their findings support the idea that the different performance effects of social screening in different economies reflect the regional and cultural heterogeneity of SRI around the world and, consequently, the different degrees of development regarding investor awareness and understanding of the evaluative impact of ESG practices.

3.3 The Outperformance Hypothesis of SRI

The hypothesis that socially responsible investment can lead to a better outcome with a more significant financial gain finds its root in the *stakeholder theory* (Freeman, 1984), according to which initial SRI efforts in meeting ESG criteria can lead to a competitive advantage in the future. This simple but reasonable idea has led researchers to analyse the problem by considering the effects of screening activity on financial performance and testing whether positive/best in classes screening efforts can reduce the likelihood of additional business costs driven by environmental disasters or crises (Barnett & Salomon, 2006; Capelle-Blancard & Monjon, 2014).

In this regard, some studies have demonstrated a U-shaped relationship between the number of screens used to select or exclude funds and the relative financial performance. More precisely, Barnett and Salomon (2012) and Capelle-Blancard and Monjon (2014) point out that as the number of screens increases, the fund's returns initially decrease and then rise again. The basic idea is that using a smaller number of screen actions implies that just fewer companies are potentially removed from the portfolio. As a result, performance may not be significantly impacted. Conversely, as the number of screens increases, a more significant number of companies may exit the portfolio, the portfolio becomes less diversified, and consequently, performance decreases. However, as Capelle-Blancard and Monjon (2014) explained, once a certain number of screens is reached, the companies that remain in the portfolio are those with higher quality and consequently with lower inherent risk and better performance (see also Derwall et al. 2005; El Ghoul & Karoui, 2022; Gil-Bazo et al., 2010; Henke, 2016).

More in general, contrary to portfolio theory, proponents of SRI argue that investing in social screens may generate better financial performance. Social screens can help portfolio managers to identify companies with better management capabilities and, as a result, benefit from superior and sustained financial performance over time (Bollen, 2007).

In this view, several studies, listed in Tables 3.1 and 3.2, seem to support this hypothesis.

Looking at the North American, European, Australasian and Asian markets, Magnier et al. (2008) found no significant differences in performance between SRI and non-SRI indexes/funds. However, the authors show how best-in-class screening funds that did not use exclusionary criteria are those able to perform better than SRI funds that excluded sectors.

Cortez et al. (2009) found that European SRI mutual funds exhibit higher performance than the United States. This difference is attributed to the different styles of SRI investing. While the US SRI approach is more oriented towards negative screening or exclusions, the European SRI approach generally uses positive screening criteria. Kempf and Osthoff (2007) construct value-weighted long-short portfolios from stocks in the S&P 500 and DS 400 over the 1992–2004 period for the US market, finding significantly positive alpha for sectors with higher ESG scores. Statman and Glushkov (2009) confirm the results of Kempf and Osthoff (2007). Both studies also find that portfolios built on the basis of "good" employee–employer relations display the highest returns, while environmental and human rights aspects do not seem to affect returns.

In a recent article, El Ghoul and Karoui (2022) go further to corroborate the positive effects of SRI in the financial market. From an analysis of 2516 US mutual funds during 2010–2017, they found that socially responsible funds exhibit lower risk, with also positive performance effects for all mutual funds.

Other work traces the positive link between ESG action and returns resulting from increased firms' value. As pointed out by Renneboog et al. (2008), good social and environmental performance can be considered a sign of high managerial quality, which can ensure favourable financial performance in the long run (see also Moneva & Ortas, 2010).

Gil-Bazo et al. (2010) consider a sample of 86 SRI funds and 1761 conventional funds in the United States for the period 1997–2005, showing that SRI funds can outperform their conventional counterparts, mainly when they are managed by management companies specialised

in managing SRI funds. According to this view, Gil-Bazo et al. (2010) argue that investors do not pay a price for investing in SRI mutual funds (i.e., the "*ethical price*"). On the contrary, their analysis shows that SRI funds can generate a risk-adjusted performance premium over conventional mutual funds with similar characteristics. This result supports the idea that investors should consider other aspects of companies, such as management capacity, as this affects the ability of SRIs to provide a higher performance premium than conventional ones.

Another explanation for the higher expected returns for SRI mutual funds is related to the fact that they are subject to greater scrutiny than conventional funds, with the ultimate effect of identifying a narrower but superior investment universe.

Derwall et al. (2005) focus their attention on the concept of eco-efficiency. They compose two equity portfolios of stocks sorted by eco-efficiency ratings. After controlling for differences in risk, investment style and sector exposure, using a four-factor model and industry-specific factors, they found that the high-rated portfolio significantly outperformed its low-rated counterpart by approximately 6% per annum from 1995 to 2003.

Derwall et al. (2011) provide a more detailed analysis of SRI returns by focusing on "values-driven" and "profit-driven" investors to empirically validate the "*shunned-stock hypothesis*" compared to the "*errors-in-expectations hypothesis*". They find that stocks shunned by value-driven investors (i.e., those that use negative screens for excluding certain stocks from their universe of investments) earn positive returns. However, their analysis also indicates that errors-in-expectations hypothesis may coexist so that, in the short run, SRI can deliver superior performance (due to the positive screens) because the market undervalues the importance and the full value of ESG factors.

Supporters of ethical investments also claim the nature of SRI as a long-term investment.

Indeed, the higher costs generated by screening or monitoring activities to implement ESG attitudes can adversely affect returns. This implies that another possible explanation for the higher performance of SRIs can be found by analysing the problem from the market's perspective, which fails to fully incorporate those intangible aspects that can provide superior returns (Borgers et al., 2013; Lean et al., 2015).

Lean et al. (2015) highlight the sustained financial benefits of SRI funds over time. They analysed about 500 European SRI funds and

248 North American SRI funds against the benchmark in 2011, demonstrating the better and sustained performance of SRI funds compared to conventional funds. Their results suggest that the lack of diversification in SRI funds does not hinder financial performance, that there is no price for being ethical and that abnormal returns are possible due to the increased ability of managers to identify suitable investments.

Borgers et al. (2013) consider the period 1991–2009 and different ESG cut-off points to define different long-short value portfolios. Their estimate of the four-factor model shows positive and significant alphas until 2004, after which the latter tend to be closer to zero and insignificant. Their main results show how the ESG investment outperforms in the initial sample period as in Kempf and Osthoff (2007) due to market underreaction, but then such an outperformance tends to disappear.

Using a dataset of environmental, social and corporate governance ratings for the European market, Auer (2016) examines whether socially responsible screening can affect portfolio performance. Looking at the period from 2004 to 2012, they found that negative screens allow investors to significantly outperform a passive investment; in contrast, governance screens substantially increase portfolio performance, corroborating the idea that investors in the European stock market can do well (financially) by doing good (socially). On the other hand, positive screens, due to less diversification, can lead SRI portfolios to underperform the benchmark. These results support the idea that investors should focus on eliminating the worst firms by thus applying negative screens to obtain better portfolio performance.

Interesting results emerge by analysing the behaviour of SRI during episodes of financial instability. Based on estimating risk-adjusted abnormal returns, Nofsinger and Varma (2014) analyse US funds from 2000 to 2011, finding that SRI equity funds significantly outperform conventional funds during crisis periods. More specifically, SRI funds outperformed conventional funds by 1.61% to 1.70% annually during crises.

Becchetti et al. (2015), analysing a more extended period from 1992 to 2012, show how SRI funds outperformed conventional funds during the 2008 global financial crisis but not during the 2001 dot-com crisis. For the Japanese market, Nakai et al. (2016) compare SRI funds and conventional funds concerning the impact of the 2008 global financial crisis, suggesting that SRI funds withstood the failure of Lehman Brothers

better than conventional funds. Similarly, Leite and Cortez (2015) investigate the performance of French SRI funds during crisis and non-crisis periods, confirming that SRI underperformed conventional funds during the non-crisis period but matched the performance of their peers during market downturns.

Although previous studies have examined the better performance of SRI during financial crises, little is known about their performance during the recent crisis due to COVID-19 pandemic. Omura et al. (2021) and Capelle-Blancard et al. (2021) contribute to this body of literature by offering evidence on the trend of SRI indexes in the context of the COVID-19 pandemic. Omura et al.'s results corroborate previous work, confirming an improved trend in SRI indexes during the pandemic period, both globally and regionally, on the other hand, the results of Capelle-Blancard et al. (2021) seem not to confirm such a trend.

3.4 The Neutral Performance Hypothesis of SRI

The third hypothesis states that SRI provides neither higher nor lower risk-adjusted returns; consequently, at the empirical level, no statistical difference in performance with respect to conventional funds should be identified.

This result is empirically well documented in most of the studies over different methodologies, geographical areas and periods (see Tables 3.1 and 3.2). One of the primary explanations supporting this evidence is the possibility for stocks with social responsibility characteristics to be priced so that, according to conventional portfolio theory, the factors that are priced should not affect expected returns. Therefore, the (risk-adjusted) expected returns of socially responsible portfolios are equal to the (risk-adjusted) expected returns of conventional portfolios.

Looking at an international database containing more than one hundred ethical mutual funds in Germany, the UK and the US, Bauer et al. (2005) used Carhart's four-factor model to test the significance of the difference in risk-adjusted returns between ethical and conventional mutual funds for the 1990–2001 period. Although the authors found no statistically significant differences in returns between the two types of mutual funds, they emphasised how socially responsible mutual funds have distinct investment styles. Indeed, ethical mutual funds' underperformance at the beginning of the 1990s was followed by a catching-up

phase which brought the performance of ethical funds on par with that of conventional funds.

Same results are confirmed in Bauer et al. (2006, 2007) for Canadian and Australian mutual funds. Scholtens (2005), Fernandez-Izquierdo and Mattalin-Saez (2008) and Leite et al. (2018) analyse the performance of Dutch, Spanish and Sweden funds, respectively, and document that the performance of SRI funds in those markets does not differ statistically from that of conventional funds.

Other works have analysed the performance of SRI funds in multiple markets, such as Cortez et al. (2012), Magnier et al. (2008) and Kreander et al. (2005). Although the works consider different market areas and periods, the results show no significant differences between ethical funds and other funds in the collective investment industry. Shifting the focus to the SRI portfolios (see Table 3.2), many studies argue that higher returns associated with socially responsible investments have a natural tendency to decline over time (e.g., Halbritter & Dorfleitner, 2015; Revelli & Viviani, 2015), or that firm-level ESG actions may not influence financial performance (Lee et al., 2013; Van de Velde et al., 2005).

The work of Revelli and Viviani (2015), based on a meta-analysis of SRI portfolio performance studies, concludes that investing in SRI funds neither benefits nor penalises performance compared to conventional funds. Similarly, Berry and Junkus (2013) propose a review of the empirical works on SRI performance, finding that the returns obtained by different screening techniques do not differ under normal market conditions.

Halbritter and Dorfleitner (2015) conduct an extensive study to assess the profitability of SRIs, comparing different data sources. Their work shows that abnormal returns produced by ESG strategies are statistically insignificant, and this result appears robust to different portfolio ESG thresholds. Similarly, Humphrey and Tan (2014) conclude that after transaction costs and fees, no difference is found between the returns of screens and unscreened portfolios.

In his paper, Schröder (2004) assesses the goodness of SRI funds in the United States, Germany and Switzerland by testing the combined hypothesis of fund management quality and asset performance. To do this, he expands the fund performance analysis by examining 10 SRI indexes representing social asset performance. His results show that only a few funds and indexes significantly underperform the benchmarks.

In contrast, most SRI assets—investment funds and indexes—exhibit a similar performance compared to their benchmarks.

Same results but only for the US market emerge in the work of Galema et al. (2008) and Lee et al. (2013). To test the return implications of SRI, these authors construct different portfolios based on positive screens from 1992 to 2006. Estimating the Fama and French (1993) asset pricing model augmented with the Carhart (1997) momentum factor in a system GMM framework, their results confirm that the risk-adjusted performance of SRI stocks is not significantly different from that of conventional ones.

The "no-linkage" hypothesis, which argues that no significant difference in the risk-adjusted performance is expected between high-ranked and low-ranked ESG portfolios, is also supported by Lee et al. (2013), who find little evidence that high-ranked or low-ranked ESG portfolios systematically differ in terms of performance, size or book-to-market ratio.

Mollet and Ziegler (2014) analyse the UnitedStates and European stock markets from 1998 to 2009. The nonsignificant abnormal stock returns for SRI in both regions are the main result of their work, supporting the hypothesis that market participants correctly price SRI stocks.

Van de Velde et al. (2015) analyse the link between sustainability and financial performance in the European market. Portfolios are not selected on the basis of positive or negative screening but companies' total sustainability rating. The results show that portfolios with high sustainability ratings perform slightly better than those with low ratings. However, these performance differences are not high enough to be considered statistically significant because of the short period considered in the analysis. As the authors themselves state, the period 2000–2003 is too short to capture the long-term nature of SRI investments.

Finally, Auer and Schuhmacher (2016) analyse the performance of socially (ir)responsible investing in the Asia–Pacific region, the United States and Europe for the period 2004–2012, showing how the geographic and sector aspects of an ESG-based investment strategy and ESG criteria strongly influence the portfolio performance. In Asia–Pacific and the United States, the selection of high (low) ESG stocks does not appear to increase or decrease investment performance relative to the benchmarks. The same result emerges in Europe; however, in some sectors and depending on the ESG criteria applied, European investors

pay a price for being socially responsible in their strategies, i.e., they end up with significantly lower risk-adjusted performance than no SRI benchmarks.

3.5 Conclusions

In this paper, we have provided a review of the empirical literature analysing the performance of responsible investments, trying to shed light on one of the most interesting questions in recent economics and finance: Can SRI be considered assets that produce superior or inferior returns with respect to conventional investiments? With this in mind, we have reported the main findings from the literature examining the performance of SRI mutual funds and SRI portfolios compared with traditional non-SRI investments, bringing out the different theories supporting the possible outcomes.

Despite the heterogeneity of the works, research seems to support that SRI does not result in worse returns; in fact, they seem to perform as well as standardise assets providing less volatility, especially during times of crisis. This result is significant because it offers individual investors and institutional fund managers the opportunity to pursue a SRI strategy with the expectation that investment returns will be similar or more profitable to traditional investment options.

However, although over the past 20 years, there has been a proliferation of research on the topic, different methodological issues have yet to be clearly and comprehensively addressed. To date, it is clear that the question about the effects of ESG policies on investment returns is not entirely settled. One reason for this lack of clarity is the difficulty of empirical strategies to correctly estimate the full (financial and non-financial) performance of SRI investments. Moreover, the main source of debate is (still) concerned with the data quality, the most appropriate methodology, the period of analysis and the type of economy that might lead to controversial results.

Although the works reviewed are rather supportive that SRI does not necessarily result in lower returns, the broader question of whether or not SRI strategies outperform traditional investment strategies remains, up to now, inconclusive. Future research should put much effort in scrutinising the overall value of SRI and not just its mere financial returns, by providing new measures that allow to take both the economic and social value of SRI properly into account.

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CHAPTER 4

SRI: An Insight on the Evolution of Its Definition and a Focus on the European ESG Regulation

Maria Cristina Quirici

4.1 Introduction

In recent years, *Socially* or *Sustainable Responsible Investments* (SRI) have experienced significant growth worldwide, particularly in Europe. SRI has become an important part of the international asset management capital market by incorporating environmental, social, and governance (ESG) factors into its investment selection, management processes, and decisions (Arjaliès, 2010; Crifo & Forget, 2013; Eurosif, 2016; Shöltens & Sievänen, 2013). This evolution of SRI has been characterized by an evolving definition, initially called "ethical finance", then "Socially Responsible Investment", and now "Sustainable Responsible Investment". Through a literature review, it is possible to give an account of such evolution and to identify the main elements that characterize this

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concept in recent years (Forum for Sustainable Finance, 2014; Fung et al., 2010; Puaschunder, 2016; Renneboog et al., 2008).

Typically, SRI refers to a medium-to-long-term financial investment approach that evaluates companies and institutions, integrating ESG criteria into the process to create value for investors and society as a whole. The chapter describes different SRI strategies, including negative and positive screening, and introduces a new "Classification Scheme for Sustainable Investments" proposed in 2022 in a White Paper by Eurosif, in collaboration with researchers from the University of Hamburg (Busch et al., 2022).

This scheme defines sustainable investments as those that "*have at least a low ambition to contribute to a sustainable transition*" and applies five categories to link distinctive categories and strategies used in sustainable investment.

The chapter also discusses how this concept has been drafted in the recent European ESG Regulatory Framework, particularly in the *EU Taxonomy* (852/2020/EU) and in the European Commission (EC) *Sustainable Finance Disclosure Regulation (SFDR)* (2019/2088/EU). These initiatives aim to redirect capital flows towards sustainable activities and provide harmonization of what can be considered sustainable, which benefits investors and financial markets by providing more certainty. These measures recommend greater disclosure regarding sustainable activities in order to tackle the risk of greenwashing. In fact, this risk arises due to the absence of a common definition of sustainable investment and a lack of clarity on sustainability considerations which have to be applied in investment decisions. The same objective is also shared by the EU Green Deal, which was issued in December 2019 (Von Der Leyen, 2019).

The analysis will also demonstrate the need for certain adjustment measures to achieve a complete alignment among the various definitions of "sustainable investment", particularly in the policy initiatives represented by the EU Taxonomy and the *Sustainable Finance Disclosure Regulation* (SFDR).

4.2 The Evolution of SRI Definitions: A Review

According to the "official" definition provided by the *National Sustainable Finance Forum*, "*Sustainable and Responsible Investment is an investment strategy oriented to the medium-long term which, in the evaluation*

of companies and institutions, integrates financial analysis with environmental, social and good governance, in order to create value for the investor and for society as a whole" (Forum for Sustainable Finance, 2014).

This definition incorporates objective features that are strictly linked to optimizing the risk-return profile of an investment portfolio. By introducing ESG criteria in the investment decision-making process, SRI enables the objective of maximizing profit in the medium to long term while also pursuing social and environmental goals (Puaschunder, 2016, 2017).

At the same time, this definition represents an effective synthesis of the evolution of the concept of SRI. There is no single definition or approach to this concept. Over time, various expressions have been used to define sustainable investments, many of which have a similar meaning, but place emphasis on one particular aspect, thus reflecting an evolving definition.

Originally, SRI was founded on moral and ethical principles and was known as "ethical finance". This approach provided an alternative way of thinking about finance. After a period of "irrational exuberance" in the financial markets (Shiller, 2000) and the global financial collapse of the 2007–2008 crisis, the financial world was "pushed" to recognize a different way of understanding finance represented by ethical finance. This approach did not repudiate traditional finance practices (such as brokerage, collection, and lending), but instead reformulated its reference values to focus on the person rather than capital, the idea rather than assets, and equitable returns on investment rather than pathological speculation. Ethical finance introduced new elements of judgement, such as considering the investment's impact on the real economy, promoting environmental protection, and respecting the individual even if not financeable by the "traditional" financial system (Quirici, 2013; Weber & Feltmate, 2016).

In this approach, finance and ethics are not opposing elements, but rather their complementarity can bring important advantages to the economic and social system as a whole. This idea has been supported by various scholars such as Sen (1991), Becchetti and Paganetto (2003), and Signori et al. (2005). The diversity of ethical finance lies in its purpose, which is to promote the well-being of humanity and achieve sustainable

development. The Brundtland Report[1] of 1987 provided for the first time the definition of sustainable development as "*development that allows the satisfaction of the economic, environmental, and social needs of current generations without compromising the development of future generations*" (Brundtland, 1987).

According to the ethical finance approach, the concept of socially responsible investing (SRI) has connections with religious beliefs (Camilleri, 2021; Cavallito et al., 2020). Therefore, a possible corresponding definition of SRI could be represented by the following one: "*SRI is a generic term for investments and investment strategies that take into consideration the attempt to create positive social change, minimize environmental damage, and incorporate one's own religious or ethical convictions*" (Fung et al., 2010, p. 1).

However, because of the diversity of ethical beliefs, the concept of ethical finance has evolved into responsible finance. Hence, the Global Sustainable Investment Alliance (GSIA), an international organization that aims to increase the impact and visibility of sustainable investments worldwide, provides an evolution of the definition of SRI as "*an investment approach that considers environmental, social, and governance (ESG) factors in portfolio selection and management*" (GSIA, 2018).

It should be noted that the GSIA's definition of sustainable investment offers a possible global classification standard according to the second and most recent approach. However, each forum that composes GSIA has the possibility of modelling this definition in its own way. This is because many different manifestations are included under the umbrella of socially or sustainable and responsible investments, and, still, it is difficult to find a definition that includes them all (Sullivan & Mackenzie, 2006).

The same Eurosif Study 2014 reported that there was no consensus on an only definition of SRI in Europe:

> *"At this stage, no consensus on a unified definition of SRI exists within Europe, whether that definition focuses on processes used (referred to as strategies in this study), sought outcome or debt and quality of the processes applied.*

[1] *The Brundtland Report*, drafted in 1987 by the *World Commission on the Environment and Development* chaired by the Norwegian G.H. Brundtland, was entitled "*Our Common Future*" and became famous because it contains the first definition of the "Responsible Development", that can reconcile economic development with the safeguarding of social and environmental balances (Brundtland, 1987).

> *The present edition of the European SRI Market Study does not, therefore, impose a specific definition of SRI and the Study continues to cover any type of investment process that combines investors' financial objective with their concerns about Environmental, Social and Governance (ESG) issues".* (Eurosif, 2014)

Eurosif, in its *European SRI Study 2016*, reached the missing consensus, providing a definition of SRI aimed at encompassing the greatest number of manifestations of the phenomenon in the following terms:

> *"Sustainable and responsible Investment ('SRI') is a long-term oriented investment approach. Which integrates ESG factors in the research, analysis and selection process of securities within an investment portfolio. It combines fundamental analysis and engagement with an evaluation of ESG factors in order to better capture long-term returns for investors, and to benefit society by influencing the behaviour of companies".* (Eurosif, 2016)

As explained by Eurosif in its *European SRI Study 2018*, which confirms the definition provided in 2016, considering a more complete notion of SRI than that provided by the GSIA, allows to take into account also the existing changes at the level of corporate governance and investor preferences (Eurosif, 2018).

Even if we consider the definition provided by the US Sustainable Investment Forum (US SIF), according to which "*Sustainable, responsible and impact investing (SRI) is an investment discipline that considers environmental, social and corporate governance (ESG) criteria to generate long-term competitive financial returns and positive societal impact*" (US SIF, 2018), it emerges that it is substantially equivalent to those previously outlined (albeit also including *Impact Investing*).

Based on the analysis carried out, it is possible to identify some key elements of SRI. Firstly, SRI is characterized by a medium to long-term orientation that goes beyond the financial dimension. This approach considers the investor's financial goals and their role in driving change towards a sustainable economy and society. Therefore, SRI can be applied to all financial products as long as issuers demonstrate a long-term vision in line with ESG criteria. Secondly, from a technical point of view, sustainable and responsible investment is carried out "*through the integration of financial analysis with environmental, social and good governance in the evaluation of companies and institutions*" (Bello, 2005). Sustainability analysis and research are common to all SRI strategies, which evaluate

companies and institutions based on specific ESG indicators. Finally, the objective of SRI "*creation of value for the investor and the company as a whole (…). In other words, the creation of value must be seen not only from an entrepreneurial point of view, but also placing the private sector at the centre of attention, in its economic and social dimension. The sustainable and responsible approach, in fact, does not repudiate the mechanisms of traditional finance, but rather enriches them with additional requirements that are integrated into the complex system of evaluating an investment*" (Quirici, 2013). Hence, thanks to the integration of ESG variables in the objective function of the investor, SRI creates value by improving the sustainability profile of companies and institutions operating in the overall socio-economic system. This value creation is fully aligned with the concept of intra and intergenerational equity and is achieved in a medium to long-term perspective (Bauer et al., 2005; Easton & Pinder, 2018; Forum for Sustainable Finance, 2014; Ielasi & Rossolini, 2019; In et al., 2014; Nitsche & Schröder, 2015; Revelli & Viviani, 2015; VIGEO-Eiris, 2016; Yan et al., 2019).

It is worth noting that the acronym ESG has become a sort of standard to define the responsible approach to investments (Capital Group, 2022), in the awareness that each criterion encompasses a diverse universe of factors (Ferri & Acosta, 2019; Capelli, 2016). According to the SRI approach, in fact, these dimensions should be used to evaluate and select assets for investment and, in doing so, to allow a company to be more sustainable in its operating sector. More precisely: the *environmental* dimension concerns the impact that a company has on the surrounding environment. This includes factors that are gaining global attention, such as climate change, pollution, water resource exploitation, fossil fuels, deforestation, waste disposal, and respect for biodiversity (Forum for Sustainable Finance, 2020). The *social* dimension pertains to the ways in which a company manages and develops its human capital, encompassing various aspects related to both the working environment and social development (Fung et al., 2010). The *governance* dimension refers to how a company manages the integration of sustainable finance into its management guidelines. This includes corporate governance practices, remuneration policies, the composition of the board of directors, internal control procedures, and the ethical behaviour and compliance of top management with regulations. It clearly emerges that *corporate social*

responsibility is strictly related with the concept of *corporate reputation* and its associated *reputational risks* (Quirici, 2021; MainStreet Partners, 2022; World Economic Forum, 2022).

4.3 SRI Strategies for a Possible New "Classification Scheme" of Sustainable Investments

SRI strategies integrate ESG sustainability criteria into financial decisions. As for the strategies that can be adopted to implement SRI, it is worth noting that "*Unlike conventional types of investments, SRI applies a set of investment screens to select or exclude assets based on ecological, social, corporate governance or ethical criteria, and often engages in the local communities and in shareholder activism to further corporate strategies towards the above aims*" (Renneboog et al., 2008).

More precisely, it is possible to distinguish between *negative* and *positive screenings* (Biggeri et al., 2021; Eurosif, 2018; Ferri & Intonti, 2018; Forum for Sustainable Finance, 2019):

a. Negative screenings are used to exclude companies that engage in activities that are not compatible with ESG criteria. This exclusion criterion is historically the first one applied in the SRI field. Businesses that are typically excluded include those involved in goods or services that promote addiction (such as tobacco, liquor, and gambling), offensive tools (such as armaments and weapons), environmentally hazardous activities (such as polluting productions and nuclear energy), and those that do not adhere to social values (such as those involved in human rights violations and discrimination).
b. On the other hand, positive screenings are used to select companies that are part of the "investable universe" and respect human rights, the environment, workplace policies, and the safety and health of consumers and the community (Puaschunder, 2016). Eurosif has identified and categorized SRI positive strategies into the following types (Eurosif, 2018):

    - *Best-in-class screening*: This strategy involves selecting and investing in companies that demonstrate exceptional sustainability performance compared to their competitors. There are two other strategies within this category: *Best-in-effort*, which

aims to select and include companies that have made significant progress in terms of sustainability, and *Best-in-universe*, which aims to identify and include only universally recognized high-ranking companies in terms of ESG.

- *Norms-based screening*: This strategy involves selecting companies to invest in based on compliance with specific plans and initiatives. Examples include the OECD guidelines for multinational companies, the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, the UN Global Compact, and the UN Guiding Principles on business and human rights. Norms-based screening can be used as a standalone approach or in synergy with other SRI investment strategies, such as exclusion and engagement.
- *Sustainability themed investing*: This strategy involves selecting companies from the investable universe based on specific social and environmental issues, with the aim of directing investments towards companies that offer sustainability solutions. Examples of topics include renewable energy, energy efficiency, transport development, water, food security, health, education, climate change, biotechnology, green construction, and more. The aim is to support companies that create opportunities for sustainable development in relation to these aspects.
- *Corporate Engagement & Voting*: The engagement strategy involves investors actively participating in improving the business conduct of investment companies. The goal is to induce companies to make improvements in terms of governance, ESG integration, and disclosure transparency. The assumption underlying this approach is that through engagement, it is possible to increase the company's ability to face long-term challenges, allowing an increase in its value. The *Voting strategy* represents a long-term process seeking to influence behaviour or increase disclosure of investees regarding sustainability issues. However, in contrast to engagement, the influence is based on ownership rights through voting of shares, filing or co-filing shareholder proposals, direct roles on investee boards and board committees, as well as direct control of portfolio companies, assets, or properties (PRI, 2022).
- *ESG Integration*: This strategy explicitly includes considerations regarding the opportunities and risks associated with ESG

aspects in traditional financial analysis and investment decision-making (Boffo & Patalano, 2020; Douglas et al., 2017; Eurosif, 2016; Townsend, 2020). This approach increases long-term financial performance and improves risk management (Bender et al., 2018). The 2014 Eurosif Report breaks this approach down into three distinct categories (Eurosif, 2014):

(a) Non-systematic ESG integration;
(b) Explicit ESG integration;
(c) Systematic ESG integration.

- *Impact Investing*: This strategy values companies based on their capacity to generate financial, social, and environmental value. The definition of impact investing is not univocal, as multiple and different definitions can be found in literature (Quirici, 2020). According to the *Global Impact Investing Network* (GIIN), this approach identifies an investment strategy in companies, organizations, and funds aimed at generating measurable positive impacts on the environment and society, in addition to a financial return (Eurosif, 2016, 2021; GIIN, 2017; Hanks, 2015).

The description of the different *SRI strategies* is useful to understand the new possible "*Classification Scheme*" for Sustainable Investments suggested by Eurosif, in collaboration with the University of Hamburg. This White Paper (Busch et al., 2022) develops a classification of sustainable investment categories based on their ambition to contribute to a more sustainable economy. The new classification scheme is based on five distinctive categories:

1. *Exclusions-focused investments*: In this case, the portfolio has no ambition to actively support the transition towards a more sustainable economy.
2. *Basic ESG investments*: The main objective in this case is to mitigate ESG risks, but having a marginal ambition to actively support the indicated transition, therefore they are not classified as sustainable investments.
3. *Advanced ESG investments*: These investments aim to manage ESG risks and opportunities, focusing on financially material ESG issues.

In contrast to Basic ESG investments, they apply stricter rules for positive screening, such as engagement and voting, to improve the measurement and management of ESG risks and opportunities.
4. *Impact-aligned investments*: In contrast to basic and advanced investments, this category includes the double-materiality perspective, aiming to address environmental and social challenges and to align with internationally accepted goals, such as the SDGs, using Best-in-Class/Universe, sustainability-themed approaches, engagement and voting as post-investment strategies.
5. *Impact-generating investments*: These investments actively contribute to solutions for social and/or environmental real-world challenges. Taking into account a double-materiality perspective, in their pre-investment approach, they focus on capital allocation as a mechanism of investor impact to influence the impacts of investees. Regarding post-investment strategies, they can also use engagement and voting to actively change investees' impacts through investor activities, providing evidence of their influence measuring their investor impact.

In this context, sustainable investments are defined as "*investments that have at least a low ambition to contribute to a sustainable transition, which applies to categories three to five*" (Busch et al., 2022). The new "Classification Scheme" also defines five overall dimensions in which all the indicated five distinctive categories can be included:

1. *General characteristics*: This includes the primary objective or intention of an investment. The underlying logic of the new classification scheme is to refer to a specific ambition level of each investment that actively supports the transition towards a more sustainable economy.
2. *Pre-investment strategies*: This level considers SRI strategies such as Exclusions, Norms-based screening, ESG Integration, Best-in-Class/Best-in-Universe, and Sustainability themed strategies.
3. *Post-investment strategies*: This level considers SRI strategies such as Engagement and Voting, including the use of ownership rights for both public and private equity.
4. *Performance measurement*: This fourth dimension describes the type/s of ESG or impact performance measurements necessary for an investment to be classified into the respective category. These

measurements can either refer to company impact or to investor impact generated by the investment itself.

5. *Documentation*: This last dimension consists of reporting and external verification of information on the objective, investment strategies (pre and post investment), and measurements.

In concluding their study, the authors of the White Paper emphasize that their proposed new "Classification Scheme" of sustainable investments should not be understood as "*an implementation tool for regulatory requirements. Its aim is rather to illustrate how investments accelerate the just and sustainable transition of the real economy. A such, it captures the transition contribution of different investment approaches based on the notion of investor impact. It goes beyond the current ability of concepts used in the SFDR, the EU Taxonomy and MiFID II which focus predominantly on identifying companies that are already sustainable, aligned or have a positive company impact* (…)" (Busch et al., 2022).

To better understand these considerations, it is necessary to briefly analyse how the concept of "*sustainable investment*" has been drafted in the recent European ESG Regulation.

4.4 The Concept of "Sustainable Investment" in the New European ESG Regulation Framework

Sustainability is a crucial tool in achieving ambitious goals for economic prosperity, social inclusion, and environmental regeneration. For the financial system, sustainability has a dual imperative: first, to ensure that ESG factors are at the core of financial decision-making; second, to mobilize capital to solve society's key challenges that require long-term finance. A sustainable European economy must not only better protect natural resources but also increase employment levels and financial and economic stability.

Positive steps towards sustainability have already been taken globally, such as the Paris Agreement on climate change on 12 December 2015 (known as COP21) and the United Nations 2030 Agenda, with its 17 *Sustainable Development Goals* (SDGs) (United Nations, 2015), to the recent COP26 at Glasgow (November 2021). These actions can

be considered as the foundation for Europe's transition to a sustainable economic model, which represents the future financial and economic development of Europe.

The European Union is playing an important role in contributing positively and constructively to the development of the *UN 2030 Agenda for Sustainable Development*. It is worth noting that the EU has established itself as a global leader in promoting sustainable financial growth in recent years (EUROSTAT, 2017). The EU has been pushing for concrete policy actions and regulatory frameworks that aim to transform the existing financial landscape into a more sustainable one. These efforts include initiatives such as the *EC Action Plan on Financing Sustainable Growth*, the subsequent *Taxonomy Regulation and Sustainable Finance Disclosure Regulation (SFDR)*, the *EU Green Deal* (December 2019), the *Next Generation EU* (July 2020), and the *Renewed Sustainable Finance Strategy* (July 2021).

Despite these efforts, the state of our planet is still deteriorating, and investors must direct their efforts towards investments that generate positive environmental and social outcomes. Current levels of investment are insufficient to support a sustainable economic system, and there is an investment gap of almost EUR 350 billion per year to meet the climate and energy targets set for 2030 and additional investments to achieve the EU's broader environmental objectives are evaluated to be in the range of EUR 100–150 billion per year (Platform on Sustainable Finance, 2022).

To address this issue, there must be a common understanding among all investors, financial institutions, and companies across the EU of what constitutes a "sustainable investment". A lack of clarity among investors regarding what qualifies as a sustainable investment is one of the factors contributing to the existing investment gap.

The EU has made significant efforts to promote transparency and common definitions on sustainability and sustainable investments in the European market and beyond. The first action of the *EC Action Plan on Financing Sustainable Growth*—built upon the High-Level Expert Group final recommendations (HLEG, 2018)-was "*Establishing an EU classification system for sustainable activities*" (European Commission, 2018). This was done to address the risks of "greenwashing", which can be defined according to a recent definition—among the various existing ones (Lyon & Maxwell, 2011)—"*as a misrepresentation, mislabelling, misselling and/or mis-pricing phenomenon that gives rise to potential detriment*

to investor who wish to allocate resources to sustainable investments" (ESMA 2022).

The *EU Taxonomy for Sustainable Activities* is a unified EU-wide classification system that aims to help Europe fulfil its environmental goals while aligning with the Paris Climate Agreement and the 2030 SDG dispositions. The Final Taxonomy Regulation was drafted in the EU Regulation 852/2020 and approved on June 22, 2020.[2] The regulation indicated a list of economic activities with technical screening criteria that determine when an economic activity can be considered as "taxonomy-aligned". The regulation aims to be as comprehensive as possible and cover all relevant parts of the economy. According to the EU Taxonomy, an activity can be considered "taxonomy-aligned" (Art. 3):

1. if it contributes substantially to at least one of the six environmental objectives indicated by the Taxonomy Regulation;
2. if it does not significantly harm any of the other five environmental objectives.

These six environmental objectives (all interrelated) are the following ones:

1. climate change mitigation;
2. climate change adaptation;
3. the sustainable use and protection of water and marine resources;
4. the transition to a circular economy;
5. pollution prevention and control;
6. the protection and restoration of biodiversity and ecosystem.

It is important to note that the two indicated conditions are considered met when an economic activity fulfils a set of *Technical Screening Criteria* (TSC). Furthermore, an activity must comply with a set of minimum

[2] In June 2018 the EC set up a *Technical Expert Group on Sustainable Finance* (EU TEG) which produced a *Final report on Taxonomy for Sustainable Activities* in June 2019. Later, in line with the Taxonomy Regulation (2020/852/EU, art. 20), the EC set up a new permanent expert group, the *Platform on Sustainable Finance*, or *Technical Working Group* (TWG), replacing TEG, to assist the EC in developing its sustainable finance policies The TWG started its work on the 16th of October 2020.

social safeguards listed in the Taxonomy Regulation (Official Journal of the European Union, 2020; Platform on Sustainable Finance, 2022).

The EU Taxonomy, which defines sustainable activity, is a central component of the new European ESG Regulation, along with the *Sustainable Finance Disclosure Regulation* (SFDR). Both regulations aim to increase transparency in the financial market regarding sustainability disclosure and combat the risk of greenwashing. (Morningstar, 2021). Most organizations falling within the SFDR framework are required to report on the EU taxonomy regulation. On the 10th of March 2021 SFDR came into effect and on the 1st of January 2022 the first level of alignment with the EU Taxonomy classification framework was completed, requiring additional climate-related disclosures.[3] The European Commission, on 6th April 2022, with its Delegated Act 1288/2022 adopted the *Regulatory Technical Standards* (RTS), regarding the disclosure rules of level 2. Finally, on the 1st of January 2023 this Delegated Act has come into force and so the second level of alignment with the EU Taxonomy came into force, requiring the RTS for environmentally-aligned funds.

It is worth highlighting that Art. 2(17) of the SFDR also provides a definition of "sustainable investment" as "*an investment in an economic activity that contributes to an environmental or social objective, where the company does not harm other objectives, besides having good governance practices*". However, this definition does not correspond to the EU Taxonomy's definition of sustainable investment (Eurosif, 2021), leading to possible confusion for Financial Market Participants (FMPs) as to which definition to consider. Moreover, FMPs have used the SFDR's product categories (Art. 6, Art. 8, and Art. 9) as a product standard for classification, leading to difficulties in interpreting and applying its provisions. As a result, adjustments to the SFDR are necessary, and Eurosif has drafted policy recommendations in June 2022 to make the framework fit for purpose.

[3] On the 21th of April 2021, the EU published the *EU Taxonomy Climate Delegated Acts,* a revised version of the technical criteria first launched in 2020, including the insights received from the EU countries, while on the 30th of March 2022 the Platform on Sustainable Finance presented to the EC its final Report, concerning the other four environmental objectives (from 3 to six), composed by *Part A: Methodological Report* and by *Part B: Technical Annex,* where the *Part B* drafted technical screening criteria for economic activities "taxonomy-aligned" (Platform on Sustainable Finance, 2022).

Regarding the definition of "sustainable investment", the existing duplication of two frameworks (SFDR and EU Taxonomy) creates complexity and a lack of comparability due to diverging interpretations by FMPs. Eurosif suggests two options to overcome this issue (Eurosif, 2022): developing a methodology to allow FMPs to calculate their share of sustainability investments in a homogenous way or aligning the SFDR's definition with the EU Taxonomy's definition of sustainable economic activity. These adjustments would reduce uncertainty and the risk of greenwashing while enabling the useful implementation of existing European sustainable regulations.

These adjustments would definitely amend the uncertainty points of the existing European sustainable regulation, allowing its useful implementation and reducing, at the same time, the dangerous risk of greenwashing.

4.5 Conclusions

This chapter presents a summary of the development of the concept of Sustainable and Responsible Investment (SRI), acknowledging that there is no one fixed definition or approach to this concept. Over time, various terms have been used to describe sustainable investments, many of which have similar meanings but place emphasis on different aspects, resulting in a definition that is constantly evolving.

Initially, SRI was founded on moral and ethical principles and was referred to as "ethical finance". As corporate governance and investor preferences evolved, there was a need to shift from ethical finance to responsible finance. Eurosif's SRI Study 2018 provides a definition that represents this evolving approach, incorporating ethical and moral principles as well as objective reasons linked to the optimization of the portfolio's risk-return profile.

SRI has experienced significant growth in recent years, but the current levels of sustainable investments are insufficient to support the Sustainable Development Goals of the UN 2030 Agenda (UNEP, 2021). Policy makers therefore should consider redirecting capital flows towards SRI as a principal goal, recognizing the need for a common understanding of what constitutes a "sustainable investment". The EU Taxonomy (EU Regulation 852/2020) is seen as a concrete policy action to promote transparency and common definitions on sustainability and sustainable investment, along with the Sustainable Finance Disclosure Regulation

(2019/2088/EU). However, the definitions of "taxonomy-aligned" investment in the EU Taxonomy and sustainable investment in the SFDR do not align, resulting in a lack of clarity for financial market participants (FMPs) and a lack of comparability in sustainable investments due to possible divergent interpretations by FMPs. Thus, policy makers need to adjust the SFDR to achieve necessary alignment of these definitions, in order to tackle the risk of greenwashing, which is detrimental to the growth of a more sustainable economy.

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PART II

Corporate Governance, SRI and ESG Integration

CHAPTER 5

Attractiveness of Sustainable Business and Investments: An Ethical, Legal or a Financial Issue?

Gabriella Iermano and Frank Andreas Schittenhelm

5.1 Introduction

The sustainability flag flies over almost every economic sector: from the financial sphere to the production area, the current attractiveness of sustainability issues is undeniable.

The work is the result of a joint collaboration of the authors. However, Sect. 5.1 is mainly attributable to Gabriella Iermano; Sect. 5.2 to Frank-Andreas Schittenhelm. For the remaing parts, both the co-authors take responsibility.

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But what pushes towards this new concept of making business and investments? Is taking care of the environmental, social and governance issues only due to a change in the ethical perception of investors, companies and consumers? Or is this approach also driven by legal constraints? Can financial and economic factors play a role? And what is the interplay between financial reasons and legal pressure towards sustainable growth?

These are certainly not easy questions to answer. They have been addressed at length by sociologists, lawyers and economists. However, these scholars often focus separately on only one part of the problem. A combined approach, instead, seems to be more effective and capable to lead to a better understanding of what is behind the new wave of sustainability, allowing us to address the issue in its complexity. This belief explains the interdisciplinary perspective of this contribution, having the purpose of highlighting some of the legal and financial explanations behind the success of (more or less self-declared) sustainable businesses and investments.

To this end, we first focus on the relevance that the sustainability issue is increasingly gaining both from the corporate law and from the financial law perspective, in order to assess to what extent the modern legal systems are moving towards the adoption of higher sustainability standards (Sect. 5.2).

Then, we will investigate whether compliance with these standards would just expose businesses to higher costs, or if they can result in more attractive choices also from an economic point of view (Sect. 5.3). We conclude that sustainability starts from a project perspective and make concrete proposals for a differentiated profit and risk assessment.

5.2 Legal Issues

Sustainable growth is a priority goal for the European Union's internal and external policies, as well as of the United Nations 2030 Agenda and Sustainable Development Goals. As stressed lastly in the *European Green Deal* (Racugno & Scano, 2022), in enabling the transition towards a sustainable economy the private sector capital is crucial because of the massive investments required to tackle the most pressing global challenges (Capaldo, 2020; Strampelli, 2020). Accordingly, an adequate corporate and financial legal framework plays an essential role in accelerating the transitional process towards sustainability as well (Engert et al., 2022; Fleischer, 2022).

To facilitate the channelling of private investments for the financing of sustainable enterprises and/or projects, many legal measures have been recently taken at the global (national, European and international) level. There is worldwide a clear legislative trend towards a new concept of making business and running financial investments, not (only) profit-oriented, but also more respectful of the ESG (environmental, social and governance) factors. Further, for companies and issuers of financial products at the global level, compliance with higher standards of sustainability is more and more encouraged and, in many cases, even required by the different legislators.

This new sustainability-oriented legislative wave shows, on closer inspection, a two-tier approach: on the one hand, the introduction of non-binding legal tools, that companies and issuers can voluntarily decide to adopt, and, on the other, the provision of mandatory rules, they (or at least some of them) are obliged to comply with.

5.2.1 Voluntary Legal Options

The main idea behind the option for non-mandatory rules is that the market will spontaneously move towards a new, more sustainability-oriented way of running business. In this perspective, the task of the legislator is to set up the right legal conditions for their success in order to allow more sustainable companies and products to be recognizable for their commitment, to have easier access to the market and to be more competitive (Strampelli, 2021).

Among the many others, two recent significant examples of this legislative approach are the creation of benefit corporation models and the proposal for a *Regulation on European Green Bonds*.

A. Benefit corporations

Trust in the market's spontaneous adaptation to the new sustainability standards can certainly be seen behind the introduction of the benefit corporation: a new company legal structure that can be voluntarily chosen as an alternative to the traditional (exclusively) for-profit company's forms. Introduced for the first time in Maryland, US, in 2010, the benefit corporation has spread since then in many other legal systems (Murray, 2014), also outside the US. In Europe, Italy has been the first

country to have its national model of benefit corporation (the "*società benefit*", introduced in 2015 by the Law 28 December 2015, No. 208), followed by the French "*société à mission*" (Art. 1835 of the French *Civil Code*)—which is not, however, subject to any specific rule. And similar legal structures are now present elsewhere in the world as well, such as in British Columbia, South America (Colombia, Ecuador, Peru, Argentina) and in Rwanda. Furthermore, its introduction is now under discussion in various other jurisdictions.

Despite the differences existing among the single national legislations on benefit corporations, some common features can be nonetheless clearly identified. Among these, the main character is undoubtedly the institutional combination of the traditional corporate purpose of a profit-egoistic nature with an additional benefit aim (Clark Jr. & Babson, 2012; Ferrarini & Zhu, 2021; Marasà, 2017). Further, benefit corporations take the statutory commitment to operate in a responsible, sustainable, and transparent manner towards the external stakeholders. To overcome these provisions, the shareholders must formally amend the articles of incorporation and terminate the company's status as a benefit corporation. Having the benefit aim included in the company's statute allows therefore the company to "crystallize" it over time and to untie it from the personal sensitivity of managers and/or majority shareholders towards socio-environmental issues (Iermano, 2022b).

As a further consequence, the company's directors have enlarged powers and duties. In fact, in comparison to the traditional company models, they are (not only) legitimate to (but also must) run the activity taking into consideration both the maximization of the shareholders' value and the pursuit of the specific benefit aim indicated. The statutory provision on the benefits aim thus protects the managers from liability actions based on the possible lower company's profits arising from the more sustainable way of running the business (Daccò, 2021). In fact, the benefit corporation's management system aims at balancing the interests of the shareholders with the interests of those on whom the activity may have an impact.

Finally, to ensure adequate information on the concrete pursuit of the benefit aim, the single national legislations in many cases foresee periodic report requirements and compliance statements, as well as the obligation to comply with external reference standards (third-party standard).

Some similarities with the benefit corporation can be found also in BCorps and in social enterprises. Nonetheless, both should be distinguished from the benefit corporation's model.

Many of the above-mentioned aspects of the benefit corporation recall, indeed, the conditions for the BCorp's certification (Angelici, 2018): a certification granted by the private non-profit organization BLab to all the interested companies that voluntarily commit themselves to comply with some specific requirements and to respect higher sustainability standards. From a legal perspective, however, the institutional purpose and legal form of a BCorp-certified company don't differ from the traditional (for-profit) ones.

Similarities with the benefit corporation can be also identified with the social enterprise model: enterprises whose purpose must be essentially focused on the general interest or public utility. However, even in the case where the social enterprise is incorporated as a corporation (where allowed, like in the Italian legislation), many differences exist between the two legal models (Boletto, 2022; Castellani et al., 2016; Guida, 2018). They not only concern the scope of the business sector (limited, for the social enterprises, to socially useful activities), but above all the institutional purpose (Zoppini, 2017). The benefit corporation remains, in fact, a for-profit structure, even if at the same time it aims at pursuing an additional benefit purpose. On the contrary, profit distribution is usually (at least partially) forbidden to social enterprises (see the European Parliament Resolution of 5 July 2018 with recommendations to the Commissions on a *Statute for social and solidarity-based enterprises*).

Furthermore, many countries grant them partial tax exemption and/or other fiscal privileges. On the contrary, unlike social enterprises, benefit corporations do not enjoy tax benefits or incentives of any kind (with some negligible exceptions).

It is just as true, though, that behind the concrete success that benefit corporations are experiencing worldwide also lies the perspective to consolidate their market position and to gain a competitive advantage over the other, traditional companies. The growing attention investors and consumers nowadays show to sustainability issues, indeed, certainly makes committed companies more attractive (Dorff et al., 2021). This expectation on the one hand triggers a virtuous race to the top among the different competitors, prompting them to strengthen their commitment to sustainability. On the other hand, however, it also increases the

risk of greenwashing (Caterino, 2020; Delmas et al., 2011). The declaration of a sustainable commitment often becomes, in fact, just a label that does not correspond to any real action on a concrete level.

The very negative consequences for the market (consumers, competitors, etc.), for the environment and for the community make therefore essential a strong legislative action aimed at preventing the risk of a mere façade socio-environmental ecologism and at sanctioning abuses of the benefit corporation model. Unfortunately, the existing legislations on benefit corporations do not seem particularly well versed on the point: neither in terms of preventive protection (through disclosure duties and adequate controls on them), nor in terms of sanctions applicable in the event of ascertainment of greenwashing practices. Furthermore, the legislative measures often differ from one country to another, making the model even less compatible with the globalized nature of the market and with the need for a uniform standard of protection against greenwashing at the international level.

B. Green bonds

Exposure to greenwashing risk refer also to products. This is particularly true in the financial sector. As an example, we can consider green bonds: debt securities, that are meeting with growing favour on the financial markets worldwide, designated to finance projects that contribute positively to the environment (Cheong & Choi, 2020; Cossu, 2021a, 2021b; Ehlers et al., 2020; Freeburn & Ramsay, 2020; Quirici, 2022).

Also to this regard, the adoption of a non-mandatory legislative measure (the *European Green Bonds Regulation's Proposal* of 6 July 2021) has been recently envisaged. To stimulate the transparency, comparability and credibility of the green bonds and hence to help develop the green bond market, the proposed Regulation takes, in fact, a non-imposing approach and aims to realize a better legal environment to enhance the market's spontaneous demand for green financial instruments. To this end, it proposes the creation of a European common label for bonds complying with the sustainability standards identified in the Regulation; a label that can be used voluntarily by the issuers. It also foresees a system for registering and supervising the external reviewers for the EU green bonds (Cian, 2021).

Nonetheless, even before its approval, the EU Regulation's proposal raises some criticism, concerning in particular the lukewarm effectiveness of the possible actions against greenwashing (Le Galloc'h, 2016; Tröger & Steuer, 2021): actions are essentially based on preventive protection achieved through a penetrating system of disclosure and controls on the information communicated to the public (Badenhoop, 2022; Cossu, 2021b), but much less on the provision of a severe sanctioning regime (Iermano, 2022a). Against greenwashing practices, jurisprudential remedies of course still remain available (Robles, 2021) and in this regard, the first court decisions are in fact starting to appear. Two relevant examples are the decisions taken, respectively, by the German *Landgericht* Stuttgart on 31 January 2022 (on which see Iermano, 2022a) and by the Italian *Tribunale* Gorizia, on 25 November 2021 (on which see Urbani, 2022). However, rather than reassuring the efficiency of the remedies system, these decisions cast heavy shadows on the unclear legislative framework and the difficult assessment and sanctioning of greenwashing's cases.

Furthermore, the standards set up in the proposed *Regulation* are purely voluntary. Complying with the requirements set out in the *Regulation* would be only the condition for using the "*EU Green Bond*" label, but it wouldn't have any mandatory nature. It leaves therefore fully open the possibility that other financial instruments will be self-labelled as "green" (but not as *European green bonds*), even if they do not respect the minimum criteria set in the *Regulation*.

5.2.2 Mandatory Rules

Alongside the provision of legislative measures of voluntary nature (such as the above-mentioned cases of the benefit corporations' and European green bonds' legislations), the creation of a better legal environment for the development of a sustainable economy is increasingly being pursued through the introduction of mandatory rules as well.

Entrusting the effectiveness of action towards a sustainable economy only to the free choice of the market risks, in fact, not being a fully effective solution, especially because of the additional costs of voluntary compliance with higher standards of conduct. For example, even in countries that have introduced the benefit corporation's model, the large majority of companies still opt for the traditional for-profit legal structures, which are mainly only profit-oriented and leave little room for the

consideration of the environmental and/or social impact of the activities carried out.

Furthermore, if it is true that sustainability-oriented business decisions can sometimes have a positive effect in terms of marketing or risk assessment (see Sect. 3), it is also true that they usually entail higher costs for the company. Consequently, the legislative incentives towards the spontaneous adoption of a line of virtuous managerial conduct are not always effective.

In some cases, only mandatory legal prescriptions make it possible to direct the choices of managers towards solutions that are more sustainable, but also more expensive for the company. This explains, alongside the voluntary approach described in the previous paragraph, the binding approach often taken by national legislators and the EU institutions.

Among the several expressions of this different approach, worth to be mentioned are, on the one side, the change of the very definition of the company's purpose adopted in some legal systems, comprehensive not anymore only of the shareholders' value maximization, but also the stakeholders' interest; and, on the other side, two European Directives recently, respectively, adopted and proposed on corporate sustainability: the *Corporate Sustainability Reporting Directive* and the proposed *European Directive on Corporate Sustainability Due Diligence*.

A. New legal definitions of the company's Interest

Firstly, a significant change of perspective can be found worldwide in the current debate on the very notion of a company's interest. To this regard, some national legislations have even recently introduced a general obligation for the directors to act not only in the interests of the shareholders but also having regard to the interests of other stakeholders (employees, suppliers, environment, community, etc.).

This is for instance the case of Section 172 of the UK Companies Act of 2006. According to this rule, if on the one hand «A director of a company must act in the way he considers, in good faith, would be the most likely to promote the success of the company for the benefit of its members as a whole», he also must have regard, among other matters: «(a) to the likely consequences of any decision in the long term; (b) the interest of the company's employees; (c) the need to foster the company's business

relationships with suppliers, customers and others; (d) the impact of the company's operations on the community and the environment […]».

The example of the UK Companies Act has been followed also in other company law reforms, as for instance the ones realized in India in 2013 and in France in 2018. Referring to the first one, Section 166 of the *Indian Companies Act* 2013 foresees in fact that the company directors not only «shall act in good faith in order to promote the objects of the company for the benefits of its members as a whole», but they also have to act «in the best interests of the company, its employees, the shareholders, the community and for the protection of the environment». Further, also according to French legislation, the company must not only pursue the shareholder's interest, but it must also be run taking into consideration the social and environmental impact of its activity («*La société est gerée dans son intérêt social et en prenant en considération les enjeux sociaux et environmentaux de son activité*»: Art. 1833 of the French *Civil Code*, modified in 2019 by the *Loi PACTE*).

It is worth to be noticed that the above-mentioned company's legal definitions still don't match that of the benefit corporation. Unlike the latter, the former still foresees, in fact, the profit distribution among the shareholders as an exclusive institutional purpose. Further, the benefit corporation is subject to special legislation, concerning the scope of directors' duties and obligations, a specific benefit aim, reporting obligations and compliance with higher standards of conduct. But the main difference can be seen in the binding character of the new criteria introduced by Section 172 UK Companies Act, Art. 1833 French Civil Code, etc., for all the companies incorporated in the country concerned—and not only for the more virtuous ones (unlike the benefit corporation). Rather than rely exclusively on the voluntary choice for an optional corporate model (such as the benefit corporation), the legislators have thus in these cases preferred to impose that—regardless of the socio-environmental sensitivity of managers and shareholders—all companies should (and not simply could) pay attention to the external impact of their business activity, other than to the profit.

B. European directives on corporate sustainability

Some interventions recently proposed or adopted by the EU legislator on corporate law are in line with this mandatory approach as

well. Two very representative examples are the recent *Corporate Sustainability Reporting Directive* (Directive EU 2022/2464) entered into force on 5 January 2023, and the proposal for a *Directive on a corporate sustainability due diligence* approved on 23 February 2022.

The first one imposes to all large and listed companies specific disclosure duties on the social and environmental risks they face through the publication of regular reports. In particular, it requires them to disclose information on the risks and opportunities arising from social and environmental issues, and on the external impact of their activities. In this way, investors, civil society, organizations, consumers and other stakeholders would be put in condition to better evaluate the sustainability performance of companies (Solimene, 2022).

The second one starts, instead, from the assumption that European companies, including the largest ones, could find it difficult to identify and mitigate the risks in their value chains linked to respect for human rights or environmental impacts (Stella Richter Jr., 2022). Therefore, the proposed Directive aims to foster a companies' sustainable and responsible behaviour, imposing the larger European companies to conduct due diligence in order to identify and prevent environmental and human rights risks and making possible, in this way, also to collect more data available on human rights and environmental adverse impacts.

In both cases, the path chosen by the legislator is that of imposing standards, parameters and fulfilments, on the evident assumption that the market mechanisms alone are not satisfactory to spontaneously direct companies towards more sustainable rules of conduct. Legislative incentives are therefore considered as not sufficient but must be accompanied by mandatory prescriptions.

Will these new set of voluntary rules and compliance duties be enough to enhance the process towards a sustainable economy? Or should companies also find an intrinsic, financial motivation to become more sustainable?

5.3 Financial Issues

From a financial perspective, there are two aspects. On the one hand, it is true for voluntary sustainability measures that companies will only commit to them, at least in the long term, if concrete benefits arise. These can be higher sales or profitability on the one hand, and concrete cost savings on the other. If neither is the case, companies will only accept these voluntary offers to a limited extent. In particular, it is to be feared that the company will be forced to forego such measures in the face of competition.

On the other hand, there are mandatory legal measures. Although those lead to the desired positive effect in terms of sustainability for the companies concerned, they can mean corresponding additional costs for the company. If these costs can be passed on to the customer (at least for the most part), this is not a fundamental problem. However, national regulations always harbour the risk that home-country companies will be disadvantaged in global competition.

The criticism already expressed by the first commentators on the solutions adopted or proposed by the EU legislator with the above-mentioned directives raises doubts that go into that direction. Statutory regulations always carry the risk of overregulation and escalating costs for bureaucracy or required measures. Indeed, globalization has led to companies competing on a worldwide scale. Strict sustainability laws can lead to companies not remaining competitive, "greenwashing" their products and image (de Freitas Netto et al., 2020), or simply migrating to other countries.

5.3.1 Assessment of Sustainable Investments

Unfortunately, the current discussion on stronger regulations loses sight of the fact that sustainability can bring economic benefits that go beyond some marketing effects and government subsidies (Gasior et al., 2016). However, this usually requires a differentiated and more comprehensive view of investment decisions. In addition to a pure return and profit perspective, the issue of risk plays a key role (Gasior & Schittenhelm, 2012; Schittenhelm, 2014). The main benefit of sustainable management lies in the improvement of the risk-return profile. However, this improvement in the risk position tends to pay off in the long term. ESG funds emphasize the advantage of sustainable investments, and a lot of research focuses on whether sustainability increases the profitability of

companies. Most findings here concentrate on a company level examining company performance measures such as return on equity or share price development (Ernst, 2021; Whelan et al., 2021).

Even though a company perspective can be helpful to promote sustainable behaviour and increase awareness of sustainability in general, it must be stated that the effect on individual projects is very much limited. For the most, companies still apply simple cash flow analysis for assessing projects (for the theory see for example Arnold & Lewis, 2019). Financial consequences of an investment are thereby expressed in terms of future cash flows. The idea is that those cash flows generate a certain minimum return to fulfil the expectations of shareholders and creditors. The minimum return is expressed as the weighted average cost of capital (WACC). Investment criteria such as net present value *NPV* and internal rate of return *IRR* evaluate whether the investment reaches the minimum required return. In case of different investment alternatives, the investment with the highest *NPV* or *IRR* will be chosen. In principle, this approach leads to a preference for riskier investments in the absence of hurdle rate adjustments. This is because risky investments should, at least in expectation, lead to higher cash flows.

As a consequence, sustainable investments are often rejected and considered as economically non-viable. In addition, there are other reasons why sustainable projects are widely disadvantaged:

- Risk assessment for an individual project is often limited to general qualitative statements. Quantifying risk is rather difficult and complex and therefore avoided. The missing risk quantification leads to a strong return orientation within the decision process (Ragotzky et al., 2020).
- There can be a difference between the company perspective and the investor perspective while assessing investments. The reasons are different time horizons, different parameter evaluations or even different models applied (Ragotzky et al., 2020).
- An unprofitable project can still lead to short-term positive mispricing of a company's value. Obviously, if the capital market is not aware of possible risks, those are not considered (Schittenhelm, 2014).

5.3.2 Risk Measures

The first important step for a more differentiated view of profitability lies in strengthening a company's risk management (Lam, 2003), by establishing an Enterprise Risk Management (ERM) system, which ensures the organizational framework within the company for dealing appropriately with risk. Corresponding corporate governance codes are also aimed at this (for example Deutscher Corporate Governance Kodex, 2022). On an operating level, an ERM system helps to assess risk and provides viable risk measures. When evaluating sustainability measures, we rather expect to reduce risk and therefore, risks arising from non-sustainable behaviour are of particular importance. These could be, for example, the following aspects:

Reputational risks can result in a loss of customers to the competition. Low sales and thus declining profitability are the result. High employee turnover is another risk that can be traced back to corresponding unsustainable behaviour. Triggers can be poor working conditions, low wages and insufficient social security. The loss of qualified employees makes losses in the company's product and service quality likely. The two points mentioned above can also lead to a deterioration in the company's access to possible financing, thus increasing capital costs. Finally, there are possible penalties or restrictions on doing business to be considered (Schittenhelm, 2022). Sustainable investments help to reduce these risks and can be seen as a form of insurance. There are different measures that can help to get a more complete consideration of the effect of such sustainable investments.

A. Hurdle rate adjustment

If risk is reduced by a sustainable measure, the cost of capital and hence the discount rate for the *NPV* calculation decreases. Consequently, the hurdle rate for an *IRR* consideration is also reduced. In fact, a reduction of discount rates leads to an increase in the *NPV* for such simple cash flow streams.

A glance at classical measurement approaches for the cost of equity show that such a positive effect will hardly find its way into the calculation. The most widely used theoretical approach using CAPM and SML

are rather backward orientated (Arnold & Lewis, 2019) so a manual individual adjustment of the hurdle rate (discount rate) seems to be most appropriate (Chava, 2014; Gormsen & Huber, 2022).

B. Separation of the sustainability measure

Sustainability measures that require an investment to protect against future damage or penalties can be interpreted as insurance. The original investment represents an insurance premium. And, as for other classical insurances, the usefulness of this "sustainability" insurance should be done separately, by estimating expected insurance benefits and comparing them with the paid insurance premium. Several difficulties are to be faced in this context. Obviously, the occurrence probabilities and insurance benefits. But also an adjustment of the discount rate could be justified.

C. Scenario Analysis

Scenario Analysis is a commonly proposed tool for assessing projects (Wengert & Schittenhelm, 2013). Scenarios need to be appropriate and require an estimation of the occurrence probability. Approaches define a small number of specific scenarios and allocate an occurrence probability, for example by using decision tree analysis. An alternative are Monte Carlo simulations (Wengert & Schittenhelm, 2013). Here, one assumes specific distributions for one or more parameters of the model. Random numbers, which are generated based on those distributions, create a large number of scenarios, then.

The assessment of scenarios can be done in a two-dimensional way. The first dimension is return orientated, either by calculating the expected value of *NPV*s or the expected value of *IRR*s. The second dimension should be risk orientated. The most obvious risk measure is shortfall probabilities in our context (Wengert & Schittenhelm, 2013). A shortfall probability describes the probability of not achieving a predefined goal z. For project assessments, this goal can be easily defined as a case with an *NPV* of at least 0 or an *IRR* of at least the hurdle rate. Often higher returns come together with higher risk and decision-makers have to decide upon their risk appetite. For the acceptance of a project, companies should define a maximum permissible level of shortfalls (Wengert &

Schittenhelm, 2013). If this level is exceeded, projects are rejected even if the expected *NPV* is positive.

5.3.3 Obstacles

To sum up, investment decisions are often based on incorrect hypotheses and a lack of consideration of negative consequences (risks). Even though no one can foresee the future this should lead to an increased effort in making investment decisions. Risk assessment plays an important role in this context. Because of specific challenges such as low occurrence probabilities, extreme long-term nature, lack of data and perceived arbitrariness in the assessment process the establishment of an ERM system is crucial and helps to reduce the lack of knowledge in a company (Lam, 2003).

The ERM system initially serves to create a heightened awareness of risk aspects within the company. To this end, it provides an organizational framework and integrates risk management into all corporate processes (Lam, 2003; Wengert & Schittenhelm, 2013). In addition, the operational risk management process regulates the identification, assessment, control and reporting of risks. Nonetheless, two key problems remain (Schittenhelm, 2014):

- Activities might be misvalued in the short term and someone takes profit out of it. In fact, management and existing shareholders might benefit from short-term positive share price developments by receiving bonus payments or simply by selling shares in time.
- Non-sustainable activities can increase the value of the company, which basically means that companies increase their value at the expense of others. This might happen for example through extensive use of cheap resources, natural resources available for free or at minimal cost or exploitation of labour.

This closes the circle and leads back to the legal framework that must serve to prevent such incentives. It remains to strike a balance between rules and economic incentives that preserves the competitiveness of companies but still acts in the spirit of sustainability.

5.4 Conclusions

The need for sustainable behaviour is beyond question. From an ethical perspective, we should take that for granted, unfortunately, reality proves us wrong. Still, there exist many obstacles to acting sustainably. In our article, we discuss how legislators and regulators have changed dynamically the business environment over the last few years. Being aware of the benefits but also the limitations of this top-down approach, we conclude that companies need an intrinsic interest. A successful transformation of the current business world into a more sustainable one must be accompanied by a more comprehensive assessment of profitability, which includes a profound awareness and assessment of risk aspects.

Even though risk assessment has always been an important part in theoretical profitability measurement, it is often completely neglected in practice. As a first step, the implementation of an ERM system in a company helps to ensure the transparency of investment decisions and a continuous improvement of risk assessment tools. However, this requirement that also arises from different corporate governance codes is still on a very abstract, superficial level. Only concrete proposals for the risk assessment on the project level insure a behavioural change. Even though risk measurement remains difficult, creating awareness helps to break down a one-sided view of returns. This is not to be confused with a nice-to-have investment calculation in favour of sustainable measures but a more profound assessment.

The expansion of an ERM system in the company does not necessarily lead to an exclusively sustainable behaviour. However, a systematic examination of the consequences and risks of one's own activities can also bring long-term benefits. Obviously, even under the consideration of risk aspects, not all desirable measures will turn out to be profitable, so legal restrictions and prohibitions will also be necessary in the future. It becomes apparent that legal and economic aspects cannot be considered separately. Where there are limits to one, the other must step in to create substantial progress towards greater sustainability.

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CHAPTER 6

ESG Initiatives and Directors' Fiduciary Duties

Dario Latella

6.1 Introduction

On February 23, 2022, the European Commission adopted a Proposal for a Directive of the European Parliament and of the Council on *Corporate Sustainability Due Diligence* and amending Directive (EU) 2019/1937.

In particular, the Proposal aims to harmonize existing national or voluntary rules on due diligence by establishing a corporate sustainability due diligence duty to address negative human rights and environmental impact (see on topic Liang & Renneboog, 2020; Pacces, 2020; Ringe, 2022; Winter, 2020).

As we know, the initiative of the European Union is based on several studies written by scholars and experts, condensed into the 2020 final report issued by Ernst&Young on "*Directors' duties and sustainable corporate governance*": a third of companies recognizes the need to act and

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take measures to address adverse effects of their actions on human rights or the environment.

In a wider sense, everyone understands that business plays a key role in creating a sustainable and fair economy and society.

Nations have tried to face such matters, by improving autonomous and domestic tools on corporate, sustainability-related due diligence obligations; but stand-alone measures are not enough to help companies act sustainably.

6.2 The Theoretical Frame

The literature on Corporate Social Responsibility ("CSR") was predominantly, for long years, a minority literature that opposed the dominant Shareholder value culture and the consequent prevalence of a short-term financial view of business strategies.

Later, this critical literature had been fueled mainly by considerations of business ethics; at some point (roughly, beginning in the 1980s), a new ideology of CSR emerged in the U.S., one that draws its foundation no longer (or, at least, not only) from ethical reasons, but elaborates a reasoning of economic analysis that assigns a central role, in business strategies, to reputational investments: strategic business choices aimed at preferring, on a voluntary basis, production methods that respect human rights and natural environments, appear rational insofar as they are likely to elevate the company's image and inspire long-term investor and consumer confidence.

This reasoning has its appeal because it proposes a reconciliation between CSR and the competitive mechanisms of the market economy, but it also has some serious weaknesses:

(a) Reputational competition no longer works at times of deteriorating company accounts and urgent cost-cutting;
(b) Reputational competition carries less weight for those firms that do not target the vast consumer goods market or offer credence goods;
(c) It is unclear to what extent reputational competition, such as that thus vague, can be consistent with corporate policies of strong productive and organizational innovation, and thus with overall market efficiency.

These perplexities did not imply a principled rejection of the doctrine, but rather led to calls for CSR to be supported by public incentives aimed at triggering virtuous competition of firms on this level.

Such minority theoretical position stood in opposition to that shareholder value doctrine which, around the year 2000, seemed to reach an absolute dominance: from 2001 is Hansmann and Kraakman's article on the end of the corporate governance story; in the 2003 Italian corporation reform, the thesis of the primacy of shareholder value was not even questioned; the 1997 BRT (Business Roundtable) statement fully adheres to this position (see of course on the topic Enriques et al., 2017; Hansmann & Kraakman, 2020).

In the following decade, the absolute dominance of the shareholder value doctrine cracked (Stout, 2012).

Instead, the last decade has seen a powerful and at least to this writer-surprising acceleration of stakeholderism. Writings on CSR have taken on a tone, while still oppositional, but increasingly bold, such as those of Yablon (2016), Yosifon (2018), and Mazzucato (2018).

The watershed year can be considered 2019. Emblematic moment was the BRT statement of August 2019 (which presents a 180-degree conversion from that of 1997). No less important is the World Economic Forum's Davos Manifesto 2020 (actually published in December 2019). It can be noted that the decisive turning point, on the level of the history of ideas, has not so much matured in academic debate as in the stances of practitioners and even institutional investors (the annual Letters to Issuers, in 2020 and 2021, by L. Fink, chairman and CEO of Blackrock, have attracted particular attention: Blackrock (2020) and (2021).

Also, more distinctly different versions of stakeholderism emerge. The "weak" instrumental version of stakeholderism (actually, an enlightened shareholder value) soon gives way to a "strong" version, in which stakeholders' interests are considered a value in themselves.

Thus, within a few years, the thesis of the superior rationality (including corporate rationality) of ESG strategy became commonplace. What is surprising is that the turnaround is not justified based on new rational arguments, but is rather presented as an objective, self-evident fact that conforms to the nature of things.

Into this picture, then, come principled legislative provisions (from sec. 172 of the English Company Act of 2006 to the French *Loi PACTE* of 2019, and many others scattered around the world); important signs of the emergence of a mainstream, which cannot be underestimated.

Such a strong and rapid evolution of ideas, referred to by many as an epochal turning point, must have deep-seated reasons, although often not conscious and stated, as is always the case when a cultural orientation becomes mainstream.

Among the explanations that can be given and have been given, I would highlight three:

(1) General cultural factors: the growing perception of environmental risk and the social costs of globalization, as well as the social costs of the financialization of the economy.
(2) According to a rather widespread observation, there is also an ideological explanation: the interest of the top management of large corporations in strengthening and stabilizing their position, in the face of the growing aggressiveness of institutional investors (following a line of thought that ideally combines old and new institutionalist theories of the firm). However, this argument must come to terms with the new trend, emblematically expressed by Blackrock's letters, mentioned above.
(3) As a development of the previous argument, I would add the interest of corporations (or, rather, those who exercise entrepreneurial power) in resisting the aggression and uncertainties caused by populist governments and, in general, by the improvisation of governments in Western democracies; as well as, to some extent, in acquiring lines of resistance against regulators and antitrust authorities.

The pandemic has helped to strengthen these positions, because it forces thinking in a long-term perspective and exposes the insufficiency of market mechanisms to deal with the general crisis.

What specifically has changed? It is plausible that the stances taken by business leaders are rhetorical in nature and do not involve legally binding commitments to substantially differentiate corporate strategies from the past (Bebchuk & Tallarita, 2020 and 2022 notes how the so-called epochal turning point was entrusted to individual public communications by CEOs, without any formalization by board resolutions or other acts, and was not followed by changes in the annual and multi-year plans of the companies concerned; see also, Gözlügöl and Ringe, 2022).

In L. A. Bebchuk—R. Tallarita's essay (2020), a plausible economic analysis of the lack of incentives for directors, and for shareholders, to look after the interests of stakeholders is also set forth. The Authors say that, to «address growing concerns about the negative effects of corporations on their stakeholders, supporters of stakeholder governance—"stakeholderism"—advocate a governance model that encourages and relies on corporate leaders to serve the interests of stakeholders and not only those of shareholders»; they conduct a conceptual, economic, and empirical analysis of stakeholderism and its expected consequences; thus, they conclude that stakeholderism is an inadequate and substantially counterproductive approach to addressing stakeholder concerns. The serious problems of weighing and balancing these interests and the difficulty of translating stakeholderism into appropriate organizational formulas are also convincingly highlighted.

Consider that this diagnosis is proposed in a system, such as the U.S., in which the majority of state laws contain constituency rules in favour of categories of stakeholders, but not accompanied by appropriate remedies.

6.3 The State of Art on CSR

The state of the art, on the issue of CSR, seems to be this: CSR has suddenly become mainstream on a cultural level, but its translation into legal-positive terms remains entrusted to differentiated choices of national legal systems, usually limited to simple provisions of principle. When a cultural framework changes, legal norms should adjust in the process of interpretation and application; in any case, a radical change of pace seems to be maturing, precisely at the level of positive European law.

The European Commission's approach to CSR, in the documents of the first decade of the twenty-first century, took it for granted that CSR choices were optional and went, by definition, beyond the level of mere compliance with legally imposed standards of business conduct.

The difference with the current European approach, as reflected in the Commission's latest documents, lies in the fact that the Commission now wants to address the issue not so much with rules of principle relating to the purpose of the business, but with binding regulations designed to incentivize or even impose the social responsibility conduct of directors. This policy choice is a clear break from the Commission's previous CSR positions, which had always relied on the voluntary and discretionary choice of individual companies.

Now, in the Inception Impact Assessment for Sustainable Corporate Governance Initiative (July 30, 2020) it is instead explicitly stated that "*If left to voluntary market action, short-termism is unlikely to decrease*". Moreover, these innovations are part of an already very advanced framework of EU interventions that tend to give positive law relevance to sustainable development principles.

If the program is carried forward, it should lead to a real revolution in corporate law.

Apart from the points already covered by existing directives (non-financial disclosure and transparency of institutional investors), it is sufficient to recall briefly the points contained in the documents of last months.

The Sustainable Corporate Governance paper of July 2020, which was submitted for public consultation, is characterized by a valuable introduction in which the policy choices are made explicit, with a strong critique of the doctrine of shareholder primacy, seen as a tool to support, in reality, the primacy of a small circle of capitalists and with a careful analysis of the factors that have supported short-termism (from the pressure of institutional investors to the shortcomings of traditional regulations on the purpose of the company and the duties and responsibilities of directors).

On this basis, the paper lays out a series of incisive proposals:

1. A new definition of corporate interest that should clarify the content of directors' fiduciary duties: long-term strategic perspective and care for stakeholders' interests. This opens a new frontier on directors' discretion, with possible disruptive remedial repercussions.
2. Incentivizing a long-term approach by investors, through loyalty rewards.
3. Eliminate the quarterly reporting requirement.
4. Require the board of directors to conduct an adequate investigation when sustainability issues are at stake.
5. Remuneration of directors: introduce ESG metrics and provide for long-term inalienability of shares held by them.
6. Strengthen professionalism requirements for directors.
7. Involve stakeholders in management. Legitimize stakeholders to take action against directors in case of breach of duties of care and loyalty.
8. Strengthen the powers of action of national regulators.

A serious problem also emerges from the paper: the Commission's study acknowledges that, in the short run, reform could lead to increased costs for companies, but it also states that this would be offset by long-term benefits.

This statement seems to be fideistic.

Even more so is the Inception Impact Assessment's assertion that "*As first movers in the sustainability transition, EU companies could gain remarkable competitive advantages on global markets*".

These concerns are serious, but they do not give decisive arguments against the action program designed by the Commission. Europe can see itself as economically strong enough to launch even risky challenges when they are based on fundamental value choices.

This is also the message that seems to be emerging from the results of the public consultation (which ended on February 8, 2021; the results are summarized in a Summary Report published on May 18, 2021). The overwhelming majority of the responses endorse the Commission's proposals, although at the same time a majority of respondents (52–58%) express concern about rising business costs, the risk of competitive disadvantages for European companies, and the risk that only the largest companies will be able to sustain such a challenging turnaround.

The coordinates of policy reasoning thus seem to be marked: concerns yes, but also the need to move forward, in the face of fundamental values, such as respect for human rights and the natural environment.

Note the difference with the old appeals to business ethics, which had the flavour of minority messages wishing for a conversion of minds with respect to a different and sinful reality.

Today, the ethical–political duties of businesses are presented, instead, as expressions of values deeply rooted in common sense: respect for human rights, environmental protection, and legality. In the face of these values, the ethical relativism of the recent past would seem to be cast aside.

6.4 The EU Proposal for Corporate Sustainability Due Diligence

So, the "Proposal" takes inspiration first from the recent approaches to financial crisis, that are mostly based on the consideration of short-term capitalism (aka quarterly capitalism: see Reich, 2007) as the bad perspective and, on the other side, the long-terminism as the best way to sustainability and growth.[1]

Mark Roe trenchantly says that: "*increasingly rapid stock trading and sharply rising activist pressure on public firms … lead to pernicious economy-wide results*" (Roe, 2018). However, as Roe goes on to explain, there is no convincing economic evidence supporting the short-termism thesis.

In any case, the EU thinks that short-termism has serious adverse economic effects on companies, their shareholders, and their stakeholders. As a result, companies risk to become less productive and innovative in the long term, with adverse consequences on the sustainability of the company as well as for the local and global economy.

So that, for an assumed equivalence, the "medicine" is the long-terminism, that is to say a view of the business that can be considered

[1] Several documents are available on the topic: of course, see the EUROPEAN COMMISSION, *Proposal for a directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937*, Brussels, 23.2.2022, COM (2022) 71 final; the EUROPEAN COMMISSION, *Corporate sustainability due diligence. Fostering sustainability in corporate governance and management systems,* [no date], available online at: https://ec.europa.eu/info/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en); the EUROPEAN COMMISSION-EY, *Study on directors' duties and sustainable corporate governance. Final report*, July 2020, available at: https://op.europa.eu/it/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-de; the EUROPEAN COMMISSION, DIRECTORATE GENERAL FOR EMPLOYMENT AND SOCIAL AFFAIRS, Unit D.1., *Abc of the Main Instruments of Corporate Social Responsibility*, Employment & Social Affairs—Industrial Relations and Industrial Change, Luxembourg: Office for Official Publications of the European Communities, 2004, 9–55; EUROPEAN COMMISSION, DIRECTORATE GENERAL FOR JUSTICE AND CONSUMERS, *Study on directors' duties and sustainable corporate governance: final report*, Publications Office, 2020, available online at: https://data.europa.eu/doi/10.2838/472901; of course, for any previous deepening, EUROPEAN COMPANY LAW EXPERTS GROUP (ECLE), *The European Parliament's Draft Directive on Corporate Due Diligence and Corporate Accountability*. Available at: *ECLE_ECGI_19 April 2021 (wordpress.com)*. Also published in Riv. Soc. 2-3/2021, 276–296; and EUROPEAN COUNCIL, *Conclusions on Human Rights and Decent Work in Global Supply Chains*, Brussels, 1 December 2020, 13512/20.

nearly 10 years long and, for this reason, can involve the corporate business and its value chain in keeping:

- The interests of employees and customers;
- The interest of local and global environment;
- The interest of society at large.

Such Proposal provides for the obligation for companies to take care of aspects related to *ESG* (*Environmental, Social, and Governance*) issues with regard to human rights, such as child labor and the exploitation of workers, and the environment in order to contain and eliminate pollution and protect the biodiversity.

In particular, this Directive will:

(1) Improve corporate governance practices to better integrate risk management and mitigation processes of human rights and environmental risks and impacts, including those stemming from value chains, into corporate strategies;
(2) Avoid fragmentation of due diligence requirements in the single market and create legal certainty for businesses and stakeholders as regards expected behaviour and liability;
(3) Increase corporate accountability for adverse impacts, and ensure coherence for companies regarding obligations under existing and proposed EU initiatives on responsible business conduct;
(4) Improve access to remedies for those affected by adverse human rights and environmental impacts of corporate behaviour;
(5) Being a horizontal instrument focussing on business processes, applying also to the value chain, this Directive will complement other measures in force or proposed, which directly address some specific sustainability challenges or apply in some specific sectors, mostly within the Union.

The new due diligence rules, which will offer companies legal certainty and a level playing field with a view to greater transparency for investors, divide their recipients into two groups:

(1) Companies resident in an EU member state, divided in turn into 2 sub-groups:

- The first, which includes joint stock companies with more than 500 employees and a worldwide net turnover greater than Euro 150 million;
- The second, which includes other joint stock companies operating in certain sectors with a high impact (environmental, social, etc.) with more than 250 employees and a worldwide net turnover equal to or greater than Euro 40 million;

(2) Companies from third countries active in the EU with a threshold of turnover generated in the EU in line with groups 1 and 2.

The Proposal aims to promote sustainable and responsible corporate behaviour, providing for the obligation for companies to identify and, if necessary, avoid, stop, or mitigate the negative impacts (i) of their operations, (ii) of the operations of their own subsidiaries and (iii) of the operations along the so-called "Supply chain", on the social, environmental and economic fabric.

In particular, the directors of the companies to which the Proposed Directive is addressed will have the obligation to integrate the company strategies in order to pursue the ESG objectives in the long term by monitoring, inter alia, the effectiveness of the policies and due diligence measures.

On the other hand, the national administrative authorities designated by the Member States will be responsible for monitoring the application of the mentioned new rules and, where necessary, sanctioning the same companies if they do not comply with the provisions of the Proposal for a Directive.

This issue is very important to understand how the new rules have to be imported in home country legislation and what could be the options available for the law makers.

The rules of directors' duties are enforced through existing Member States' laws. The directive does not include an additional enforcement regime in case directors do not comply with their obligations under this directive.

But, on the side of compensation of victims of adverse impacts, Member States should be required to lay down rules governing the civil liability of companies for damages arising due to its failure to comply with

the due diligence process. The company should be liable for damages if they failed to comply with the obligations to prevent and mitigate potential adverse impacts or to bring actual impacts to an end and minimise their extent, and as a result of this failure an adverse impact that should have been identified, prevented, mitigated, brought to an end or its extent minimised through the appropriate measures occurred and led to damage. In order to ensure that victims of human rights and environmental harms can bring an action for damages and claim compensation for damages arising due to a company's failure to comply with the due diligence obligations stemming from this Directive, even where the law applicable to such claims is not the law of a Member State.

So, we can say that the duties coming from the Proposal are addressed to the companies and their directors for the following concrete actions:

(1) Integrating due diligence into policies and management systems,
(2) Identifying and assessing adverse human rights and environmental impacts,
(3) Preventing, ceasing or minimising actual and potential adverse human rights, and environmental impacts
(4) Assessing the effectiveness of measures
(5) Communicating
(6) Providing remediation.

As everyone can see, such scheme reflects the s.c. *Coso Report* (2023) standard that is to say the widely known tool to be used for monitoring companies' risks.

As it happened with the internal control systems, the non financial information, and capital requirements, the EU is going to (try to) harmonize company law by taking inspiration from the bank and financial sectors, where such issues are since a long time faced and ruled.

The improvement of the Directive shall be based on specific requirements, that, in general, should not modify the legal structure of civil liability of each Member States.

In this perspective:

(a) The proposal regulates sustainability due diligence obligations of companies and at the same time covers—to the extent linked

to that due diligence—corporate directors' duties and corporate management systems to implement due diligence. Thus, the proposal concerns processes and measures for the protection of the interests of members and stakeholders of the companies.

(b) Existing Member State rules and those under preparation already have, and would further lead to diverging requirements, which risks being inefficient and leading to an uneven playing field.

(c) Large companies will be within the scope of the full due diligence obligation, also because many of them already have certain processes in place.

The Proposal lays down measures to limit the passing on of the burden from those large companies. But each State will be free to adopt the appropriate legal tool to improve such diligence obligations.

In this sense, according to the model of civil liability provided by the common law systems, companies should not be liable for failing to prevent or cease harm at the level of indirect business relationships if they used contractual cascading and assurance and put in place measures to verify compliance with it, unless it was unreasonable, in the circumstances of the case, to expect that the action actually taken, including as regards verifying compliance, would be adequate to prevent, mitigate, bring to an end or minimise the extent of the adverse impact.

If so, the traditional balance between the business judgement rule and the duty of care, that is represented by the edge of fraud and conflict of interests, has to be redetermined when speaking of companies under the "new" due diligence obligation.

In this sense, such companies shall produce a specific output (procedures, controls, review) aimed to prove that the obligations of preventing potential adverse human rights, and environmental impacts, have been observed.

In case of missing output, the obligation would be considered as violated; but, in case of the presence of such output, its quality, effectiveness, and efficiency could be considered as inappropriate or inadequate.

Finally, of course, directors should therefore be responsible for putting in place and overseeing the due diligence actions as laid down in the Proposal and for adopting the company's due diligence policy, taking into account the input of stakeholders and civil society organizations and integrating due diligence into corporate management systems.

Directors should also adapt the corporate strategy to actual and potential impacts identified and any due diligence measures taken.

If we take a look at the main European legal systems, we will see that the duty of care is now more detailed than it was according to the parameter of the prudent administrator.

Belgium

According to the Belgian measure, directors will be personally liable to the company for any damage resulting from his failure to act as a prudent manager.

France

Each director owes individual duties to the company, to promote the success of the company for the benefit of its shareholders as a whole and must act in good faith.

Germany

Each director has a general obligation to act with the diligence of a prudent businessperson.

Italy

Directors must fulfil their obligations with the diligence required by the nature of their duties and their specific competences.

Since 2019, all companies have been obliged to set up and maintain organizational, accounting, and administrative measures adequate to the nature and size of their businesses, to promptly detect any signs of an impending crisis.

This is a typical way of giving obligational substance to a general duty of conduct.

Spain

Directors have a general duty of diligence for the good management and control of the company.

Directors are required to act in good faith, without personal interest in the matter that is under decision, with sufficient information, and in accordance with an appropriate decision process.

What is mentioned can thus be quickly summarized, without pretending to describe the content of the Directive in detail:

(I) A duty on companies to have a "due diligence strategy" (Art. 4 Dir.), which becomes a new policy document, with which the company will have to concretize, in its own situation, the provisions of principle dictated by the directive. The document must be made available to the public (Art. 6 Dir.).

If the proposal becomes current law, it will open a debate on the binding value of the program and on the availability of injunctive, compensatory, or invalidating remedies in cases where the company violates the commitments made in its strategy document (commitments which, in turn, are only concretizations of rules of conduct imposed on companies by law). In the Italian legal system, it is easy to foresee a wide application of the discipline on the prohibition of unfair business practices and the consequent flourishing of class actions (if the "third phase" of the relevant discipline, which has recently come into force, will bring with it—as is expected from many quarters—that success of the institute that has so far been lacking).

(II) Duties on companies to set up consultation procedures ("fruitful, meaningful and informed discussions") with stakeholders ("stakeholders") (Art. 5 Dir.). Qualified information duties are also imposed on workers' unions.

The rights of stakeholders do not stop at the duty of consultation imposed on the company but are strengthened by the provision of a right of complaint, given to them by Art. 9 of the Directive. This is a new instrument, which will require the company to consider claims and proposals from stakeholders and to provide complaints with an appropriate response.

The concretization of the duty to consult and grievance mechanisms will be implemented by national legislators and corporate autonomy. However, it is difficult to imagine that this norm, if it ever comes into force, will remain on paper. Complaints about the company's social, environmental, etc. policies, hitherto entrusted (apart from pure political

action and interventions by the criminal courts) to disruptive interventions in the assembly, now find a platform likely to enhance them. Mandatory discussion will result in strengthened duties of motivation for corporate bodies that decide to disregard stakeholder demands. Here, too, a new remedial season could open, in which the business judgment rule (which also has its own principled rootedness in the freedom to conduct business in Art. 16 CDFUE) may prove to be a fragile tool in defense of the traditional regime.

(III) Obligation for member states to provide appropriate means of "out-of-court redress" of wrongs committed by the enterprise, in violation of the duties of "due diligence" (Art. 10 Dir.). The remedial apparatus is partly traditional and partly original ("financial and non-financial compensation, reinstatement, public apology, restitution, rehabilitation or contribution to investigation").

Here again, if the proposal becomes law, the bottlenecks of the traditional theory of compensation will be overcome and a very large chapter will be opened about non-contractual corporate liability.

(IV) Obligation for member states to designate "one or more competent national authorities responsible for supervising the application" of the directive (Art. 12 Dir.). These authorities will be endowed with informational and inspectional supervisory powers, along the lines of independent regulatory and antitrust authorities, and will be able to impose corrective measures, any violation of which will lead to the imposition of penalties.

Thus, for the new frontier of sustainable corporate governance, the combination of public and private enforcement is proposed, which European law has experimented with, with substantial success, in antitrust, unfair business practices, and regulated markets.

6.5 Conclusions

On the level of legislative policy, the choice of the proposed Directive is extreme: it relies, in designing a radical reform of corporate law, on some principled provisions, centering on the triple duty of business to respect human rights, the natural environment, and the rules of good governance. There are some indications of content, on these three values, which will be spelled out in more detail in the annexes, but certainly the basic legislative technique remains that of norms with indeterminate content (i.e., intended to be filled with content in the interpretation and application phase).

We are facing a revival of "strong" institutionalism that, even a few years ago, would have seemed unthinkable.

Targeted by the new discipline would be large companies (in the sense of European law, that is, all—not a few—companies larger than the European standards for defining SMEs) and all listed companies, even if SMEs. Thus, the new discipline would have a very pervasive impact.

Like all major reforms, it could fail in its objectives and could lead to unintended effects.

The flowering of opinion in this regard has already begun and is bound to grow.

Equally numerous will be the criticisms focused on the vagueness of the discipline and the new duties imposed on companies, compared with the incisiveness of the implementation tools and remedies provided. Many will feel that a discipline so designed is essentially unworkable and can never go beyond the proposal level.

I would not rule out, however, that things may be otherwise, because cultural factors are powerful, in social and economic affairs. Significantly, the current discussion is veering from the topic of CSR to that of sustainable finance, with a deluge of literature on ESG ratings and ESG investment returns and the emergence of growing ESG activism. The conversion of sovereign wealth funds has not yet occurred, but it, too, may occur soon.

The cultural factors involved are manifest globally and could result in a synergistic process with European reforms, alleviating the concerns of competitive disadvantage for European companies mentioned earlier.

It is important to note that the current trend, in the final analysis, no longer refers only to a slow maturation of consumer preferences in the end market. The determining factor is the choices of investors. There is

thus a centrality of sustainable finance. Thus, reputational competition has investors, even before consumers, as its primary point of reference.

If this cultural shift consolidates, even if the obstacle to CSR from the interests of institutional investors does not completely disappear of its own accord, a favorable ground will still be formed for that obstacle to be overcome by mandatory legal rules.

Even a basic political problem, such as the one posed by Bebchuk, that stakeholders' interests are best protected not by a thorough reform of corporate law, but by appropriate legal and regulatory standards (workers' statute, consumer code, environmental laws, etc.), can be overcome, with a model of regulatory intervention such as the one being discussed in the EU. The proposed reform does not directly (at least for now) affect company law, but it does provide for the creation of a platform in which stakeholders' voice rights will be able to find a hitherto unimagined space.

The effects on corporate law will be indirect, but no less incisive (especially on the duties and responsibilities of directors and controlling shareholders).

So, in a few words, I think that the new "due diligence" would be considered as a mandatory specification of the general duty of care.

This is a fiduciary duty requiring directors and/or officers of a corporation to make decisions that pursue the corporation's interests with reasonable diligence and prudence. Or the duty by which a corporate director or officer is required to perform their functions in a manner that they reasonably believe to be in the best interests of the corporation.

Such general "duty of care" is now moreover specified into a concrete duty of adopting the company's due diligence policy, taking into account the input of stakeholders and civil society organizations and integrating due diligence into corporate management systems.

This way, we can say that directors will be responsible on two levels:

(1) The one of the lack of such policies and procedures;
(2) The one of their inadequacy.

The second one is probably the topic that we shall further deepen.

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CHAPTER 7

Insurance Industry and Sustainability Preferences: Contracts and Products

Luca Della Tommasina

7.1 Insurance Companies and ESG: Introductory Remarks

Everybody knows the tendency of European law to strengthen the commitment of large companies to the achievement of SDGs, with particular regard to human rights and the environment, as well as the engagement of institutional investors and asset managers to improve ESG performances through their corporate rights or, more generally, their influence powers (Ringe, 2022).

It is also well-known that the insurance industry plays a key role in this context (Gómez Santos, 2022).

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The *UNEP FI Principles for Sustainable Insurance*, supported by the UN Secretary General and launched in 2012, establish a set of strategic objectives, the most impressive of which are the following:

- To perform processes to identify and assess ESG issues inherent in the portfolio and be aware of potential ESG-related consequences of the company's transactions;
- To integrate ESG issues into risk management, underwriting and capital adequacy decision-making processes, including research, models, analytics, tools and metrics;
- To develop products and services which reduce risk, have a positive impact on ESG issues and encourage better risk management (Landini, 2022).

That said, it must be acknowledged that there is also more besides managing the relationship with customers: large insurance companies influence the entire equity and credit market, and their commitment to sustainability can manifest itself in many other ways, starting with the many stewardship initiatives. Insurance undertakings, especially the undertaking operating in financial life sector and managing internal funds or pension funds (Landini, 2022), are often members of listed companies, and that is when their commitment as institutional investors comes into play, thus their ability to take an active part—through their voting rights or selective dialogues with the board—in the pursuit of encouraging ESG performances by the investee companies.

In this regard, the Sustainability Report 2022 by Allianz is worth noting (and it is just an example, but many more could be mentioned in the same perspective). Allianz Group identifies two key ways—related to its core business activities—in view of generating "long-term value": (a) on the one hand, acting as an insurer providing insurance policies, thus covering health impacts, property damage or litigation claims, and through changes in the sectors and business models underwritten by Allianz; (b) on the other hand, acting as a large-scale institutional investor "with significant stakes in various economies, companies, infrastructure and real estate that might be affected by the physical impact of climate change and the transition to a low-carbon economy".

Moreover, a CSR engagement could also mean the insurance company's ability to bring legal proceedings, if only to protect itself against

reputational risks, in the event of breaches of the sustainability commitments entered into with the market by the investee company's directors, or at least in cases of malicious infringement (all of us remember the scandal of the Volkswagen mufflers and the wrath of Allianz, at the same time insurer and institutional investor of the car company); more generally, it implies a wide range of initiatives to progressively involve stakeholders in the decision-making processes and to monitor and assess behaviours of the most important business and financial partners, starting from the investee companies (and their compliance with the standards laid down in their sustainability reports or imposed by law, such as for German companies subject to the *Lieferkettengesetz*).

7.2 Tools for Enhancing Sustainability in the Insurance Sector: Exclusion Lists; Technical Provisions and Investment Strategies; the Manufacturing of ESG-Oriented Policies

There are many ways to steer an insurance company's offer towards ESG factors. One of them consists in adopting policies based on the exclusion of socially and environmentally irresponsible companies from the circuit of potential customers. More generally, the adoption and publication of exclusion lists, subject to periodic updating and regarding the entire network of potential stakeholders, may help in ensuring the achievement of ESG goals. Allianz, for example, has cut off from its portfolio the weapons that fall under the scope of some of the most important international conventions (anti-personnel landmines, cluster ammunition and bombs, biological and toxin weapons; chemical weapons), has restricted financing coal-based business models since 2015 ("equity stakes have been divested, existing fixed income investments put in run-off and no new investments have been allowed since 2015": *Sustainability Report 2022 by Allianz*), has restricted investments in sovereign bonds from countries associated with severe human rights concerns, has released a new oil and gas business model, based on the "the expectation of a commitment of portfolio companies to net-zero GHG by 2050, in alignment with science-based 1.5 °C pathways".

Secondly, every insurance company invests its liquidity—thus, its technical provisions—in financial instruments according to principles of risk

diversification: the ESG commitment may result in the selection of investments (Anchino et al., 2022), and it is precisely of such an investment policy that the insurance company will give evidence in the document laid down in the Art. 124-*quinquies* of the legislative decree No. 58/1998 (also known as "*Testo unico della Finanza*" or—for brevity— "*t.u.f.*") and in any other sustainability reports (Busch, 2021). This is clearly understood by insurance companies: Allianz has remarked that such a "sorting of the investee universe on the basis of investees' potential climate change risks will be one important outcome enabled by recently proposed climate change disclosure regulations".

In this perspective, the competence rules provided for by the Italian Supervisory Authority on insurance market (IVASS) and focused on the board of directors and the senior management function, are of strategic importance. According to the IVASS Regulation No. 36 of 31 January 2011, the investment policy is the subject of a specific framework resolution adopted by the board of directors and reviewed at least once a year, which, depending on the size, nature and complexity of the activity carried out, states the investment guidelines. For its part, the senior management function periodically reports to the board of directors, in the manner and frequency established by the latter, on the results of the investment activity, the monitoring of risk exposures and the effectiveness and adequacy of financial management. It is clear that the IVASS Regulation regards financial aspects, but the same scheme of organization and division of powers should apply to the investment selection as for its adherence to the insurance company's ESG objectives (and to the guidelines drawn up in the engagement policy).

However, the most important way is probably the very manufacturing of insurance policies. The real challenge lies in designing and creating ESG-oriented policies (Salerno, 2022). In this regard, the incorporation of ESG factors into insurance products is quite simple in relation to the life sector, where index and unit-linked policies known to practice meet essentially financial needs of the policyholder; this makes it possible to approach both financial products (offered by banks and investment firms) and insurance products as a whole (Montalenti, 2022), and it is easy to predict that the basket of financial instruments—to which the capital or the annuity payable by the insurer are related—will then include green bonds, blue bonds and any other sustainable products (Davini & de Gioia Carabellese, 2021; Lenzi, 2021).

Moreover, even non-life sector is well suited to embed assessments based on ESG factors. Abstractly this could mean several things: a policy that provides for the application of penalties for those who do not meet certain sustainability requirements; a policy that insures against the same risks but provides for preferential rates for insured people (or undertakings) meeting certain sustainability requirements; if it is a multi-year contract, a policy providing for the application of a preferential tariff to subsequent premium instalments if during the relationship the policyholder reduces the polluting emissions below certain thresholds (some sort of automatic adjustment clause of the premium in proportion to the insured's ESG performances).

It should not be forgotten, then, that, among the folds of the regulation of the insurance contract carried by the Italian Civil Code, there is an indication—which deserves to be valued in the perspective of an ESG-oriented insurance offer—aimed at promoting solidarity. Indeed, it is well-known that as a rule the insurance does not cover damages resulting from events due to intent or gross negligence of the insured, and the parties may agree otherwise, but limited to cases of gross negligence. However, notwithstanding any previous and opposite agreement, and without any distinction between intent and gross negligence, the insurer is obliged for claims resulting from *acts of the policyholder performed for duty of human solidarity* (Art. 1900, third paragraph, of the Italian Civil Code).

7.3 Non-life Insurance and ESG-Oriented Policies

In this regard, also by means of some sort of *Ausstrahlungswirkung* of the Art. 1900, third paragraph, of the Italian Civil Code on the entire regulatory framework regarding the insurance contract, it does not seem impossible to envisage contractual derogations in favour of the insured person and involving the waiver by the insurer of the exercise of certain rights provided for by law in the event of a change of risk during the contractual relationship. At the same time, it does not seem impossible to lay down rules of conduct for policyholders whose failure to do so will affect the level of compensation payable by the insurer or, in the most serious cases, the right to receive the insured amount itself.

From the first point of view, it is known that: *(a)* if the risk decreases during the relationship and the policyholder communicates such a circumstance to the insurer, the customer is entitled to the premium reduction for the following years, unless the insurer withdraws from the contract within two months of the day on which it received the risk reduction notice, and the contract will cease to have effect after one month (Art. 1897 of the Italian Civil Code); *(b)* if the risk increases during the relationship, the insurer has in any case the right to withdraw from the contract, not only because of circumstances such as to bring the risk to a level that would have led to the insurer's refusal to conclude the contract, but also because of circumstances such as to generate a risk that—if by hypothesis it had already been present in the pre-contractual phase—the insurer would have agreed to cover, albeit against the payment of a higher premium (Art. 1898 of the Italian Civil Code).

From the second point of view, it should be remembered that, according to Art. 1914 of the Italian Civil Code, the policyholder must do all he or she can to avoid or reduce the damage: it is the so-called *rescue obligation*. In this regard, the insurer has to refund the costs incurred by the insured for the purposes of rescue operations, and this even when: *(i)* such expenses, added to the indemnifiable damage, exceed the insured amount; *(ii)* the purpose is not achieved (that is, rescue operations fail). With one exception: that the insurer proves that the expenses were made *recklessly*. Similarly, the insurer is liable for material damages directly due to the means used by the insured in the rescue operations (that is, to avoid or reduce the damage caused by the accident), once again understood that the insurer is at liberty to prove that the means have been used *recklessly*.

It is not difficult to see that *the adoption of eco-sustainable technical standards by the insured reduces the very risk of damage to the insured thing, as well as the risk—within the framework of an indemnity insurance contract—that the insured thing produces damage to the environment or to third parties*: it would be enough to consider the insurance of a real estate and the weight that may be attributed to some circumstances or factors abstractly relevant as for the sustainability engagement, like the existence of forms of public–private partnership in the management of the surrounding area (so as to avoid risks of floods or natural disasters) or in the management of the estate itself, of its water resources, its waste, its energy performances. On the other hand, the contribution that the insurer may give the customer in order to prevent the insurance risk

should not be overlooked. At the pre-contractual stage or at the time of signing the policy, the insurer might provide the customer with risk analysis models, thus helping him or her to learn its extent and boundaries: even in this way, moreover, the *environmental and social vocation* of the insurance company is going to be realized.

On this ground, in order to promote ESG objectives,

(a) The insurer could waive the right of withdrawal despite the decrease in risk, if this is the consequence of socially and environmentally responsible behaviour of the policyholder. It remains understood that, if the risk ceases to exist, the contract is automatically terminated and the insurer is entitled to the payment of premiums until the event is notified to him or he becomes otherwise aware of it (Art. 1896 of the Italian Civil Code);
(b) The insurer could waive the right of withdrawal despite an increased risk—and in particular raising it to a threshold which, if it had existed at the time of the conclusion of the contract, would not have affected the willingness of the insurer to contract but only the size of the premium—when such an increase is the result of the insured person's behaviours compliant with ESG standards and objectives (announced by the insurance company in the engagement policy, in the sustainability report or in any other non-financial statement): it is enough to think of an insurance against the risk of default of a partner, where the insured person decides to break-up business relations with the same partner—thus increasing the default risk itself—as he or she is subject to civil or criminal penalties for human rights violations or environmental disasters;
(c) The insurer could design policies setting certain standards of behaviour that the policyholder has the responsibility to comply with for the purpose of the rescue obligation provided for by the Art. 1914 of the Italian Civil Code, whose non-fulfilment leads to the forfeiture of the right to receive compensation. The insurer could also bind the policyholder to implement *certain rescue procedures* or to use *certain means*, thus squeezing his or her discretion and imposing environmentally and socially responsible rescue techniques: this would have the effect of exempting the insurer from the obligation to offer a refund or compensation if the costs have been incurred in the course of *different* rescue proceedings or the damages are caused by *different* means, and *without such a refusal*

to refund costs or to compensate for damages requiring proof—by the insurer—that the expenses or choice of means have been reckless;

(d) In the field of indemnity insurance contracts and where the insured is a fairly large undertaking, the insurance coverage—relating to damage caused by the directors or the employees to the environment or to third parties—may be subject to the requirement that a statutory auditor certifies the adequacy of the company's protocols for the prevention of crimes, of the policies for managing and preventing sustainability risks and (more generally) of the corporate governance tools adopted to the same purposes (something similar in Landini (2022), 233).

7.4 Sustainability Preferences and Customers' Protection Legal Framework: Sales with Advice, Sales Without Advice, Execution-Only

The ESG-oriented product design process needs to be addressed in the light of the European (and national) customers' protection legal framework. Actually, one thing is directing the design phase of insurance products towards ESG objectives; quite different, then, in the wide and varied number of insurance products on the market, is arranging for sustainable products to come into the hands of customers.

In this regard, the distinction between two kinds of tools may be useful: *(a)* tools that concern the individual relationship between the insurance company (or the intermediary and more generally the distributor) and the customer; *(b)* tools that concern the insurance offer in general terms, and at a stage preceding the bilateral relationship with the individual customer (thus, the very packaging of the product, in the perspective of developing a distribution strategy aimed at promoting ESG preferences: Costa et al., 2022; Linciano et al., 2021).

The first area includes the rules for sales of insurance products, focused on the notion of "advice" and already known for several years to the financial market sector: so much so that such a regulatory framework, based on the so-called *suitability test*, just applies to the insurance investment products, thus excluding non-life classes. In this regard, the acquisition and the assessment of customer's sustainability preferences seem to identify an autonomous segment within the pre-contractual phase, and it is

not accidental that the Taxonomy Regulation has introduced the duty to ask the customer for such preferences:

- Prior to the conclusion of the insurance contract (Art. 20, first paragraph, of the IDD);
- With the aid of a standardized template (Cossu, 2022; Famiglietti, 2022), based on the distinction laid down in the European legal framework between: *(a)* IBIPs for which the customer determines that a minimum proportion should be invested in *environmentally sustainable investments*; *(b)* IBIPs for which the customer determines that a minimum proportion should be invested in *sustainable investments*; *(c)* IBIPs considering *principal adverse impacts* on sustainability factors (but only where qualitative or quantitative elements demonstrating that consideration are determined by the customer);
- Regardless of the type of service provided by the insurance company, whether a sale with advice, a sale without advice (but subject to the appropriateness rule) or execution-only sales.

Indeed, the traditional system, inherited from MIFID I and extended by the IDD to the insurance sector, is divided into three basic rules: when providing advice on an insurance-based investment product, the insurer or the insurance intermediary shall obtain the necessary information about the customer's knowledge and experience in the investment field (relevant to the specific product or service offered by the insurer), the financial situation (including the ability to bear losses) and the customer's investment objectives, including that person's risk tolerance; the second rule concerns sales where no advice is given, and here the insurer just asks the customer to provide information about his or her knowledge and experience in the relevant investment field; then there is the execution-only model, characterized by the waiver of both suitability and appropriateness rule (Weber & Baisch, 2017). The latter service may be requested by the customer, and the economic motivation is evident: the advantage lies in the reduction of service charges, but this requires that the insurance-based investment products are not complex and that the further conditions laid down in the IDD—the warning on the exemption from any suitability or appropriateness controls by the insurer; the compliance with the rules for managing conflicts of interests—are actually met.

In this framework, the Art. 9(2)(a) and (4) of Commission Delegated Regulation (EU) 2017/2359—as amended in 2022—has extended the third step of the suitability rule, regarding the investment objectives of the customer, to his or her sustainability preferences (Siri & Zhu, 2020).

Such a sustainability assessment does not harmonize well with the other parts of the suitability test. Suitability rule and the additional rules for customer's protection are born with very precise purposes and produce well-defined effects. The sustainability assessment has to be managed very carefully in this context, so as to avoid some sort of rejection crisis.

The Know Your Customer rule betrays a purpose of protection of the customer against a specific risk, that is, the financial risk that the negative trend of a stock market index or other underlying financial assets will adversely affect the amount of the capital or annuity the insurer has promised to pay when a human life event occurs. The same overall approach characterizes the other two rules: in the case of the appropriateness rule, the insurer verifies that the client has the necessary skills to independently select the investment; at the base there is always a logic of protection of the weak part. But ultimately the execution-only rule itself provides strict requirements for the purpose of not performing the appropriateness test, thus making objectives of the weaker contractual party's protection come through.

7.5 Sustainability Preferences in the Information Collection Process: The Role of Sustainability Assessments

When it comes to sustainability (and sustainability preferences), it is a matter of making an argument that upsets the traditional categories of the financial market law: here there is not a customer who needs insurance coverage, and then the intermediary who has the duty to know him or her and offer the most suitable product (or, in any case, a customer who issues an investment order, and the intermediary who may comply with it as long as the latter performs an appropriateness test, or, if not even such a minimum assessment is expected, as long as the intermediary informs him or her about the waiver of the appropriateness test and ensures that the product ordered by the customer is not complex). Here, there is a partially educational approach (Corvese, 2022; Colaert, 2021; Driessen, 2021; Gortsos, 2021), based on a purpose of awareness-raising

among the customers for any products or investment strategies aimed at promoting the ecological transition, the reduction of global warming, the fight against climate change.

There is a lowest common denominator, lying in some sort of paternalistic approach, but in the first case (*financial assessments*) the paternalistic behaviour of the company is provided for by law with a purpose of protection of the weak customer; in the other case (*sustainability assessments*) it comes as a result of discretionary and free business policies adopted by the company to drive private savings towards sustainable investment, thus distinguishing its offer from that of other companies.

On this ground, it seems possible to isolate the sustainability assessment from the global context of the financial service. The sustainability assessment may even look like some sort of independent service, without additional costs for the customer, which does not affect the legal classification of the main *Dienstleistung* (and the rules intended to apply to it depending on whether the investment corresponds to the scheme of the sale with advice, the sale without advice, the execution-only regime). The sustainability assessment would be then compatible with all three services regulated by the IDD.

It goes without saying that it is compatible with advice-based services (thus, with the portfolio management service as well). Indeed, it is in relation to those services that Eiopa's Guidelines provide that:

(i) "When a product does not meet the customer's initial sustainability preferences, the insurer or insurance intermediary should not recommend a product that does not match these preferences, unless the customer adapts his or her preferences", and it is important that the so-called *sustainability document* keeps track of the exchange of information between the intermediary and the customer;
(ii) If the result of the assessment is that there is not any product matching the sustainability preferences, the insurer informs the customer that he or she can adapt the sustainability preferences, but in doing so shall refrain from exerting any form of pressure.

Although, sustainability assessments are compatible even with the scheme of appropriateness rule, in the field of sales without advice. Here, the insurer, once collected the customer's sustainability preferences, could

suggest a series of alternative investments; and it is well-known that the mere description of one or more products is not enough to lead to the grounds for investment advice service. In other words, the insurer could highlight how the alternative investments meet ESG factors and to what extent they meet the customer's sustainability preferences, *without this transforming the contractual relationship between the insurer and the customer into a sale with advice for the purposes of the IDD* (and of the duty to perform a suitability test, which would entail the duty to refrain from recommending not suitable products).

Once the customer and insurer have excluded the rules on the sales with advice, there is no scope for damages claims or for declarations of invalidity of the investment contract as a consequence of the lack of information on the customer's ability to bear losses or on his or her risk tolerance: the two profiles, financial and non-financial, take different paths. On the one hand, as for financial goals, the insurer does not look for alternatives, just accepts the customer's order and verifies his or her knowledge and experience, warning him or her if the result of the appropriateness test is negative (if then the execution-only regime is chosen, not only the insurer does not look for alternatives but does not check for appropriateness, informing the customer of the total lack of controls); as for non-financial preferences, the insurer, having obtained the necessary information on the customer's sustainability preferences, can and must explain the characteristics of the product in relation to those preferences and envisage alternative products, which are financially equivalent, but more in line with the client's non-financial expectations. These recommendations, precisely as they are limited to sustainability preferences, do not change the nature of the service provided by the insurer, which remains a sale without advice, subject to the appropriateness rule or even the execution-only regime.

In this perspective, it is not accidental that Recital 11 of Commission Delegated Regulation (EU) 2021/1257 states that insurance intermediaries and insurance undertakings providing advice on insurance-based investment products should first assess a customer's or potential customer's other investment objectives and individual circumstances, before asking for his or her potential sustainability preferences. On 20 July 2022 Eiopa has followed these directives in the Guidance on the integration of sustainability preferences in the suitability assessment under the Insurance Distribution Directive: insurers and insurance intermediaries shall ask for information on the customer's sustainability preferences

"as the last element within the collection of information on investment objectives" (provided that it is a mere default rule, not preventing the customer, at his or her own initiative, from bringing up his or her sustainability preferences in an earlier part of the information collection process).

Such a rule concerns the sales with advice and it is aimed to preventing sustainability preferences from becoming a convenient way to impose not appropriate investment strategies (only because they are related to green or light-green products), in violation of the rules established by the IDD for intermediaries providing advice, and indeed the same Recital 11 of Commission Delegated Regulation (EU) 2021/1257 states that "the inclusion of sustainability factors in the advisory process must not lead to mis-selling practices". However, it seems possible to apply the same operating scheme to sales without advice.

Ultimately, the sustainability assessment may be regarded as something on its own within the wider insurer's performance: in the case of sales with advice, this means that sustainability assessment cannot be used to reverse the failure of the suitability test; in the case of sales without advice, it means that reporting products that are financially equivalent but more in line with the customer's sustainability preferences is something that is added to the service and that does not alter the nature of the checks that are due to the intermediary. The service, therefore, does not become a sale with advice just because the intermediary performs sustainability assessments and reports the existence of alternatives that seem to be more adherent to the ESG preferences of the customer.

7.6 POG and Insurance Sector: Premise. Large Risks and Sustainability

The second area includes the rules of the *product oversight and governance* (*POG*), which the IDD, in the footsteps of the MIFID II, has cleared in the insurance sector.

The POG is based on a simple concept: insurance protection is a commodity offered in a standardized way to business entities and consumers; the insurance contract is not a tailored suit, but a ready-to-wear suit; the insurance company sells mass-produced contracts and, then, it is in turn a manufacturer. But each product has its risks: in the best cases, the risk of being purchased without any use to the buyer or to be purchased instead of another product more in accordance with his or her

needs; in the worst case, the risk of loss of invested capital. And then the IDD obliges the insurer-manufacturer to put into circulation the product with a package leaflet, some sort of warning label defining the categories of potential customers for which the product is designed and the categories to which is not recommended (Buck-Heeb, 2015; Ginevra, 2019; Salerno, 2020; Sethe, 2021).

This package leaflet is called *product approval process*. It defines the product's target market and the measures taken by the manufacturer—if different from the distributor—to ensure that such a target market will not be changed in the distribution phase. Where an insurance distributor advises on insurance products which it does not manufacture, it shall have in place adequate arrangements to obtain the information by the side of the manufacturer and to understand the characteristics and identified target market of each insurance product (Böttcher-Berchtold, 2023; Breilmann, 2017). Like the suitability rule, the product oversight and governance has recently been importing ESG factors and sustainability preferences as well. It is not without reason that, according to the Eiopa's Guidelines, "when considering the sustainability factors of products in order to then match them with the customer's sustainability preferences, insurers and insurance intermediaries may rank and group IBIPs included in their product range in terms of: (a) the proportion invested in economic activities that qualify as environmentally sustainable; (b) the proportion of sustainable investments; (c) the consideration of principal adverse impacts".

However, the product approval process and the subsequent scheduling duties—surrounding the implementation of the distribution strategy—do not apply to all insurance products: they are excluded for policies falling within the scope of the so-called *insurance of large risks*. That means:

(a) Risks of damage to (or loss of) railway rolling stock, aircraft, sea vessels (and river, canal and lake vessels), goods in transit or baggage, irrespective of the form of transport;
(b) Risks classified under credit and suretyship classes, where the policyholder is engaged professionally in an industrial or commercial activity or in one of the liberal professions and the insured risks relate to such activity;
(c) Risks for damage to (or loss of) land vehicles other than railway rolling stock, land motor vehicles and land vehicles other than

> motor vehicles, in so far as the policyholder exceeds the limits of at least two of the following criteria: *(i)* a balance-sheet total of EUR 6.2 million; *(ii)* a net turnover of EUR 12.8 million; *(iii)* an average number of 250 employees during the financial year (and, if the policyholder belongs to a group of undertakings for which consolidated accounts are drawn up, the criteria shall be applied on the basis of the consolidated accounts).

In the financial product governance—that is the product governance as regulated by MiFiD-II Directive—there are not exemptions: the obligations of product governance on manufacturers and distributors are laid down anyway, regardless of the activity carried out by the customer.

The impression is that the insurance legal framework, lacking a distinction between professional and retail customers that is relevant in the financial markets law perspective of suitability and appropriateness rules, recovers—at the stage of POG—a distinction that is at least partly convergent with this. What emerges clearly from the above-mentioned exemption rules is the intent to distinguish strong and weak customers, even within the abstract planning phase of the insurance offer. In other words, *the POG, understood as a duty of product oversight and governance, is a rule for the weaker contractual party's protection* (Berti de Marinis, 2019; Malvagna & Sciarrone Alibrandi, 2020; Marano, 2017; Santagata, 2022), and indirectly for the distributors' protection against the risk of unaware placement transactions (Cossu, 2021), thus against the risk of subsequent claims for damages by (in their turn unaware) customers. So much so that:

- The rules of POG do not mock railway undertakings, air transport undertakings, freight transport undertakings (which are by definition big companies);
- They do not benefit those who, wishing to insure their land vehicles, carry out a sizeable activity;
- They do not cover risks related to insolvency, export credit, instalment credit, mortgages, and also to suretyship, both direct and indirect, but not as such; on the contrary, to the extent that the

> insurance coverage is required by someone who carries out a professional activity and the insured risk is part of it: and this brings out the consumer-oriented approach of the Art. 25 IDD.

However, it goes without saying that it is above all in relation to large companies that the supply of ESG-policies makes sense, since they are undertakings which—probably more than others—are able to bear, already in the short and medium term, the costs of policies that are sensitive to ecological transition and the fight against climate change (obviously, with the long-term objective of an economic return). Not only that: these are companies that, where certain turnover thresholds are exceeded, must (not only can but must) implement business strategies aimed at reducing the negative impacts on human rights and environment: the recent proposal for a corporate sustainability due diligence directive regards actually the biggest companies. Then, it is in relation to these companies that a hypothetical ESG-oriented insurance offer, thus a detailed system of corporate arrangements in compliance with the POG's standards, could turn out to be anything but useless.

7.7 POG and Insurance Sector: From a Weaker Contractual Party Protection Model to an Instrument for the Implementation of ESG Goals

The effort consists in borrowing rules that the insurance legal framework has introduced as mandatory rules (and—above all—with purposes of retail customers' protection) and extend them, *in a voluntary way*, to:

(i) Cases not falling within the scope of the IDD, like the insurance of large risks;
(ii) Cases already falling within the scope of the IDD, but in relation to aspects—like the sustainability preferences or, more generally, the education of customers for a sustainability culture (Brozzetti, 2022; Pilaj, 2017)—that POG regime, as originally conceived, left on the fringes of its *Schutzbereich*.

Of course, it changes the practical meaning and the goal behind the product approval process. Indeed, in the legal model, POG aims to

prevent misselling practices. That is: it aims to prevent (insurance-based investment products from circulating, thus) any potential customers from purchasing IBIPs *without the awareness of the drawbacks for the purchasers*. In this hypothesis, the POG would constitute a tool for the implementation of the CSR-commitment of the insurer (when) manufacturer. It would be a means to stimulate the customer to look beyond the horizon of its financial or hedging objectives.

In this context, to borrow the rules of POG and put them at the service of ESG-oriented policies means—above all—organizing relations with distributors in a way that binds them, legally or in fact, to take care of ESG-profiles in compliance with the top instructions, the same that are contained in the product approval process, and it is essentially the competence of the board of directors to define the company's lines of action for these purposes (Martina, 2021), both at the group strategy planning level—if manufacturing and distribution of IBIPs take place *within the same group*—and in contractual relationships *with (outsider) placing agents* (as well as with brokers or other intermediaries). Besides, such an influence on the product distribution channels can be performed in a twofold way:

(a) If the distributor is a subsidiary (belonging to the same group of companies of the manufacturer), to exercise a power of direction and coordination programmatically extended to environmentally and socially responsible strategies, which requires the subsidiary to incorporate non-financial goals in its business plans, and consequently to incorporate the acquisition of non-financial information from customers (all or a certain target) and the supply of ESG products into its corporate policies. The product approval process shall enhance product sales accompanied by a targeted sustainability assessment (which does not lead to the grounds for the advice service provided by the IDD and the Art. 121-*septies* of the Italian Private Insurances Code, thus the advice triggering the above-mentioned suitability test);
(b) If the distributor does not belong to the same group of companies of the manufacturer, influence shall be exercised at the contractual level: the manufacturer shall conclude distribution agreements that make the inclusion of the ESG-oriented offer in the basket of products of the distributor in various ways binding.

In any event, the manufacturer shall obtain periodic information from the distributor about its offer, for any review in the approval process but also to regulate the contractual relations with the various rings of the distribution chain, and if necessary to interrupt some of these relations and to find new distributors.

All this requires insurance companies to raise the standards of good governance (Genovese, 2022; Rolli, 2022; Schneider, 2022): there is no doubt that it is the entire insurance company's governance that needs to be rethought and reprogrammed in line with the implementation of the ESG objectives. Remuneration policies have a crucial importance in this regard: the recent draft for the European corporate sustainability due diligence directive reminds us of this, and indeed Member States shall ensure that biggest companies—precisely the ones referred to in the Art. 2(1)(a) and 2(2)(a)—*not only* adopt a plan to make their business model and strategy compatible with the transition to a sustainable economy and with the limiting of global warming *but also* take into account the fulfilment of such obligations when setting variable remuneration. Secondly, the key words become *knowledge and competence*: employees of insurers selling sustainable IBIPs "should have a more detailed knowledge and competence, in accordance with the nature of products they provide advice on" (Eiopa), and this is in keeping with the UNEP FI Principles for Sustainable Insurance, encouraging insurance companies to *integrate ESG issues into recruitment, training and employee engagement programmes* (*Principle 1*).

But there is another aspect of corporate governance that should not be overlooked: the creation of special structures dedicated to the promotion of SDGs-objectives within the relationships between employees, actuarials, directors and senior management function. This might be an ad hoc ESG-committee (if appropriate assisted by a board observer), whose usefulness could be at least threefold.

If set up within the manufacturer, such a committee could act as a filter for the information that the first receives from the distributor following product testing processes, but it also could collect these assessments and each recommendation or suggestion received from institutional investors, asset managers and any other stakeholders, so as to create a business information set to submit to the board of directors.

Secondly, when established within the distributor (regardless of whether it is also a manufacturer), the ESG-committee could be useful

in monitoring customers and their ESG performances, to be subsequently assessed through sustainability reports or any other non-financial statements, both mandatory and voluntary.

Thirdly, the ESG-committees could perform a strategic role in the coordination of business departments that the corporate policy for preventing and managing conflicts of interest has kept separate in compliance with the Art. 27 IDD: departments that can thus remain separate but at the same time benefit from a unified address in the field of sustainability policies, and indeed the Art. 34(3)(a) of the EU Regulation 565/2017, with regard to the financial sector, provides that (financial) intermediaries have to adopt "effective procedures to prevent or control the exchange of information between relevant persons engaged in activities involving a risk of a conflict of interest" (thus, not only to prevent, but also *to control*). Moreover, it has been said that "*als nach wie vor ungeklärt gilt, wie sich das mögliche Spannungsverhältnis zwischen der Beschränkung des Informationsflusses durch* Chinese Walls *und der Verpflichtung zur bestmöglichen Beratung, Information und Ausführung von Kundenaufträgen auflösen lässt*" (Buck-Heeb, 2010, 1653). In this respect, also with a view to ensuring the effectiveness of the sustainability policies adopted by the insurance company, it may be useful to invest a committee with the task:

(a) Of collecting the results of the profiling of customers by the individual departments and, as regards transactions involving the same customer (but carried out by different departments),
(b) Of cross matching the questionnaires and documents on the information obtained from the client, so as to submit to the board of directors a report on the profiling activities of individual employees and to promote the improvement of the inherent corporate policies.

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PART III

ESG Integration: Valuation, Products and Risks

CHAPTER 8

The Role of ESG on Credit Rating in the Banking Sector: A Mediation Analysis to Disentangle the Direct and Indirect Effects

Manuela Fasano, Barbara Guardabascio, and Elena Stanghellini

8.1 Introduction

In recent years, public authorities, banks, and financial markets have shown increasing attention to sustainable finance. In Europe, the perceived relevance of financial sustainability is mainly due to the European Commission's commitment to integrate Environmental, Social and Governance (ESG) parameters into all aspects of the financial system. For example, initiatives implemented by the European Commission,

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supported by the Technical Expert Group, include: (a) the implementation of methodologies for EU climate benchmarks; (b) the development of EU Green Bond Standards to ensure comparison and transparency of green bonds; and (c) the drafting of guidelines to improve the disclosure of climate-related information by companies. In addition, the European Commission recently published the "Action Plan on Financing Sustainable Growth" EC (2018) to define a clearer taxonomy of sustainable activities, to avoid misinterpretation, and to strengthen ESG company disclosure (see Chapter 5).

The relationship between compliance with ESG standards and Credit Risk is at the centre of much debate (see e.g., AIFIRM, 2021). Many academic studies suggest that compliance has a positive impact on credit risk, see e.g. Friede et al. (2015); Nicolosi et al. (2014). Also Oikonomou et al. (2014) show that good corporate social performance leads to lower bond yields and better Credit Ratings. These findings are confirmed by Graham and Mahe (2006) and Dorfleitner et al. (2019), who analyse the impact of environmental and social sustainability on Credit Risk. However, other studies indicate a neutral or negative impact of sustainability on Credit Risk (Lin et al., 2016).

Many authors argue that the aggregate scores may hide differences across the three dimensions (Environment, Social and Governance), and opt to perform separate analyses. As an instance, Brammer et al. (2006) focus on the setting before the subprime crisis and find that firms with higher Social performance scores tend to achieve lower returns and that the Environmental and community indicators are negatively correlated with returns.

The disaggregated employment indicator is weakly positively related. However, other studies found evidence of different patterns across industries (Nicolosi et al., 2014).

With a focus on the financial sector only, this paper aims to analyse how, in Europe, ESG criteria, separately considered, have an impact on Credit Risk, measured by Credit Rating. A factor which has helped to encourage financial intermediaries in Europe to adopt ESG factors is that the initiatives introduced by the European Commission will soon be shared by supervisory authorities, leading to a profound change in the activities of banks. Many studies focus on the banking and financial sector, with the purpose of verifying if rating access policies could be affected by the sustainability elements (AIFIRM, 2021).

Before 2008 financial crisis, financial sector was responding more slowly than others to sustainability challenges (Jeucken, 2004). This crisis seems to have influenced substantially the behaviour of banks in terms of corporate social responsibility (CSR). Esteban-Sanchez et al. (2017) show that during the crisis, however, better responsible relationships with the community led to higher returns, thereby suggesting that in a crisis scenario a stronger link with the community on ethical and philanthropic issues may improve the company's overall performance. This proves that good governance and labour performance are positively related with financial performance, but that the financial crisis attenuated this effect. Also, Wu and Shen (2013) find that banks active on sustainably issues and focused on Environment, Social, Governance aspects, more than others, were able to survive during the crisis. More in detail, analysing 162 banks in 22 countries over 2003–2009, they found a positive relation between social responsibility and financial performance in terms of return on assets, return on equity, net interest income, and noninterest income. According to Cornett et al. (2016), U.S. banks, especially large ones, that were at the centre of criticism for their lack of social conscience, have worked to improve their CSR engagement. They also found that, overall, this activity has not penalised their financial performance. On the contrary, a significant positive relationship between ESG score and ROE emerged, which is attenuated for small banks. However, according to some empirical analyses, irresponsible enterprises have longer durability than socially responsible ones, and firms that rarely engage in socially responsible activities have better financial performance than those that are more sensitive to the Social pillar (Price & Sun, 2017).

As Dell'Atti et al. (2017) show, there are some inconsistencies in the link between CSR and corporate reputation. Using the Reputation Index (Cravens et al., 2003), they only found a positive relationship between reputation and Social scores and a negative one with Environment and corporate Governance. The Reputation index is, however, positively related to economic performances and negatively to riskiness profile. Similar results are in Miralles-Quiro´s et al. (2019) that find that "whereas the environmental and government performance are positively and significantly related to banks' share prices, social performance is negatively and significantly associated with them". These results highlight the importance of environmental performance for financial shareholders. At the same time, they also suggest that "corporate Governance is an important dimension of CSR that guarantees accountability, compliance, and

transparency and implies a reduction in agency costs for financial stakeholders". The authors find that social performance does not have a direct relationship with bank's financial stakeholders. They also find that the value relevance of ESG performance is significantly higher for banks from common law countries, in which shareholder protection is stronger.

With a focus on China, Zhou et al. (2021) noticed that green credit acts as a moderator in the relationship between CSR and bank financial performance. Using the data of listed banks in China from 2008 to 2018, they proved that this negative relationship on bank financial performance is more evident in the short term than in the long run.

We here explore the mediating role of ESG score on the pathway between financial indicators and Credit rating. Using mediation analysis, we disentangle the effect of some balance sheet indicators, measuring the stability and leverage of a company, on Credit Ratings, into a direct one and an indirect one, this second mediated by the ESG rating. To avoid issues related to reverse causality and endogeneity, balance sheet indicators variables are measured 5 years before the Credit Rating, with the ESG rating measured in between the two time points.

To accomplish the above–mentioned objectives, the rest of the paper is structured as follows. Sect. 8.2 introduces ESG criteria and provides a definition of its Environmental, Social and Governance components. Sect. 8.3 provides a review of the Thomson Reuters variables adopted in our analysis. Sect. 8.4 shows in detail the methodology adopted, focusing on the models for ordered response variables. Sect. 8.5 contains the empirical application and details of the results. Sect. 8.6 provides a discussion. Finally, Sect. 8.7 draws some conclusions.

8.2 The ESG Pillar

Environmental, social, and governance (ESG) criteria are defined as a set of standards for a company's operations that socially conscious investors use to screen potential investments. The three main pillars could be defined as follows:

> **Environment**: consider how a company performs as a steward of nature. This pillar concerns the impact of companies' operations on the environment as well as their negative externalities. It covers climate change, pollution management, use of natural

resources, energy consumption, CO2 emissions, strategy to fight global warming, etc.

Social: this pillar covers all issues relating to the relationship between companies and society. It examines how the company manages relationships with employees, suppliers, customers, and the communities where it operates. It includes aspects such as gender equality, human rights (especially workers' rights), the company's commitment to the local community, the promotion of health and safety within the company, etc.

Governance: this pillar concerns the corporate governance aspects of companies, the independence of the board of directors, the duality of the chairman of the board and the CEO, the diversity in a broad sense of the board of directors, the level of transparency of managers, etc. It deals with a company's leadership, executive pay, audits, internal controls, and shareholder rights.

According to the Global Initiative for Sustainability Ratings (GISR), more than 125 organisations produce sustainability research and company ratings, contributing to the growth of sustainable investments. These include well-known providers with global coverage such as Bloomberg, FTSE, MSCI, Sustainalytics and Thomson Reuters. We here focus on data coming from Thomson Reuters, which offers one of the most comprehensive ESG databases, covering more than 80 per cent of global market capitalization, across more than 450 different ESG metrics and with ESG data coverage for more than 10,000 global companies, in 76 countries.

8.3 The Thomson Reuters Variables

The Credit Rating provided by Thompson Reuters ranges from BBB- to AAA + . The description is contained into Thomson-Reuters (2007). The ESG data provided by Thomson Reuters are grouped into ten categories that form the three pillar scores and the final ESG score, which reflects a company's ESG performance, engagement and effectiveness based on publicly disclosed information. We provide a specification of this in Fig. 8.1.

Fig. 8.1 ESG score (*Source* Authors' adaptation from Thomson Reuters)

Figure 8.1 shows that the category scores are grouped into three pillar scores as follows:

- The Environmental pillar, made up of the *Resource Use Score*, the *Emissions Score*, and the *Innovation Score*. The *Resource Use Score* reflects the performance and capacity of a company to reduce the use of materials, energy or water, and to find more eco-efficient solutions; the *Emissions Score* measures the commitment and effectiveness of a company in reducing environmental emissions in production and operational processes; and the *Innovation Score* reflects the capacity of a company to reduce environmental costs and burdens for its customers, and thus to create new market opportunities through new environmental technologies and processes or eco-designed products;
- The Social pillar, made up of the *Workforce Score*, the *Human Rights Score*, the *Community Score* and the *Product Responsibility Score*. The *Workforce Score* measures the effectiveness of a company in maintaining a safe and healthy workplace and ensuring diversity and equal opportunities; the *Human Rights Score* measures a company's effectiveness towards respecting the fundamental human rights conventions; the *Community Score* measures the commitment of a company to protect public health and comply with business ethics; and the *Product Responsibility Score* reflects the capacity

of a company to produce quality goods and services integrating customers' health and safety, integrity and data privacy;
- The Governance pillar, consisting of the *Management Score, Shareholders Score* (also called *Stakeholders Score*) and the *Corporate social responsibility (CSR) strategy Score*. The *Management Score* measures the commitment and effectiveness of a company towards following best practice corporate governance principles; the *Shareholders Score* measures the effectiveness of a company towards equal treatment of shareholders; and the *CSR Strategy Score* reflects the practices of a company to integrate the economic, social, and environmental dimensions into its day-to-day decision-making processes.

Finally, the ESG score is a relative sum of category weights that vary by sector. We consider the following indicators: *Beta coefficient* (BETA) as volatility measure and *Net Debt/EBITDA* (NETEB) and *EV/Market Capitalization* (EVMRKT) as leverage coefficients.

- The *Beta coefficient* defines the volatility as systematic risk of a financial asset. In terms of its values, stocks with a Beta greater than one tend to amplify the market movements: companies with aggressive business policies or high levels of debt are generally considered to have the highest Beta values.
- The *Net Debt/EBITDA* ratio is a leverage measure representing the ability of a company to repay its own debt. A high value of this ratio indicates that a company is heavily burdened with debt and may have difficulties in repaying its financial liabilities, based on its liquid assets and the sum of its earnings before interests.
- The *EV/Market Capitalization*, where EV stands for Enterprise Value, is another leverage measure. Since EV is equal to *Market Capitalization + Total Debt - Cash flows*, companies with low *EV/Market Capitalization* ratio are in a more stable financial situation.

We here assume that ESG variables, measured in 2017, act as mediators on the relationship between the balance sheet indicators as measured in 2015 and the Credit Rating as measured in 2018. In Fig. 8.2, a diagram is presented that provides a visual representation of the modelling strategy. The nodes represent the variables, the arrows represent the effects. The assumptions are that balance sheet indicators influence the Credit Rating

directly (yellow arrow) or indirectly (through the pathway on the blue arrows, that involves the ESG score). It is well-known that Credit Rating at time t is issued based on information at time (t-*1*). Therefore, given the 5-year length, the yellow arrow between the balance sheet indicators and Credit Rating is meant to capture all possible pathways not transmitted through the ESG score. Similarly, the blue arrows capture all possible pathways leading from one node to the other across time.

To disentangle the direct and indirect effect of the mediator, separated regressions must be specified and estimated, one for the ESG variables as responses and the above indicators as covariates, the other with the Credit Rating as a response, the mediator, and the above indicators as covariates. To take care of the effect of size, we also include *Market Capitalization* (MRKCAP) as a background covariate. It measures the aggregate evaluation of a company based on its current share price and the total number of outstanding shares. This is in line with the well-known fact that larger companies have a higher capacity to comply with ESG standards, see Brammer et al. (2006).

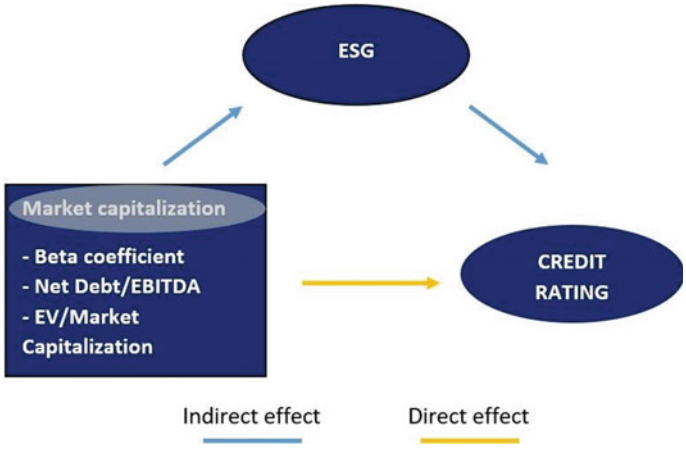

Fig. 8.2 Direct vs Indirect effect, Market Capitalization as a background variable

8.4 Methodology

8.4.1 Modelling the Response via the Cumulative Logit Model

We categorise the Credit Ratings into an ordinal scale with 3 categories in a way that preserves balancedness across categories. This is as follows: value 1 for companies with rating from *BBB-* to *BB-*; 2 from *BB* to *A-*; 3 from *A* to *AAA*. We then used the Cumulative logit model.

Let $x = \left(x_1, \ldots, x_p\right)^T$, be the $p \times 1$ vector of the explanatory variables measured at time 2015 (baseline covariates) together with the mediator, i.e. the ESG score measured at time 2017. We considered the score of each pillar, Environment, Social and Governance, separately, to identify differential pattern in each aspect of compliance with ESG.

The Cumulative logit model (see Agresti, 1981 and Agresti, 2018, ch. 6 for more details), reflects the order of the values of the response variable. For c outcome categories, the cumulative logits are defined as:

$$logit[P(Y \leq j|x)] = \alpha_j - \beta^T x \tag{8.1}$$

for $j = 1, \ldots, c-1$ and for a column vector β of parameters whose elements correspond to the effects of the explanatory variables x, on the response variable. The intercept varies for each logit and satisfies the condition $\alpha_1 \leq \alpha_2 \ldots \leq \alpha_{c-1}$ because $P(Y \leq j|x)$ increases in j for each fixed value of x, and the logit is an increasing function of this probability.

Moreover, model 1 postulates constant coefficients β for each j, and it is often referred to as a *proportional odds model*, as:

$$\begin{aligned} logit[P(Y \leq j|x_1)] - logit[P(Y \leq j|x_2)] &= \frac{P(Y \leq j|x_1)/P(Y > j|x_1)}{P(Y \leq j|x_2)/P(Y > j|x_2)} \\ &= \beta^T(x_2 - x_1) \end{aligned} \tag{8.2}$$

i.e., the odds of $Y \leq j$ is proportional to the distance between x_1 and x_2 and is independent of j. It also follows that if $\beta_r > 0$, all other covariates being constant, the odds of $Y > j$ increases if x_r increases. In our context, a positive coefficient implies that a higher value of the covariate increases the odds that the company has a high Credit Rating. The implied expression for the cumulative probabilities is:

$$logit[P(Y \leq j|x)] = \frac{exp\left(\alpha_j - \beta^T x\right)}{1 + exp\left(\alpha_j - \beta^T x\right)} \tag{8.3}$$

where $j = 1, \ldots, c-1$. For the cell probabilities themselves:

$$logit[P(Y = j|x)] = \frac{exp(\alpha_j - \beta^T x)}{1 + exp(\alpha_j - \beta^T x)} - \frac{exp(\alpha_{j-1} - \beta^T x)}{1 + exp(\alpha_{j-1} - \beta^T x)}. \tag{8.4}$$

A significant value of the coefficient of each baseline covariate identifies direct effect, while a significant coefficient of the mediator M conveys the information that the score as an impact on the outcome, also after conditioning on the covariates measured at baseline.

8.4.2 Modelling the Mediator via a Linear Regression

Let the Environmental, Social and Governance play the role of a mediator M on the pathway from the covariate at time 2015 and the finale rating. For each sector, a linear regression model of the score against the covariates measured in 2015 has been performed. The following regression has been fitted:

$$M = \gamma_0 + \gamma^T x + \epsilon$$

where M denotes, in turn, the score on the Environment, Social and Governance pillar, γ is a column vector of regression parameters. A significant positive value of a coefficient γ_r denotes that firms with a larger value of the corresponding covariate x_r on average present a higher score on the value of the mediator M.

8.4.3 The Decomposition of the Effects

Previous investigations lead to identify which covariate X could contribute to the direct path $X \to Y$ as well as to the indirect path $X \to M \to Y$. We now present a decomposition of the total effect of a covariate X on the outcome Y into direct and indirect effect. We assume that an external intervention could be performed, that raises the value of the covariate from a baseline $x^\star$ to a value x, with $x > x^\star$, leaving the rest of the system unchanged. Let $M(x)$ denote the value of the mediator of interest under the status $X = x$ and $Y(x, m)$ the value of the outcome resulting if the treatment and mediating variables are set to x and m, respectively. Notice that these values are potential values, as in principle we could only observe

$M(x)$ and $Y(x, M(x))$ when $X = x$. The total effect can be written as:

$$TE = E\big[Y(x, M(x)) - Y\big(x^{\star}, M\big(x^{\star}\big)\big)\big]. \tag{8.5}$$

Following Pearl (2001), it is possible to decompose the total effect in two components: the *Natural Direct Effect* (NDE) and the *Natural Indirect Effect* (NIE). The NDE describes the expected difference between potential outcomes by moving X from $x^{\star}$ to x keeping the mediator at the value that it would naturally take if X is kept at the baseline level $x^{\star}$:

$$NDE = E\big[Y\big(x, M\big(x^{\star}\big)\big) - Y\big(x^{\star}, M\big(x^{\star}\big)\big)\big]. \tag{8.6}$$

NIE describes the expected difference between potential outcomes if X is kept constant to x, but the mediator varies from the value it would naturally take under $x^{\star}$ to the value it would naturally take under x:

$$NIE = E\big[Y(x, M(x)) - Y\big(x, M\big(x^{\star}\big)\big)\big]. \tag{8.7}$$

To identify the causal effects additional assumptions are needed. Let C be a vector of the observed confounders. We then assume:

$$M(x) \perp X|C \; for \; all \; x \tag{8.8}$$

$$Y(x, m) \perp X|C \; for \; all \; x, m \tag{8.9}$$

$$Y(x, m) \perp M|X, C \; for \; all \; x, m \tag{8.10}$$

$$Y(x, m) \perp M\big(x^{\star}\big)|C \; for \; all \; x, x^{\star}, m \tag{8.11}$$

where the notation $Z \perp W|U$ is used to denote that the random variables Z and W are conditionally independent after conditioning in U. Condition (8.8) rules out that, after conditioning on C, unobserved factors influence both the mediator and the X, while conditions (8.9)—(8.10) rule out the possibility of unobserved factors influencing (a) X and Y and (b) M and Y, also after conditioning on X. Condition (8.11), also known as cross-world independence, rules out the possibility of unobserved factors influencing the potential outcome of Y and M under two possible external interventions, one with $x^{\star}$ and the other with x (see e.g. Andrews & Didelez, 2021). In this context, we notice that *Market*

Capitalization, which is the aggregated evaluation of a company based on its current share price and the total number of outstanding shares, could have an influence not only on the value of the balance sheet indicators and the consequent *Credit Rating* evaluation, but also on the decision to comply with ESG standards. It therefore constitutes a natural candidate as an observed confounder. All further analyses are therefore conditioned on the value of this covariate. Notice that, if the above assumptions are not fulfilled, we may interpret the decomposition of the effects as a tool to deepen our understanding of the phenomenon, but not as a prescriptive indication of the effects of an external intervention on the variable.

8.4.4 Computational Issues

Causal effects have been estimated by making use of the R package **mediation**, see Tingley et al. (2014). We here used the parametric algorithm, which performs the following steps:

Step 1. Fit the outcome and mediator models.
Step 2. Simulate model parameters from their sampling distribution ($n = 1000$).
Step 3. Repeat the following steps: (a) simulate the potential values of the mediator, (b) simulate the potential outcomes given the simulated values of the mediator, (c) compute the causal effects.
Step 4. Compute summary statistics (point estimates and confidence intervals).

8.5 Empirical Application

8.5.1 Data Sample

With the aim of detecting a differential pattern of influence across pillars of ESG, each of them considered separately, this paper presents the result of a mediation analysis on a sample of 89 European companies in the financial sector.

Table 8.1 reports the distribution of our sample by country. Most listed financial companies are in the UK, followed by Sweden and Switzerland, in line with the general knowledge. We have no companies in our sample from the Czech Republic, Greece, Luxembourg, and Hungary.

Table 8.1 Sample distribution by Country

Country	*Financial*
Austria	1
Belgium	3
Czech Republic	0
Denmark	4
Finland	2
France	5
Germany	6
Greece	0
Hungary	0
Ireland	3
Italy	7
Luxembourg	0
Netherlands	4
Norway	1
Poland	6
Portugal	1
Spain	5
Sweden	8
Switzerland	8
United Kingdom	25
Total	89

8.5.2 Results

Preliminary analysis to check if the assumption of linearity embedded in the above models is acceptable have been performed (details omitted). They showed that a log transformation of the MRKCAP variable permits to achieve linearity on both the mediator and outcome model.

A summary of the results, for each score, is in Fig. 8.3. For what concerns the linear regression for the Environment score as a mediator, the results in the last three columns of Table 8.2 show that NETEB presents a negative significant effect, while EVMRKT exhibits a positive significant effect. While the first finding is in line with the expectations, as companies with a higher value of NETEB are less able to invest resources to comply with environmental standards, the second seems to contradict this notion, indicating that companies with a high value of EVMRKT tend to be better complier than the others.

Furthermore, from the first three columns of Table 8.2, it is possible to notice that both variables have a significant impact on the Credit Rating, in the expected direction. However, the Environment score does not exhibit a significant impact on the Credit Rating (P-value 0.33) and thus

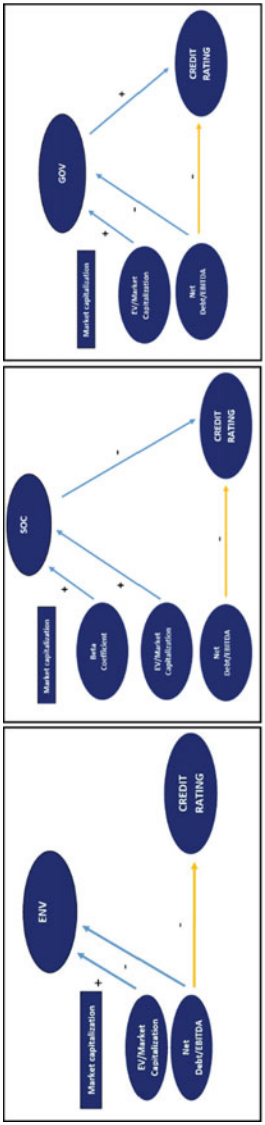

Fig. 8.3 Direct vs Indirect effect for Environmental, Governance and Social

Table 8.2 Financial Sector—Model selection for environmental score

Coefficient		*Outcome model*			*Mediator model*		
		Estimation	*SE*	P-*value*	*Estimation*	*SE*	P-*value*
1	(Intercept)				**−392.10**	**58.28**	**0.00**
2	(Intercept):1	−4.46	4.61	0.33			
3	(Intercept):2	−2.96	4.60	0.52			
4	EVMRKT	−0.76	0.54	0.16	**27.38**	**7.82**	**0.00**
5	ENV	0.01	0.01	0.33			
6	MRKCAP	0.22	0.21	0.30	**18.52**	**2.56**	**0.00**
7	NETEB	**−0.37**	**0.13**	**0.01**	**−4.43**	**2.00**	**0.00**

Significant coefficients with a p-value lower than 10% are in bold (in grey the mediator variable)

is not a mediator along the pathway from the balance sheet indicators and Credit Rating. This finding may be explained as the attention towards Environment, like reduction of impact and emission, are not so relevant in the financial sector. Therefore, we may conclude that compliance with environmental standard is not a possible mediator on the pathway between the balance sheet indicators and the Credit Rating. Notice that in both the outcome and the mediator models the Beta Coefficient is not significant.

For what concerns the linear regression for the Social score, results in Table 8.3, last three columns show that, also in this case, the EVMRKT shows a positive impact on the Social score while NETEB results in a non-significant effect. Notice further that the *Beta* coefficient also exhibits a positive impact on the Social score. Overall, these results indicate that companies that are in a less stable financial situation and higher volatility tend to invest more resources to comply with social standards.

These results should be paired with the highly significant negative impact that Social score presents on the Credit Rating (*P*-value 0.01). This aspect deserves attention, as it seems to indicate that the outlook of companies investing to maintain a healthy workplace, ensuring diversity and equal opportunities, and committed to protect public health and human rights is significantly worse than the one of companies which are not showing this attention.

Focusing now on the linear regression for the Governance score, the results in the last three columns of Table 8.4 show that, as expected, NETEB presents a negative significant effect, while once again EVMRKT

Table 8.3 Financial Sector—Model selection for social score

Coefficient		*Outcome model*			*Mediator model*		
		Estimation	*SE*	P-*value*	*Estimation*	*SE*	P-*value*
1	(Intercept)				**−207.33**	**36.08**	**0.00**
2	(Intercept):1	**−15.31**	**4.90**	**0.00**			
3	(Intercept):2	**−13.76**	**4.85**	**0.00**			
4	Beta	−0.41	0.38	0.28	**5.82**	**3.50**	**0.10**
5	EVMRKT	−0.26	0.51	0.62	**8.44**	**4.83**	**0.08**
6	SOC	**−0.03**	**0.01**	**0.01**			
7	MRKCAP	**0.77**	**0.23**	**0.00**	**10.46**	**1.60**	**0.00**
8	NETEB	**−0.43**	**0.13**	**0.00**	−1.24	1.24	0.32

Significant coefficients with a p-value lower than 10% are in bold (in grey the mediator variable)

exhibits a positive significant effect. Both variables have a significant impact on the Credit Rating, in the expected direction although the effect of EVMRKT has a *P*-value which is at the significance limit (0.12). The Governance score exhibits a rather significant positive impact on the Credit Rating (*P*-value 0.08), in line with the expectation that companies following best practices in this pillar present a better outlook than the others. Notice that in both the outcome and the mediator models the Beta Coefficient is not significant.

Given the existence of two possible pathways (the direct and indirect one) from NETEB (and possibly EVMRKT) to Credit Rating, it is therefore worthwhile to address the issue of the role of the Governance score in

Table 8.4 Financial Sector—Model selection for social score

Coefficient		*Outcome model*			*Mediator model*		
		Estimation	*SE*	P-*value*	*Estimation*	*SE*	P-*value*
1	(Intercept)				**−174.34**	**48.26**	**0.00**
2	(Intercept):1	−5.08	4.02	0.21			
3	(Intercept):2	−3.56	4.00	0.37			
4	EVMRKT	−0.83	0.53	0.12	**15.28**	**6.47**	**0.02**
5	GOV	**0.02**	**0.01**	**0.08**			
6	MRKCAP	0.23	0.18	0.22	**9.59**	**2.12**	**0.00**
7	NETEB	**−0.37**	**0.13**	**0.01**	**−2.96**	**1.66**	**0.08**

Significant coefficients with a p-value lower than 10% are in bold (in grey the mediator variable)

the decomposition of the effects of the two balance sheet indicators. We then address the following question: is the total effect significant? If yes, how much of the total effect is due to the indirect effect played by the Governance score? More technically, how much an increase of NETEB (or EVMRKT) from the median level ($x^\star$) to the third quartile (x) would influence the Credit Rating of a company overall? And how much would this effect be if investment on Governance varies from the value it would naturally take under $x^\star$ to the value it would naturally take under x, while keeping the value of NETEB constant and equal to x?

Points and interval estimates are reported in Table 8.5. As expected, EVMARKT does not exhibit any significant effects. The only significant effects are (a) the positive direct and total effect of NETEB on $P(Y = 1)$ and (b) the negative direct and total effect of NETEB on $P(Y = 3)$. This is in the expected direction, as an increase of this indicator significantly increases the probability of a company to fall in the worst categories of Credit Rating. However, the mediator does not seem to play a role in this decomposition, as the indirect effect is not significant. We may therefore conclude that if a company has a higher value of the balance sheet indicator NETEB than this will impact the Credit Rating five years later mainly through causal mechanisms that do not involve compliance towards good governance standards.

Table 8.5 Total, direct and indirect effect of NETEB and EVMARKT on Credit Rating with Governance score as a mediator

Covariates	*EVMARKT*			*NETEB*		
	P(Y = *1*)	P(Y = *2*)	P(Y = *3*)	P(Y = *1*)	P(Y = *2*)	P(Y = *3*)
NIE	−0.0128	−0.0001	0.0129	0.0127	−0.0004	−0.0123
2.5%	−0.0394	−0.0055	−0.0059	−0.0073	−0.0070	−0.0400
97.5%	0.0059	0.0045	0.0374	0.0447	0.0035	0.0080
NDE	0.0478	−0.0033	−0.0445	0.1105	−0.0172	−0.0933
2.5%	−0.0258	−0.0211	−0.1239	0.0060	−0.0693	−0.1851
97.5%	0.1249	0.0106	0.0252	0.2303	0.0102	−0.0064
Total Effect	0.0343	−0.0018	−0.0325	0.1117	−0.0208	−0.0909
2.5%	−0.0341	−0.0153	−0.1095	0.0059	0.0059	0.0059
97.5%	0.1079	0.0108	0.0327	0.0059	0.0059	−0.0060

8.6 Discussion

Cornett et al. (2016) state that comparative studies of the relationship between sustainability reporting and performance are scarce. Our analysis reveals that investments in compliance with each aspect of the ESG standards could have a differential impact on the overall Credit Rating.

As summarised in Fig. 8.3, in our analyses, the Environmental score does not appear to have a significant effect into the Credit Rating of a company. This is in line with what suggested by Branco and Rodriguez (2008) who argued that little attention has been paid to the environmental impact of companies belonging in both banking and financial services and Dell'Atti et al. (2017) who underline the absence of importance that stakeholders of banking sector assign to environmental issues. It is, however, in conflict with the findings of Miralles-Quiro´s et al. (2019).

Larger companies tend to invest more in protecting the environment, together with the ones with large EVMARKT. As companies with higher EVMARKT are the ones with higher value of indebtedness, these analyses suggest that borrowing money to invest in compliance with Environmental standards does not seem to pay off in terms of Credit Rating. Also, a lower NETEB is associated with higher compliance with the Environment and higher Credit Rating. These results seem to denote that Environment is not a mediator on the pathway between NETEB and Credit Rating, as the covariate only exhibits a direct effect on the outcome.

Furthermore, a negative correlation between compliance with Social standards and the Credit Rating has been found. This result is in line with part of the literature, see among others Miralles–Quiro´s et al. (2019). The added value of our analysis is that compliance with social standard is also a possible mediator on the pathway between the balance sheet indicator EVMAR and the Credit Rating, through an indirect effect: companies with higher EVMAR tend to be better complier with the social standards (P-value 0.08), which in turn negatively influences the Credit Rating.

Finally, our analysis reveals that Governance score exhibits a positive impact on the Credit Rating. It also shows that larger companies tend to be better compliers. Also, EVMAR has a positive effect on Governance, and shows a direct effect on Credit Rating. Therefore, Governance plays a role in the pathway between EVMAR and Credit Rating, showing that investments on Governance lead to a positive return in terms of

Credit Rating. On the other hand, NETEB also directly influences the Credit Rating in the expected direction, as a higher value is associated with a lower Credit Rating and lower compliance with Governance standards. The decomposition, however, highlights that the indirect effect is negligible.

8.7 Conclusions

The analyses show the total effect of two balance sheet indicators measured at 2015 (NETEB and EVMARKT) on the Credit Rating measured at 2018 and its possible decomposition via direct and indirect effect, the second one mediated by the score, measured at 2017, in the three pillars of ESG. As expected, the two indicators negatively influence the Credit Rating. For some of the pillars, they also play a role in compliance with the ESG standards. For the Environment and the Governance, NETEB shows a negative impact, while EVMRKT shows a positive impact. For what concerns the role of the ESG score on the Credit Rating, while compliance with Environment does not seem to have an effect, compliance with the Social pillar has a negative effect denoting that investing to ameliorate social aspects both in their own habitat and in the society as a whole does not improve the overall creditability of a company. Compliance with Governance standards, on the contrary, show a positive impact on the Credit Rating, and it therefore may constitute a possible mediator on the pathway between the two indicators and the Credit Rating. The only situation where there could be both a direct and indirect effect is when Governance acts as a mediator. However, when decomposing the total effect of the two balance sheet indicators on the outcome into the direct and indirect ones, only the direct one seems to be significant, in the expected direction. As we may not rule out the possibility of unobserved confounders, direct and indirect effects may not be endowed with a causal interpretation. Therefore, we take these results to deepen our understanding of the phenomenon, rather than as prescriptive indications.

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CHAPTER 9

The European Blue Economy Framework and Blue Bonds as New Instruments of Blue Finance

Maria Cristina Quirici

9.1 Introduction

The growing awareness of the delicate condition of our planet has attracted the attention of different stakeholders and policymakers all around the world. At the beginning of the XXI century, the United Nations, as well as the World Bank, kicked-off various projects with the aim to preserve the precarious equilibrium of our earth and oceans, to tackle the more and more evident negative effects of climate change, protecting disappearing animal species and also the oceans from plastic pollution and sea rising levels. Sponsoring the transition to an economy with a lower level of carbon dioxide emissions, in line also with the COP21 Paris Climate Agreement reached in 2015, the United Nations, in the same year, issued the 2030 Agenda for Sustainable Development

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with its 17 Sustainable Development Goals, drafting a roadmap towards a more sustainable economy, having as a focus also the preservation of marine species and the health of oceans.

Europe is playing a global pivotal role in sponsoring this transition, with the EU Commission that has issued several important documents: from the *EC Action Plan on Financing Sustainable Growth* (March 2018)—and consequent initiatives, such as the *Taxonomy Regulation*, the *EU Green Bond Standard* or the *Sustainable Finance Disclosure Regulation*—to the EU Green Deal (December 2019) and the *Next Generation EU* (July 2020).

In light of this evolving contest, the objective of this chapter is to investigate the new frontier of the Blue Economy, considering, in particular, its European dimension, showing trends and drivers in creating a new Blue Economy Framework, necessary for pursuing the Goal n. 14 "*Life below water*" (regarding "*Conserve and sustainable use of the oceans, seas and marine resources for sustainable development*") of the 17 Sustainable Development Goals of UN 2030 Agenda.[1]

Getting inspired by the recent *EU Blue Economy Reports 2021 and 2022* (European Commission, 2021a, 2021b; European Commission, 2022), the chapter will address the blooming commitment of policymakers and private institutions to the new Blue Economy and its developments from a regulatory and financial point of view.

In particular, the author wants to underline the necessity of the development of new and innovative financial instruments to attract a broader set of financial resources for financing all blue activities necessary for the conservation and sustainable use of oceans. Consequently, the work will investigate the Blue Bond as a new instrument of impact investing aimed at re-orienting flows of funds, both public and private, towards the Blue Economy, comparing the Blue Bond with the better-known Green Bond and considering the efforts necessary for reaching a regulation that, in fact, is absent in relation to Blue Bonds.

[1] Within the 17 Sustainable Development Goals by UN 2030 Agenda, there is also another "blue" goal, linked to water, represented by the SDG N. 6 "*Clear Water and Sanitation"* having the aim to "*Ensure availability and sustainable management of water and sanitation for all*". In this case, water is connected to rivers, lakes and other forms of water inside various regions or urban territories. In this work, the author will consider only the SDG N. 14 "*Life below Water*" regarding oceans, seas and marine coastal activities.

Then the rising *Blue Bond Market* will be analysed, considering not only the recent first global issuance of *the Seychelles Blue Bond* and the first European issuance of the *NIB Nordic Bank Blue Bond* but also some issuances of Green Bond having Blue elements, showing that if the Global Sustainable Fixed Income Market is growing fast, above all thanks to Green Bond issuances, the Blue Bond Market is just moving its first steps.

Conclusions and elements for further research will complete the work.

9.2 The Blue Economy in Its Growing Global Relevance

In the last decade, the global economy shifted towards a more sustainable and inclusive business model. The scope of the new global economic strategy undertaken by the private and public sector is to decarbonize the global economy, making our society more resilient from all natural disasters caused, in the long term, by climate change.

In this context, characterized by the research of ways to achieve a sustainable growth of the global economy, there is a growing political awareness of the importance of ocean and polar regions as integral parts of the Earth's climate system and of the need to ensure the integrity and resilience of these vulnerable ecosystems, closing the research gaps on ocean essential climate variables and improving ocean models for reaching these aims.

Humanity's relationship with the oceans and how people use their resources is evolving in important ways. There is now a better understanding that oceans are not only a source of food, energy and other products but that they are vital for life on Earth and that they are not limitless. Oceans are suffering because of increasing and often cumulative human impacts (Copernicus Marine Service, 2022), but oceans that are not healthy and resilient are not able to support economic growth (Konar & Ding, 2020). Oceans could contribute to poverty eradication by creating sustainable livelihoods, providing food and minerals, generating oxygen, absorbing greenhouse gases and mitigating the impacts of climate change, serving also as highways for seaborne international trade (Asian Development Bank, 2019; UNCTAD, 2016; World Bank, 2017).

In other terms, oceans represent a large storage system for the global reservoirs of climate-regulating factors, particularly carbon. Recent studies are advancing knowledge innovations to develop ocean-based solutions/mitigation options, helping to close the emissions gap and to stop ocean

acidification, preventing the consequent biodiversity losses (High Level Panel for a Sustainable Ocean Economy, 2022; OECD, 2022).

In December 2020 the members of the Ocean Panel[2] (High Level Panel for a Sustainable Ocean Economy 2020) announced their shared ambition to sustainably manage 100% of ocean areas under their national jurisdiction by 2025, guided by Sustainable Ocean Plans. In addition, they urged all coastal and ocean states to join them in this commitment, so that by 2030 all ocean areas could be sustainably managed. The Ocean Panel commissioned a study that was launched on 7 December 2021 (High Level Panel for a Sustainable Ocean Economy, 2021). This guide, which is the result of consultation within the Ocean Panel and experts from the Ocean Panel Expert Group, identifies nine attributes of a "Sustainable Ocean Plan" that will lay the groundwork for maximum success and impact, thus setting concrete foundations for the development of a sustainable Blue Economy.

Hence, the Blue Economy concept seeks to promote economic growth, social inclusion and preservation or improvement of livelihoods ensuring, at the same time, environmental sustainability.

It is worth recalling that the Blue Economy concept was introduced for the first time by the Belgian economist Gunter Pauli who defined it as a "*sustainable business model that is capable of generating a positive and long-term impact especially on the health of our oceans. More generally, it includes all economic activities that have to do with the sea, coasts and seaboards, such as fishing and maritime transport, aiming to revolutionize them*" (Pauli, 2010).

Oceans and all related activities have to be considered as a real asset that needs not only protection but also investments to increase its productivity. According to the Ocean Panel (High Level Panel for a Sustainable Ocean Economy 2020), the oceans alone have produced goods and services for a total of 2.5 trillion dollars a year, the value of which has been estimated at around 24 trillion dollars. As a consequence, ensuring the health of the oceans is not a mere environmental issue, because it can allow enormous opportunities for an exponential growth of ocean-related

[2] The *Ocean Panel*, or *High Level for a Sustainable Ocean Economy*, founded in 2018, is a group composed by the Prime ministers of 14 countries representing the 40% of the global coasts having the duty to manage oceans in a sustainable way, reaching at the same time the economic development of their countries. See at https://www.oceanpanel.org/.

activities and of the global economy too. In light of these considerations, the Blue Economy includes not only those activities regarding oceans, seas and coasts but also all those activities that make it possible to exploit ocean resources more efficiently and sustainably, according to the UN Global Compact *Sustainable Ocean Principles* (UN Global Compact, 2018, 2020a, 2020b, 2020c).

9.3 The New European Blue Economy Framework

9.3.1 The Main European Initiatives Developing Sustainable Economy

The European Commission has showed a growing attention for reaching a Sustainable Economy, as testified by its numerous recent regulatory initiatives, able to draft a EU's wider *Sustainable Finance Framework* that has the aim to create a playing field across the whole EU, in response to the Paris Agreement and to the United Nations 2030 Agenda for Sustainable Development: from the *Action Plan for financing Sustainable Finance* presented on 8 March 2018 (European Commission, 2018)—and the consequent *EU Taxonomy Regulation* (June 2020) (EU TEG, 2020a) or the *EU Green Bond Standard* (EU TEG, 2020b)—to the *European Green Deal* (December 2019) (European Commission, 2019) and the *Next Generation EU Programme*, presented to contrast the effects of the pandemic era (European Commission, 2021a; Linciano, 2021).

On 30 March 2022, the *EU Platform on Sustainable Finance* (the evolution of TEG as Technical Working Group) presented a Final Report[3] including methodologies for developing technical screening criteria regarding those taxonomy-aligned activities that contribute to the following environmental objectives of the EU Taxonomy: (1) protection and restoration of biodiversity and ecosystems; (2) the sustainable use and protection of water and marine resources; (3) pollution prevention and control; (4) the transition to a circular economy (EU Platform on Sustainable Finance, 2022).

[3] The EU Platform on Sustainable Finance on 30 March 2022 presented two documents: *Part A—Methodological Report*; *Part B—Annex: Technical Screening Criteria*, indicating the full list of these criteria and relative templates as a separate document. It is worth noting that the methodological standard presented in *Part A* can help to implement the *Marine Strategy Framework Directive* (2017/848/EU), presented on 17 May 2017, laying down criteria on good environmental status of marine waters, besides specifications and standardized methods for relative monitoring and assessment.

The EC *Action Plan on Sustainable Finance* can be considered a legislative effort in response to the various calls for a more regulated and standardized playing field in the sustainable finance industry. In this way, EU legislators show to understand the necessity of urgent challenges considering the existing lack of a common definition of sustainable projects, or the lack of transparency on how sustainability risks and targets are managed by corporations, or on how ESG factors are incorporated in financial organizations investment decisions (Capital Group, 2022; Eurostat, 2017; OECD, 2017). In particular, being fundamental to channel more and more investments towards sustainable projects, the European Commission showed to have the consciousness that the existing financial gap could be reduced through a clarification about the meaning of sustainability, providing a specific taxonomy.

In December 2019, the new president of the European Commission, Ursula von der Leyen, presented the *European Green Deal*, which is a strategic plan to more effectively implement the UN 2030 Agenda, having the aim to make Europe the first climate-neutral continent by 2050. In fact, the key objectives of the *EU Green Deal* are the following ones:

a. to increase the efficient use of resources, by promoting a clean and circular economy;
b. to curb climate change;
c. to prevent the loss of biodiversity by reducing polluting emissions (European Commission, 2019).

In other terms, the *European Green Deal* represents the EU's long-term strategy for sustainable growth, built on clear ambitions such as carbon neutrality, a circular economy, zero pollution and the restoration of biodiversity.

The Blue Economy will play a major role in this transformation and, as underlined by Virginijus Sinkevicius, EU Commissioner for *Environment, Oceans and Fisheries*, (…) *we will not meet the European Green Deal ambitions without the Blue Economy. We will need the ocean for renewable energy, for sustainable and highly nutritious food, for clean alternatives to plastics (…) At the same time, all Blue Economy sectors have to reduce their climate and environmental impact and contribute to the recovery of marine ecosystems.*

> Fostering the true green potential of the blue economy can also play an integral part in mitigating the economic setback caused by the COVID-19 crisis, leading to new growth opportunities and new jobs. (…). (European Commission, 2021b)

9.3.2 The EU Blue Economy Reports2021 and 2022: Aims and Some Contents

In light of these initiatives, it is possible to understand how strengthening the nexus between the ocean and climate change represents a priority for the European Union. Surely the documents that testify the importance of the Blue Economy in the EU are represented by the *EU Blue Economy Reports*. The more recent ones, the *EU Blue Economy Reports 2021* (European Commission, 2021b) and the *EU Blue Economy Report 2022* (European Commission, 2022), respectively, the fourth and the fifth edition of these reports, provide a comprehensive overview of the sector and its achievements, which form a solid foundation that will enable both policymakers and stakeholders to make informed decisions which are necessary, in these uncertain and challenging times, to develop and implement policies and initiatives under the *European Green Deal* in line with the new approach for a sustainable Blue Economy, serving as a source of inspiration to investors too.

In fact, publishing these reports, the European Commission aims to take stock about the latest trends and developments in all economic sectors related to ocean and coastal areas. The EU *Blue Economy Report 2022*, in particular, underlines that with close to 4.5 million people employed, a turnover of more than € 665 billion and € 184 billion in Gross Value Added (GVA), the EU Blue Economy sectors contribute significantly to the EU's economy, especially in the coastal regions. The report notes that EU blue sectors are a spawning ground for innovative solutions and technologies, that can help to fight climate change, taking the green transition to the next level.

The same report also points at the high cost of inaction in climate-related issues, considering that the damage of rising sea levels can cause a direct loss of more than € 200 billion per year by 2080 in the EU (European Commission, 2022).

For their purpose, the EU Blue Economy Reports include all sectoral and cross-sectoral economic activities based on or related to the oceans, seas and coasts, dividing them into "*Marine-based*" or "*Marine-related*":

a. the *Marine-based activities* include the activities undertaken in the ocean, sea and coastal areas, such as *Marine living resources* (capture fisheries and aquaculture), *Marine minerals, Marine renewable energy, Desalination, Maritime transport and Coastal tourism*;
b. the *Marine-related activities* use products and/or produce products and services from the ocean or marine-based activities, like seafood processing, biotechnology, *Shipbuilding and repair, Port activities, technology and equipment, digital services* etc. (European Commission, 2022).

Therefore, these *EU Blue Economy Reports* reviewed both traditional Blue Economy activities, the "established Blue Economy sectors", with relative sub-sectors, and a series of "emerging Blue Economy sectors", through complete, accurate and comparable data, collected by the European Commission from EU Member States and the European Statistical System. Most importantly, these last editions of the Report (the fourth and the fifth) also analyse the impact of the COVID-19 crisis on the considered sectors, as well as the effects of mitigation measures put in place in the EU, such as the *EU Recovery Fund*. The seven "established sectors", with relative sub-sectors, and the "emerging sectors" considered in the *EU Blue Economy Reports* are shown in Table 9.1.

According to the *EU Blue Economy Report 2022,* the established sectors, the backbone of the EU Blue Economy, compared to the previous year have grown in terms of GVA (+4,5% to € 184 billion) and gross profits (+7% to € 72.9 billion). Considering the growth trends of these sectors over the past ten years, GVA registered an overall increase of more than 20%, gross profits increased by 22%, with a total turnover in employment by 15%. In relation to the emerging sectors, the report highlights the significant potential for a further growth of the Blue Economy of these highly innovative sectors, which can accelerate the transition needed to deliver on EU ambitious sustainability commitments (European Commission 2021c).

Looking ahead to the role of the Blue Economy with strategic foresights, the report underlines once again the need for a joint action on climate change for a transition to a sustainable economy. The Blue Economy can play an essential role in this transition, necessary for the oceans to remain a provider of crucial ecosystem services, such as biodiversity, carbon capture, food and materials. Marine ecosystems are under

Table 9.1 EU Blue Economy "established sectors/sub-sectors" and "emerging sectors"

Established sector	*Established sub-sector*	*Emerging sectors*
Marine living resources	Primary production	Ocean energy
	Processing of fish products	Blue bioeconomy and biotechnology
	Distribution of fish products	Desalination
Marine non-living resources	Oil and gas	Marine minerals
	Other minerals	Maritime Defense, Security and surveillance
Marine renewable energy	Offshore wind energy	Research and Education
Port activities	Cargo and warehousing	Infrastructure and maritime works (submarine cables, robotics, etc.)
	Port and water projects	
Shipbuilding and repair	Shipbuilding	
	Equipment and machinery	
Maritime transport	Passenger transport	
	Freight transport	
	Services for transport	
Coastal tourism	Accommodation	
	Transport	
	Other expenditure	

Source Author's adaptation from EC Blue Economy Report, 2021

pressure of climate change and pollution from plastic litter and chemical contaminants, so this EU report strives to monitor and anticipate the underlying trends, tackling in this way the long-term impacts of those pressures, informing EU policy-making accordingly.

9.3.3 The Financing of EU Blue Economy: Some Issues

In order to point out how the Blue Economy has started to attract the attention of EU policymakers and investors, it is possible to notice that the European Commission has drawn up the "*Sustainable Blue Economy Finance Principles*", launched in March 2018, collaborating in 2020 with the *European Investment Fund (EIF)* to launch the *"BlueInvest Fund Initiative"*, to support the innovative Blue Economy initiatives (European Commission, 2021a, 2021b).

For reaching this goal, in 2020 the *European Investment Bank* (EIB) approved also the "*Climate Bank Roadmap*", providing EUR 24,2 billion to fight climate change (and this amounts to 37% of all EIB financing funds), according to its *Blue Sustainable Ocean Strategy* (European Investment Bank, 2019).

Recently, the *European Investment Bank* is stepping out of its "*Clean and Sustainable Ocean Programme*" that includes two main components: *The Clean Ocean Initiative (COI)* and *The Blue Sustainable Ocean Strategy (Blue SOS),* aimed to improve the health of oceans, the sustainable coastal protection, the sustainable seafood protection and the green shipping (European Commission, 2022).

Moreover, the *European Bank for Reconstruction and Development* (EBRD) as a signatory to the "*Sustainable Blue Economy Finance Principles*" continues its mission to promote a sustainable blue future for the marine natural capital and to complement the ongoing work on sustainable use and protection of marine resources. This engagement combines direct investments, capacity-building activities, policy dialogue and the development of partnership. For example, the EBRD direct investments to date in Blue Economy sectors amount to EUR 7,37 billion (at front of EUR 20,9 billion of total project value) (European Commission, 2022).

9.4 The Blue Bond as a New Instrument of Blue Finance

The Blue Economy is showing growing importance and gaining momentum among policymakers across the world. The earth's surface is 71% covered by water and billions of people rely on the oceans for their livelihoods and socioeconomic well-being. But the effects of climate change and many human activities are destroying the biodiversity of our oceans.

Blue Finance is an emerging area in Climate Finance with increased interest from investors, financial institutions and issuers globally. The ocean economy is expected to double to USD 3 trillion by 2030, employing 40 million people: hence, innovative financing solutions are required to enhance ocean and coastal preservation and resilience, increasing clean water resources (IFC, 2022; UNEP FI, 2022). So Blue Finance has a huge potential to help in realizing these goals, protecting the marine environment and consequently all the ocean

economy (OECD, 2020b, 2021; Sumaila et al., 2020a, 2021; Thiele et al., 2020, UNEP FI, 2019).

The Blue Bond can be considered a new and innovative financial instrument of Blue Finance, able to attract a broader set of resources that are necessary for the conservation and sustainable use of the oceans, re-orienting investments towards sustainability. In other terms, Blue Bonds are emerging as a new asset class that helps to solve water-related challenges, to create sustainable ocean business opportunities, signalling responsible ocean stewardship (Blanco-Iturbe et al., 2021; Roth et al., 2019; Stanley, 2019; Sumaila et al., 2020b).

In first meaning, Blue Bonds can be considered a new type of Sustainable Bond "*issued to finance projects relating to the conservation and sustainable use of the oceans and the transition towards a sustainable ocean economy*" (World Bank, 2018).

In fact, Blue Bonds, together with Green Bonds, Social Bonds and Sustainability Bonds (or GSS Bonds), represent financial instruments known as "Sustainable Bonds", where the proceeds have to be exclusively applied to eligible environmental projects (Green or Blue Bond), or to social projects (Social Bond) or to a combination of these various projects (Sustainability Bond). Considering that the growing importance of the GSS Bonds is just transforming the Fixed Income Market (PwC, 2022), it is possible to underline that Sustainable Bond can be considered also as instruments of *Impact Investing* (Quirici, 2020), where Impact Investing represents the most recent SRI strategy of positive screening, used to realize "*investments made into companies, organizations and funds with the intention to generate social and environmental impact alongside a financial return*" (GIIN, 2019).

At the same time, Sustainable Bonds are known also as *Sustainable Development Bonds* because they are able to underpin the Sustainable Development Goals (SDGs) of the UN 2030 Agenda for Sustainable Development (ICMA, 2020; United Nations, 2015). In particular, Green Bond and Blue Bond can be considered *Environmental Bonds*, because their use of proceeds must be specifically aimed to finance environmental or climate-change projects and this character makes Green and Blue Bond perfectly aligned with the SDGs. In particular, Blue Bonds are aimed to finance the goal N. 14: "*Life below water*" regarding "*Conserve and sustainable use of the oceans, seas and marine resources for sustainable development*" (UNEP FI, 2018; UN-Environment, 2018).

Blue Bonds differ from Green Bonds with respect to the projects that can be financed by the use of their proceeds: proceeds from a Blue Bond issuance are used specifically to finance marine and ocean-based projects, or to safeguard the blue economy, while proceeds from a Green bond issuance are used to finance green eligible projects. Surely both Green and Blue Bonds are able to reorient flows of capital to Sustainable Projects, respectively, green or blue (Fritsch, 2020; IFC, 2022; UN Global Compact, 2020d).

The Blue Bond can be considered a pioneering debt financial instrument issued usually by governments and development banks to support investments in healthy oceans and blue economies. Blue Bonds have to follow the same components of the *Green Bond Principles* by the International ICMA: (1) Use of Proceeds; (2) Process for Project Evaluation and Selection; (3) Management of Proceeds; (4) Reporting (ICMA, 2021a, 2021b).

So it is possible to point out that there is another deep difference between Green Bond and Blue Bond: according to a regulatory point of view, Green Bonds are regulated both by ICMA *Green Bond Principles* and by the new *EU Green Bond Standard* (Quirici, 2022), while Blue Bonds have actually no specific regulation.[4] There are guidelines, such as the *Sustainable Ocean Principles* (UN Global Compact, 2018) or the *Sustainable Blue Economy Finance Principles* drafted by the European Commission, that represents a framework for activities of the Blue Economy, but they do not regard the structure of a Blue Bond issuance. Blue Bonds will be probably regulated in the following years according to what has been done in relation to the Green Bond, following their example for a specific regulation (Roth et al., 2019).

In fact, the Green Bond market has experienced an exponential growth, transforming from a niche impact market to one of the most dynamic segments in fixed income, becoming a mainstream market and reaching its milestone, with USD 1 trillion in cumulative issuances since 2007 until December 2020 (Climate Bonds Initiative, 2021; Quirici, 2022). The Blue Bond market, on the other hand, is a growing market,

[4] The Climate Bond Initiative has developed criteria for marine renewable energy to be incorporated in the *Climate Bonds Standards and Certification Scheme*, which is a labelling scheme for bonds used globally by bond issuers (governments or corporations) which want to contribute to tackle climate change effects (Climate Bonds Initiative, 2021; Quirici, 2020).

that is doing its first steps, with its first issuance at a global level in 2018, while at a European level in 2019. But the Blue Bond market needs some further considerations.

9.5 The Rising Blue Bond Market

If in the past several Green Bond issuances had as eligible projects also blue projects, it is possible to relive that also recently Green or Sustainable Bonds have been issued incorporating blue elements (OECD, 2020a):

- In 2017 Fiji was the first developing country to issue a Green Bond, the *FiJi International Finance Corporation Green Bond*, comprising also elements relating to coastal blue natural capital. The size of this sovereign bond was 100 million Fijian dollars, equivalent to USD 50 million;
- In March 2018 the government of Indonesia issued the first *Sovereign Green Sukuk*, a Green Islamic Bond. This issuance, attracting conventional, Islamic and green investors, was oversubscribed, signalling the growing demand for sustainable and responsible investments. Proceedings financed a range of projects, including the replacement of fossil fuel-derived electricity with solar PV-based batteries for sea navigation facilities, such as lighthouses.
- In 2018 the European Investment Bank (EIB) issued the *EIB Sustainability Awareness Bond*, focused also on blue projects, according to its *Blue Sustainable Ocean Strategy* (European Investment Bank, 2019).
- In 2019 the World Bank issued a USD 10 million *Sustainable Development Bond*, with proceeds focusing on plastic waste reduction in the ocean and the sustainable use of marine resources in developing countries, including relative scientific research and regulatory reform (Stanley, 2019; World Bank, 2019).

The *Seychelles Blue Bond* issued in October 2018 can be considered *the world's first sovereign blue bond*. Explicitly advertised as "blue", it was launched by the Republic of Seychelles for USD 15 million, with a maturity of 10 years and a coupon (annual interest payment) of 6.5%, with a credit rating B– (by Moody's). This issuance was partially guaranteed

by the World Bank (International Bank for Reconstruction and Development) and by The Nature Conservative (TNC).[5] The bond, which raised USD 15 million from international investors, demonstrated the potential also for small developing countries to harness capital markets for financing the sustainable use of marine resources. The use of proceeds included support for the expansion of marine protected areas and to help the national transition to sustainable fisheries, in order to develop the Seychelles' Blue Economy. Part of the proceeds from this bond had also contributed to the *World Bank's South West Indian Ocean Fisheries Governance and Shared Growth Programme*, which supports countries in the region to sustainably manage their fisheries, increasing the relative economic benefits.

In January 2019 the Nordic Investment Bank (NIB) issued the *first European Blue Bond*, the *NIB Nordic Baltic Sea Blue Bond* to protect and rehabilitate the Baltic Sea (Nordic Investment Bank, 2019a). This bond was issued for SEK 2 billion, equivalent to USD 200 million, with a maturity of five years and a coupon of 0,375%, very law considering that the NIB showed a AAA credit rating (S&P Global Ratings). The *Nordic Baltic Sea Blue Bond* was twice oversubscribed, with only 1% by retail investors and the other part by Investment Funds. Its proceeds had the aim to support lending to waste water treatment and water pollution prevention projects, storm water systems and flood protection, protection of water resources and marine ecosystems, with related biodiversity.

In October 2020 the Nordic Investment Bank (NIB) issued a second Blue Bond for USD 350 million. Both the issuances (2019 and 2020) were based on the *NIB Environmental Framework* (Nordic Investment Bank, 2019b) drafted on the Green Bond Principles, being coherent with them according to the positive CICERO evaluation.

After these first issuances, other Blue Bonds have been issued all over the world. The *first Asian Blue Bond* was issued by the Bank of China in November 2020, funding more than USD 942 million, while

[5] The Nature Conservative (TNC) is a no-profit organization, having the aim of the conservation of natural habitat and biodiversity, that in 2016, thanks to the the work of NatureVest, its impact investing unit, and through the programme "Blue Bond for Ocean Conservation", showed to want to develop a new financial instrument to consent to Small Island Developing States to refund part of their sovereign debt. See at https://www.nature.org/en-us/.

in September 2021 the Asian Development Bank (ADB), after the implementation of its *Green and Blue Bond Framework* (ADB, 2021), issued its first Blue Bond for USD 300 million, totally subscribed, to finance several projects localized in Pacific Ocean.

Considering the opportunities in Latin American areas (Caribbean Development Bank, 2018), in November 2021 the Inter-American Development Bank (IDB) issued a Blue Bond for equivalent USD 30 million, having maturity of ten years and an annual coupon of 2.2% (IDB Invest-UN Global Compact, 2021).

More Blue Bond issuances are expected in the coming years. Several countries are exploring the feasibility of Blue Bonds, especially small island developing states (SIDS) (Bangladesh Planning Commission, 2021; Government of Belize-TNC, 2021), but some critical issues need to be solved by regulators and policymakers in relation to these instruments for reaching a greater development of the relative market.

9.6 Conclusions

The present chapter documents the significant developments in the Blue Economy over recent years, from both a global and European perspective. There is in fact a growing consciousness that ensuring the health of ocean and coastal ecosystems is not just an environmental issue but also presents enormous economic opportunities for exponential growth, not only in ocean-related activities but for the entire global economy. Therefore, there is a growing need to direct sustainable investments towards activities necessary for achieving sustainable ocean economies, so that the action of all actors, both public and private, is required. The need to increase Blue Finance resources goes hand-in-hand with the need to reorient private finance away from harmful activities. However, this goal must be supported by the development of new and innovative financial instruments to attract a broader set of resources for the conservation and sustainable use of oceans and coastal habitats.

Blue Bonds represent a new type of sustainable bond issued to finance blue projects aimed at promoting the implementation and achievement of SDG 14 "Life Below Water", contributing to the good governance of ocean and coastal ecosystems. However, different critical elements are currently affecting financing in the areas of Blue Economy through Blue Bonds. Firstly, Blue Bonds lack specific regulations. Unlike Green Bonds, they cannot rely on their own definition (taxonomy) or best

practice model for their issuances. Regulators must set some "tailored" rules designed specifically for Blue Bonds, as was recently done for Green Bonds. Blue Bond issuers can address the needs of responsible investors if they: (1) align with existing global standards such as the UN Global Compact *Sustainable Ocean Principles* and the ICMA *Green Bond Principles* as the starting point; (2) develop a Blue Framework, including a blue baseline, clear and measurable targets (or KPIs) and sustainability performance metrics on a regular basis; and (3) secure a Second Party Opinion (UN Global Compact, 2020d). Reaching an *EU Blue Bond Standard* and closing the gap with blue impact measurement can be considered only some of the necessary steps to permit the more and more diffusion of Blue Bonds, following the example of what was done in relation to Green Bonds.

Considering the Blue Bond Market, it is possible to point out that it is not as mature as the Green Bond market, and the scarcity of issuances increases the liquidity risk. Consequently, existing Blue Bond issuances are targeted for Institutional Investors, not retail investors. But the development of Blue Bond Markets is urgently required because it can be considered an answer to a double request in a financial/asset management perspective:

- On one hand, it is necessary to increase the contribution of niche investments to the sustainable blue economy by exploring new financial mechanisms that can fund sustainable ocean-related economic activities and ocean conservation.
- On the other hand, there is a growing interest from investors to invest in the environmental economy, not just the green economy but also the blue economy. This is particularly important considering the various problems affecting our oceans.

Many investors are not yet aware of the impact their investments may have on the marine environment and how degrading ocean ecosystems could subsequently affect their portfolio's performance and value. Scaling the Blue Bond market will require several actions, such as creating a Blue Bond recognition with a blue bond label to provide more clarity to potential investors seeking alignment with ocean sustainability, ensuring appropriate benchmark size issues and involving the government and multilateral development banks to support issuers. Additionally, evolving

standards for strong reporting will be necessary to build a transparent and credible market. These actions will also help to address the risk of "blue-washing", a new term to significant the similar risk of "greenwashing", used to describe the risk of misrepresenting investments as sustainable in relation to Blue Sustainable Investments. And tackling these kinds of risks is one of the goals set by the *European Securities and Market Authority* (ESMA) in its *Sustainable Finance Roadmap* for 2022–2024 (ESMA, 2022). However, these issues require further analysis in future research.

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CHAPTER 10

The Effects of the European *Sustainable Finance Disclosure Regulation* on SRI Funds: A Comparison at a Global Level

Maria Cristina Quirici and Gian Luca Giurlani

10.1 Introduction

In recent years the *Socially* (or *Sustainable) Responsible Investing* (SRI) industry has become an important part of the International Asset Management Capital Market by incorporating ESG factors into its investment selection and management processes and in its investment decisions too (Eurosif, 2021; Hanks, 2015). As for the evolution of the meaning of SRI, see Chapter 13). This chapter aims to analyse the main trends that

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are currently characterising Sustainable Funds—known also as Sustainable Responsible Investment Funds (*breviter* SRI Funds)—in Europe (Renneboog et al., 2008; Schöltens & Sievänen, 2013; Townsend, 2020). The authors document how SRI Funds are reacting to the new European ESG Regulatory Framework, showing how recent actions carried out by the European Institutions—from the EC *Action Plan on Financing Sustainable Growth* (European Commission, 2018) and its subsequent *Taxonomy Directive* and *Sustainable Finance Disclosure Regulation* to the EU *Green Deal* (European Commission, 2019) and the *Next Generation EU* (European Commission, 2021)—are changing the existing financial contest into a more sustainable one. All these new ESG regulations surely represent important steps towards a new European Asset Management Industry.

The work begins considering the *EU Sustainable Financial Disclosure Regulation* (SFDR) (2019/2088/EU) in the contest of the new European ESG Regulation, carried out by the European Institutions for financing a Sustainable economic growth. In particular, the work will analyse SRI funds' current trends, pointing out the effects of the EU *Sustainable Financial Disclosure Regulation* on the Asset Management Industry and on the classification of SRI Funds. A comparison with current trends of SRI Funds at a global level will be carried out too. Some final considerations will conclude the work, indicating also some elements for further research.

10.2 The *Sustainable Finance Disclosure Regulation* (2019/2088/EU) in the New European ESG Regulatory Framework

The *Sustainable Finance Disclosure Regulation* (SFDR), approved in November 2019 as 2019/2088/EU, represents a cornerstone of the European Commission *Action Plan on Sustainable Finance* issued in March 2018. When SFDR came into force in March 2021, it signalled to the world that the European Union was ready to take a global lead on ESG reporting and disclosure in sustainable finance.

This new regulation impacts all financial market participants (MFPs) and financial advisors based within the European Union. Also non-EU participants marketing funds or products within the EU must be

compliant with the SFDR for each fund or product they market to EU-based clients. Disclosures are required also if products aren't marketed as ESG-focused.

The EU SFDR is part of that EU's wider *Sustainable Finance Framework* (see Fig. 10.1) that has the aim to create a playing field across the whole EU, in response to the Paris Agreement and to the United Nations 2030 Agenda for Sustainable Development (United Nations, 2015).

In fact, the European Commission, recognising the need to strengthen an economic and finance strategy oriented towards long-term sustainable and climate-resilient development, in September 2016 decided to establish a *High-Level Expert Group (HLEG) on Sustainable Finance*, with the aim to provide a roadmap towards a sustainable financial system

Fig. 10.1 Principal EU steps towards a sustainable finance (2015–2022) (*Source* Author's elaboration)

that fosters sustainability in economic, social and environmental developments. In other terms, the HLEG had to "*provide recommendations on how to* '*hardwire*' *sustainability into the EU's regulatory and financial policy framework and how to mobilise more capital flows towards sustainable investments and lending*" (EU High-Level Expert Group on Sustainable Finance (HLEG, 2018).

Responding to this duty, the HLEG presented on 31 January 2018, a *Final Report* in which a set of eight key recommendations were proposed to the EC.

The European Commission, "building" upon these recommendations, presented on 8 March 2018, its *Action Plan: Financing a Sustainable Growth,* that underlined the necessity to realise ten actions, in the period 2018–2019, with the aim "*to: (1) reorient capital flows towards sustainable investments in order to achieve sustainable and inclusive growth; (2) manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and (3) foster transparency and long-termism in financial and economic activity*" (European Commission, 2018).

This EC *Action Plan* can be considered a legislative effort in response to the various calls for a more regulated and standardised playing field in the sustainable finance industry. In this way, EU legislators show to understand the necessity of urgent steps considering the lack of a common definition of sustainable projects, the lack of transparency on how sustainability risks and targets are managed by corporations, and on how ESG factors are incorporated in financial organisations investment decisions (Linciano, 2021; Quirici, 2020).

In particular, considering that it is fundamental that investors channel more and more of their money into sustainable projects, in order to achieve the 2030 SDGs, the EC showed consciousness that the existing financial gap could be reduced through a clarification of the meaning of sustainability. In fact, according to the EC *Action Plan*: "*a shift of capital flows towards more sustainable economic activities has to be underpinned by a shared understanding of what* '*sustainable*' *means. A unified EU classification system –or taxonomy- will provide clarity on which activities can be considered* '*sustainable*'. *It is at this stage the most important and urgent action of this Action Plan*" (European Commission, 2018).

In June 2018, the European Commission sets up an EU *Technical Expert Group on Sustainable Finance* (known as TEG) to realise the actions drafted in the Action Plan. The TEG, which began its work in July

2018, presented on 18 June 2019, four reports, regarding the principal issues given to it by the European Commission: the *Report on EU Green Bond Standard*; the *Taxonomy Technical Report, the Guidelines for Non-Financial Reporting; the Climate Benchmarks*. On 9 March 2020, the EU TEG presented its *Final report on Taxonomy for Sustainable Activities* (EU TEG, 2020a) and its *Usability Guide for the EU Green Bond Standard* (EU TEG, 2020b). According to these documents, the Final Taxonomy Regulation has been drafted in the *EU Regulation 2020/852*, approved on 22 June 2020, and the *EU Taxonomy Delegated Act* has been presented on 21 April 2021, while it is necessary to wait for April 2022 to see the EU Council that approves the *EU Green Bond Standard* and on 6 July 2022, to read the *EU Proposal for a Regulation of the European Parliament and of the Council on European Green Bond* [COM (2021)391 Final]. It is possible to point out that if some rules have just been adopted or entered into force, such as the *Sustainable Finance Disclosure Regulation* (SFDR) and the *Delegated Acts on MiFID II* (ESMA, 2022a), other equally important regulatory requirements are expected to be fully rolled out over the next few years.

Considering in particular the EU SFDR, it is worth to underline that it drafts a set of EU disclosure rules, rules that have to be applied both at product and entity level, just to make it clearer and easier for investors to understand and compare the sustainable profile of investment funds. SFDR aims to trigger changes in behavioural patterns in the financial sector, discouraging greenwashing and promoting responsible and sustainable investments.

The SFDR rules, in fact, require asset managers and other MFPs to disclose ESG information concerning their investment decisions and financial products, whether or not they are listed as sustainable. SFDR reporting aims to create a unified set of ESG standards within the EU, increasing transparency around sustainability-related risks and the potential impact of financial products available on the market. The SFDR focuses on pre-defined metrics for assessing ESG outcomes of the investment process at a fund level, and it is designed to prevent greenwashing, ensuring a systematic, transparent and harmonised approach within financial markets.

While on 10 March 2021 SFDR came into effect, on 1 January 2022 the first level of alignment with the EU Taxonomy classification framework was completed, requiring additional climate-related disclosures. The European Commission, on 6 April 2022, adopted with its Delegated

Table 10.1 The SFDR (2019/2088/EU) impacts on market financial participants

SFDR: Product level	*SFDR: Entity level*
Art. 6	PAI indicators
Art. 8	Sustainability risk
Art. 9	Remuneration policy

Source Author's elaboration

Act 2022/1288 the *Regulatory Technical Standards* (RTS), regarding the disclosure rules of level 2. On 1 January 2023, this Delegated Act has come into force and so the second level of alignment with the EU Taxonomy can be considered effective, requiring the *RTS* for environmentally aligned funds. Disclosing the *Principal Adverse Impact* (PAI) statement will begin at the entity level.[1] Then, since 30 June 2023, the PAI annual statement will be reported necessarily on June 30 every year.

SFDR disclosure requirements can be divided into organisation-level reporting and fund/product reporting (see Table 10.1). At the organisation level, Market Financial Participants (MFPs) have at least to disclose:

a. the potentially negative impacts that an investment decision may have on ESG factors (such as water usage or energy consumption);
b. whether they consider such ESG risks in their investment decision-making process; and
c. how remuneration policy aligns with the integration of sustainability risk.

At the product/fund level, MFPs have at least to disclose:

a. how sustainability risk might impact financial performance;
b. whether and how the product considers potentially negative impacts on sustainability risk; and

[1] The *Principal Adverse Impact* (PAI) statement is an integral part of the SFDR. It consists of 18 mandatory indicators and two elective ones chosen from 46 options. These indicators consist of quantitative questions about the potentially negative impact of a fund or organisation on ESG factors. These disclosures have to be applied both at the fund and entity level. So SFDR represents a significant step towards the consolidation and harmonisation of ESG worldwide (ESAs, 2022; Morningstar, 2021).

c. how products labelled as sustainable investments monitor, measure and assess their sustainability impact.

The implications of the SFDR application for fund providers are manifold. According to the new regulation, in fact, they have to explain in pre-contractual disclosures how sustainability risks are considered in their investment process as well as how sustainability risks may impact the returns of their financial products. The new SFDR regulation also requires that funds and mandates are classified into three categories, as laid out by Art. 6, Art. 8 and Art. 9, to make it possible to compare different financial funds (OliverWyman-AIPB, 2021; Qi & Philipova, 2021). In other terms, the new set of rules introduced by SFDR forced asset managers to reveal the differing levels of sustainability integration and focus of each investment strategy that they are offering, providing also, on a pre-contractual basis, clients and investors with information on sustainability factors and risks at both product and company level.

Hence, under the new SFDR classification, fund managers will label their funds under Art. 6, Art. 8 and Art. 9 considering that:

- Art. 6 covers funds that do not integrate any kind of sustainability into the investment process and that could include stocks currently screened and excluded from investment mandates by SRI funds such as coal-fired power generation, mining or tobacco companies. Art. 6 funds will be allowed to be sold in the EU, providing a clear labelling system which defines them as non-sustainable, but it could be harder their placement if compared to more sustainable funds.
- Art. 8, also known as "*environmentally and socially promoting*" can be applied "*when a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices*". Their investments may include energy companies with a mix of generation assets and companies able to show clear progress towards better ESG practices. Negative screens may be used to identify suitable investments.
- Art. 9, also known as "*products targeting sustainable investments*", covers products targeting as sustainable investments and applies "(…) *where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark*".

Investments should have clear ESG benefits as a primary goal, rather than the benefits being incidental to the primary business activity. All holdings must be sustainable investments that meet the standard of "*do no significant harm*" of the EU Taxonomy. Positive screenings may be used to identify suitable investments.

10.3 EU SFDR'S Effects on SRI Fund Trends in Europe

Since the EU *SFDR* came into effect in March 2021, most fund providers have already applied to their sustainable investment funds the labels provided by the new regulation. So, funds available for sale in the EU have been classified by their managers into one of three categories indicated by the SFDR (Art. 6, Art. 8 or Art. 9) depending on their own sustainability objectives.

Considering SFDR data collected by Morningstar (a leading provider of independent investment researches), from prospectuses on 91% of funds available for sale in the EU—excluding money market funds, funds of funds and feeder funds—on 31 December 2021 assets in Art. 8 (the so-called "*light-green*") and Art. 9 (the so-called "*dark-green*") funds reached EUR 4.05 trillion, representing 42.4% of all funds sold in the European Union—split into 37.7% for Art. 8 products and 4.7% for Art. 9 products with a 57.5% for Art. 6, as shown in Fig. 10.2—considering that at the end of September Art. 8 and Art. 9 were at 36.9% (Morningstar, 2022a).

At the same time, considering that the combined assets of Art. 8 and Art. 9 products amounted to EUR 3.32 trillion at the end of September, in the fourth quarter of 2021 Art. 8 and Art. 9 funds were able to capture 64% of EU funds, corresponding at EUR 81.4 billion inflows. In terms of assets, these two fund groups accounted for a more and more big share of the EU universe: according to Morningstar, they were on track to reach 50% of overall fund assets by mid-2022, or even sooner, as fund managers were continuing to upgrade strategies and launch new products meeting articles' 8 and 9 requirements.

Considering the number of funds, as of 31 December 2021—as shown in Fig. 10.3—25.2% were classified as Art. 8, while 3.4% were classified as Art. 9, with the remaining 71.4% as Art. 6 (Morningstar, 2022a). According to Morningstar, the increasing market share of Art. 8 and Art.

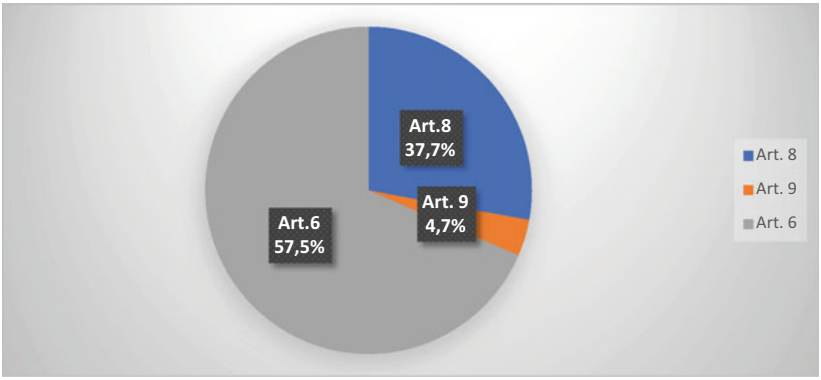

Fig. 10.2 SFDR fund type breakdown by assets (31 December 2021) (*Source* Author's adaptation from Morningstar [2022a])

9 funds in overall fund flows can be explained by the growing investor interest in ESG and sustainability issues, especially climate change, and the expanding range of options available, as the industry was moving into more retail flows into sustainable funds as financial advisors. According to Morningstar, this trend could be considered able to continue, with an increasing number of Art. 8 and 9 funds launched and distributed in the following times.

In the fourth quarter of 2021, Art. 6 fund flows declined by over 30%, while Art. 8 and Art. 9 captured 64% of Morningstar's reviewed fund universe total flows. It is possible to underline that this 64% can be compared with 56% in the third quarter 2021 (Q3-2021) and 41% in the second quarter (Q2-2021).

SFDR has acted as a catalyst for product development and innovation in Europe. In fact, considering Art. 8 and Art. 9 Fund Launches, the same Morningstar report shows that since SFDR introduction in March 2021 totally 600 new funds belong to these indicated groups of funds, representing almost half of all EU new fund launches over the period (Morningstar, 2022a).

As a result, the share of Art. 8 and Art. 9 funds in the total new funds launched in the EU incrementally increased to reach 54% in the fourth quarter of 2021 (Q4), from 53% in the third one (Q3) and 42% in the second one (Q2). In particular, in Q4 we can observe 198 new launches of Art. 8 and Art. 9 funds (split in 157 Art. 8 and 41 Art. 9, while 170

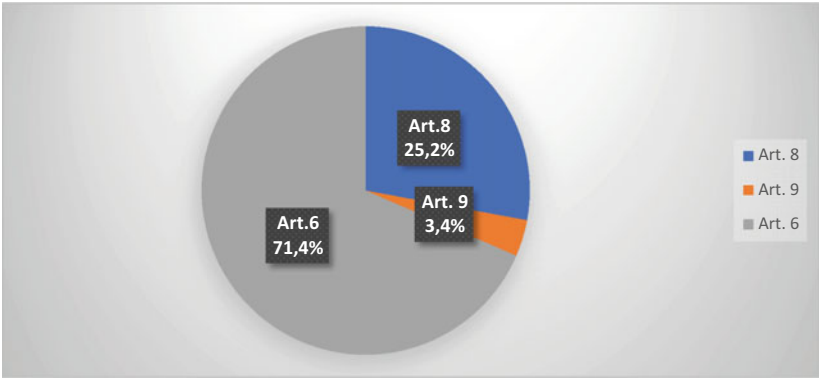

Fig. 10.3 Fund type breakdown by number of funds (31 December 2021) (*Source* Author's adaptation from Morningstar [2022a])

are launches of funds Art. 6), that have intercepted the 64% of total flows of the period, corresponding to 81,4 billion euros (ZEB - Morningstar, 2022).

Throughout the year, asset managers expanded the range of Art. 8 and Art. 9 funds options available to investors in terms of asset class, investment style and theme. Equity remained the source of the greatest product proliferation. In fact, as of 31 December 2021, looking at the asset class exposure and comparing Art. 6, 8 and 9 funds, it is possible to notice that Art. 8 and 9 categories lean more towards equity, with equity funds accounting for half of Art. 8 offerings and two-thirds of Art. 9 products. Close to 29% and 24% of Art. 8 and Art. 9 funds offer exposure to fixed income.

But launching new Art. 8 and Art. 9 funds is not the only way showed by asset managers to respond to the increasing investor demand for ESG and sustainable investments: they have reclassified the existent Art. 6 funds by enhancing their ESG integration processes and/or adding binding ESG criteria to their investment objectives and/or policies. Since March 2021, around 1800 funds were upgraded principally from Art. 6 to Art. 8 or Art. 9, but also from Art. 8 to Art. 9. Only a minority of these upgraded funds were changed in their name, while there were no Art. 8 or Art. 9 funds downgraded to Art. 6.

One year after the introduction of the SFDR, at the end of March 2022, it is possible to see that assets in Art. 8 and Art. 9 funds have increased as a share of all European fund assets, while Art. 6 funds have shrunk in relative terms since April 2021 (Morningstar, 2022b).

In the first quarter of 2022 (Q1 2022), Art. 9 funds attracted net inflows of EUR 8,6 bn, while Art. 8 funds, registered net outflows of EUR 3,3, bn (mostly due to sales of bond funds). So, at the end of March 2022, the two categories of funds, aligning with Art. 8 and Art. 9 of the EU SFDR, combined increased their share of total European fund assets to 45,6% (from 42.4% at the end of 2021), corresponding to EUR 4.18 trillion. At the same time, they covered together a share of 31.5% of total number of funds (from 28.6% at the end of 2021), split in 27.9% of Art. 8 funds and 3.6% of Art. 9 funds, as shown in Fig. 10.4 (Morningstar, 2022b).

More recently, considering an updated Morningstar Report on the rapidly evolving landscape of Art. 8 and Art. 9 funds according to the EU SFDR at the end of the third quarter of 2022 (Morningstar, 2022c), it is possible to observe a continuously challenging backdrop of high inflationary pressures, a looming global recession and increasing geopolitical risks following Russian Federation's invasion of Ukraine.

Despite this difficult backdrop, the market share of Art. 8 and Art. 9 fund assets continued to increase and reached 53.5% at the end of September, split into 48.3% of Art. 8 funds (up from 45.9% at the end of

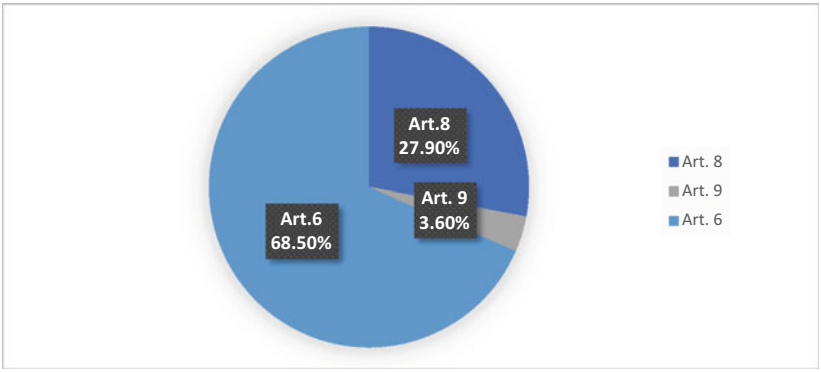

Fig. 10.4 SRI fund type on total number of funds on 31st March 2022 (*Source* Author's adaptation from Morningstar [2022b])

June) and 5.2% of Art. 9 funds (up from 5.1% at the end of June), with a remaining 46.4% of Art. 6 funds.

In terms of assets, in the third quarter of 2022 Art. 8 funds bled EUR 28.7 bn, only slightly less than in the previous quarter, while Art. 9 funds recorded inflows of EUR 12.6 bn, double those of Q2 2022, boosted by passive strategies. Combined Art. 8 and Art. 9 assets rose by almost 3% over the third quarter to EUR 4.3 trillion, while Art. 6 fund assets dropped by 9.6%.

In terms of reclassifications, over 380 products changed SFDR status in Q3 2022: the vast majority were upgraded to Art. 8 from 6, but 41 were downgraded to Art. 8 from 9, and more are expected to follow suit in the coming months.

Regarding these downgrades from Art. 9 to Art. 8, it is worth to underline that in recent months asset managers are preparing the implementation of the *EU Regulatory Technical Standards*, which will come into effect at the beginning of January 2023. These standards require managers to disclose more information on their fund's ESG approach, sustainability risks and impact in precontractual documents and periodic reports. Ahead of this upgraded disclosure regime, some managers have reviewed their funds' classification, downgrading some Art. 9 products to Art. 8.

Analysing key data shared by asset managers through the *European ESG template* (or EET), which includes minimum sustainable investments and taxonomy alignment exposures as well as principal adverse impact (or PAIs) consideration,[2] it is possible to notice that in mid-October nearly all (95%) of Art. 8 and Art. 9 funds report to consider PAIs, showing significantly improved coverage of the data field since mid-July (43%). In particular, the vast majority of the two groups of funds stated they do consider PAIs (84.8% for the respondent Art. 8 funds and 93.4% for the respondent Art. 9 funds), although it may come as a surprise that not all Art. 9 funds do it (6.6% of them do not consider PAIs).

2

PAI indicators are intended to show investors what adverse impacts a financial product may have on sustainability factors relating to environmental, social and employee matter, respect for human rights, anticorruption, and antibribery matters. (Morningstar, 2022c, p. 24)

Considering Art. 8 and Art. 9 funds, it emerges that still less than half (48%) disclose a minimum percentage of sustainable investments, and just one-third report a minimum percentage of taxonomy-aligned investments.

Moreover, less than 5% of Art. 9 funds target sustainable investment exposure between 90 and 100%, and only 26 funds aim for a 100% allocation to sustainable investment, raising questions about the feasibility of some new regulatory guidance. Considering the Art. 8 and Art. 9 products that report taxonomy alignment, 85% provide 0% values, while a mere 2% of Art. 9 funds target exposure to taxonomy-aligned investments higher than 10%.

In terms of asset class exposure, while general ESG and sustainability-focused offerings continued to account for the largest part of the product development activity, climate funds and biodiversity funds remained by far the most popular theme.

10.4 A Comparison with the Current Trends Of SRI Funds at the Global Level

We often hear the question about what kind of differences may be identified among asset management companies headquartered in different regions in a global perspective. To give an answer to this question it is possible to analyse data as of December 2021 from Mainstreet Partners by geographical areas (based on the location of their company headquarters) such as Europe, UK & Ireland and the US, using the average rating (MainStreet Partners, 2022).

As expected, the average holistic ESG rating improves as we move from Art. 6 towards Art. 9 funds, regardless of where the companies are headquartered. In terms of Art. 6 and Art. 8 funds, the difference in ratings across regions was not overly distinct. But for funds with clear sustainability objectives (Art. 9), the dispersion of ratings among the regions considered was far higher. In fact, there is a gap in terms of ESG ratings between Art. 9 funds located in Europe and their peers in the US. It emerges that US-based asset managers are still catching up with their European counterparts, in terms of ESG integration in the investment process, the building out of large teams and pouring capital into sustainable resources. However, it has to be acknowledged that demand for ESG strategies in the United States is lower compared with some European-based Asset Managers. Looking more deeply at Art. 9 funds,

it is interesting to note that the pillar pertaining to the asset manager overall (Pillar 1) shows the largest variation between the United States and Europe.

Considering the global sustainable fund assets at the end of December 2021, they reached USD 2.74 trillion, from USD 2,51 trillion at the end of September (expanding by 9% in the fourth quarter of 2021 relative to the third one) (Morningstar, 2022d).

During Q4 2021, inflows grew as well, driven by continued investor interest in ESG issues and by regulation. Investors poured USD 142 billion into sustainable funds globally, representing a 12% increase with respect to Q3 2021. Product development remained strong, with 266 new sustainable fund launches globally in Q4 2021. Asset managers continued to repurpose and rebrand conventional products into sustainable offerings too.

The EU is continuing to dominate the sustainable space, where the global universe is here divided into three segments by domicile of the asset management companies: Europe, the United States and the Rest of the World. In fact, Europe accounted for close to 80% of fourth-quarter 2021 inflows, while the United States accounted for 10%, as did the Rest of the World (Canada, Australia and New Zealand, Japan and Asia combined) (Morningstar, 2022d).

According to a prevision by PriceWaterhouseCoopers (PwC, 2022a), in 2025 50% of the assets managed in funds at the European level might follow ESG criteria and from 2020 the expected annual average increase might be 29%. If in 2020 the AUM ESG represents 15% of Total AUM (closing at EUR 2100 billion), according to this PwC Report, in 2025 AUM ESG might reach 57% of Total AUM (closing at EUR 7600 billion). The same increasing trend is expected in relation to the offering, in terms of a number of SRI funds (Capital Group, 2022; PwC, 2022a).

But this forecast has to consider the particular trend shown by SRI Funds in the course of 2022. In fact, in August 2022 Morningstar enhanced its *Sustainable-Investing Framework* (Hale, 2022), used to build the global sustainable fund universe. According to this report, the global universe of sustainable funds attracted USD 22.5 billion of net new money in the third quarter of 2022 (Q3 2022), compared with a revised USD 33,9 billion of inflows in the second quarter of 2022 (Q2 2022).

> *This contraction can be observed also looking at quarterly organic growth rates. Calculated as net flows relative to total assets at the start of a period, global sustainable funds saw their organic growth rate decline to 1% in the third quarter from 1,2% in the second quarter.*
>
> *Nonetheless, flows in sustainable funds held up better than those in the broader market. In comparison, the overall global fund universe suffered outflows of USD 198 billion in the third quarter of 2022, after suffering USD 278 billion of outflows in the second quarter*. (Morningstar, 2022e)

The reasons for these net outflows in Q2 2022 and in Q3 2022 are mainly due to a global recession. Macroeconomic headwinds, including enduring inflationary pressures, rising interest rates, disruption of global energy supply and the conflict in Ukraine, have become more acute in the course of the third quarter of 2022, spelling trouble for global fund markets. Surely, sustainable fund inflows plummet, but again hold up better than their conventional peers.

Europe, the biggest market for sustainable funds, registered a drop in net new money: European investors poured USD 22,6 billion into sustainable products in Q3 2022, a historical low since the first quarter of 2020, when the coronavirus pandemic first struck. Of this net new money, the quasi-totality (96%) poured into passive funds, while active sustainable products registered the worst quarter in at least five years.

US-domiciled sustainable funds recovered from the USD 1.6 billion outflow in Q2 2022 and registered small net inflows of USD 459 million in Q3 2022. Considering the rest of the world, it is possible to observe that in Australia and New Zealand, net inflows clocked positive too, albeit lower than in the previous quarter, at USD 445 million, while Asia-ex Japan and Japan experienced outflows, bleeding USD 660 million and USD 493 million, respectively (Morningstar, 2022e).

So, in a global comparison, at the end of Q3 2022 Europe continued to make up the lion's share of the sustainable fund landscape, with 82% of sustainable fund assets, followed by the United States, which housed 12% of sustainable fund assets through September 2022, and in third position by Asia–ex-Japan (of which China is the biggest sustainable market, with more than 68% of the region's asset base).

Global sustainable fund assets slipped slightly to USD 2.24 trillion as of September 2022 from the restated USD 2.28 trillion at the end of Q2 2022. This 1.6% decline was the third consecutive drop since the first

quarter of 2020, but it is possible to underline that sustainable fund assets held up better than the overall global fund market, which saw its assets shrink by 7.5% in the Q3 2022 (Morningstar, 2022e).

10.5 Conclusions

The present work documents the great development of importance of Sustainable and Responsible Investments, with an increasing volume in the Assets under Management (AuM) of SRI Funds in the last years both from a global and European point of view. This can be considered a long-term trend, both for new investments and for existing SRI funds, that are implementing new responsible processes. Moreover, this move to sustainability-focused strategies can be considered a structural trend among asset managers, that will continue independently of the market and business cycle backgrounds. And this is confirmed by the European sustainable fund flows observed in Q2 2022 and in Q3 2022: net outflows in sustainable funds plummet in these periods, concerning over a global recession—macroeconomic headwinds, including enduring inflationary pressures, rising interest rates, disruption to global energy supply, and the conflict in Ukraine—but surely hold up better than their conventional peers.

As demonstrated in the last two quarters—Q2 2022 and Q3 2022, as well as in 2020 at the start of the Coronavirus pandemic (United Nations, 2020)—sustainable fund flows, amid investors' concern about a global recession, showed overall resilience against market volatility compared with their traditional peers (or conventional fund flows). In other terms, sustainability-focused investors, who are typically values-driven and long-term oriented, are slower to pull money from funds they are invested in.

Then, considering European sustainable fund flows by asset class, sustainable equity and allocation funds suffered the most in the third quarter of 2022, registering much lower inflows than in the second quarter, while fixed income showed signs of recovery after decreasing inflows for three consecutive quarters. Investors continued seeking global inflation-linked bonds and global flexible bond strategies to entrench themselves against high inflation across major developed economies. So, fixed income turned out to be another area where sustainable funds were much more resilient than their conventional counterparts in terms of flows (Morningstar, 2022e; PwC, 2022b).

In recent years, the EU has positioned itself as the world leader in promoting a sustainable financial growth, pushing for concrete policy actions: in a global comparison, at the end of Q3 2022 Europe continued to make up the lion's share of the sustainable fund landscape, with 82% of sustainable fund assets, followed by the United States, which housed 12% of sustainable fund assets through September 2022.

The new ESG Regulatory framework in the EU is more and more rich of initiatives for the growth of Sustainable Finance, with some goals as those ones showed by the European Securities and Market Authority (ESMA) in its *Sustainable Finance Roadmap 2022–2024* (ESMA, 2022b):

- integrating sustainability in the development of the single rulebook;
- building common approaches for incorporating ESG factors in the supervisory practices of the National Competent Authorities;
- monitoring market developments, identifying risks related to sustainable finance;
- tackling the risk of greenwashing;
- improving transparency on the role of ESG factors in the credit rating process.

The suitability assessment within the MiFID framework is pursuing the same goals, representing a requirement for providers of investment advice and portfolio management to offer personal recommendations to their clients or make appropriate investment decisions on their behalf, identifying clients' sustainable preferences and offering financial products and investment solutions accordingly.

However, by analysing the impact that the new European legislation is having on the sustainable investment market and by evaluating whether the predisposed goals would be achieved or not, it is possible to point out some critical elements concerning, in particular, the application of the EU SFDR to the SRI Funds Industry (Duarte et al., 2022). These critical elements reside not so much in the disclosure obligations, but at an earlier stage, namely, the definition of sustainable investment and in the product classification (as Art. 6, Art. 8 and Art. 9) drafted by SFDR (Eurosif, 2022). The inconsistency in the classification of the products represents nothing more than the prolongation of the problem that the SFDR itself had set out to eliminate, which is represented by greenwashing. This leads to a situation characterised by an excessive subjectivity by asset managers

when they qualify the products that they offer. And the scenario could even get worse: in the absence of an intervention by the European legislator, the national supervisory authorities could provide clarifications on the classification within their own markets. Consequently, the European investment market could be fragmented, compromising the cross-border distribution of sustainable products and forcing asset managers to navigate through a "patchwork" of different regulatory regimes.

Therefore, it is clear that there is a need for an urgent regulatory intervention that can definitively amend the uncertainty points of the existing regulation, "*for making the framework fit for purpose*", providing useful implementation and reducing, at the same time, the risk of greenwashing.

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PART IV

Legal and Regulatory Issues on SRI and ESG Integration

CHAPTER 11

ESG Targets for the Financial Sector and the Choice of Legal Instruments

Mark D. H. Nelemans

11.1 Introduction

Environmental, Social and Governance (ESG) is a topic of high priority within financial supervisory law. The climate change and challenges of our time create an urgency for effective and efficient legislation and regulation. More than 12 years ago, during the financial crisis, there was also great urgency for stabilising and confidence-building supervisory legislation. History shows that crises give rise to reforms in financial regulation and supervisory law (Gerding, 2013). ESG legislation is taking shape during a similarly urgent period (Busch et al., 2021; Camara, 2022; Hill, 2020). This chapter deals with the question of which legal and regulatory instruments are appropriate to incorporate ESG targets into the business of financial institutions and the related internal and external supervision. As ESG can be seen as an important key concept in the discussion on a sustainable, future-oriented financial sector, the question needs to be

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answered whether the path of soft law or hard law can be chosen, or a combination of both.

Governance, business strategy, risk profile, product development and remuneration policy are aspects that are part of the internal sphere of companies. In the financial sector, these aspects are increasingly regulated by hard law, often after a transformation from soft law and corporate governance principles. The European legislative framework on sustainability and Green Finance is materialising increasingly, notably through the Taxonomy Regulation and Sustainable Finance Disclosure Regulation (European Commission, 2019, 2020). European laws and regulations are not exhaustive, there is room for ambitions and goals that are formulated in the sphere of soft law, self-regulation and corporate governance. This chapter offers an analysis and interpretation of a multi-level approach to ESG targets for the financial sector.

11.1.1 Research Question

Rules on transparency and taxonomy have taken shape in hard law, in conjunction with a range of related formal requirements (European Securities and Markets Authority, 2022). Material standards, and the actual achievement of ESG goals, are more difficult to translate into hard legislation, partly due to their empirical nature. An (international) increase in best practices, industry codes, principle-based regulation, and other forms of legally non-binding agreements is evident (Katelouzou & Klettner, 2022). Several international organizations, financial institutions and non-governmental organisations are involved in the creation of these forms of soft law (Katelouzou & Zumbansen, 2021; Van Rijsbergen, 2021). From this development, a multilevel regulatory system of ESG and Green Finance is emerging. This development is encouraging but also has fragilities. Especially with regard to the question how the various hard and soft law rules relate to each other. Hard law rules are secured through supervision, enforcement and potentially sanctions. Traditionally, soft law is seen as more non-committal in nature, due to the lack of hard compliance obligations (Lancri, 2019). An understanding and interpretation of the functioning of the layered system of ESG regulation, now and in the future, necessitates the following research question:

Which regulation, governance and standard setting on ESG objectives for financial institutions lend themselves to self-regulation and soft law, complementary to the hard law framework?

Approach and structure. The approach to answering this question will be to provide an overview and background of international financial regulation and, against this backdrop, to map the current affairs in ESG hard law regulation, particularly at the European level. Furthermore, an overview of corporate governance theories will be provided and of soft law and self-regulation as it pertains to sustainability and green finance. This chapter aims to contribute to the discourse concerning the suitable place for soft law and self-regulation, in an overall system aimed at maximising ESG objectives. Inspiration will be drawn from the lessons of the 2008–2012 financial crisis and the relationship between hard law and soft law that emerged during and after the crisis.

This chapter is structured as follows. Section 11.2 contains a compact overview of the development of (international) financial regulation. Section 11.3 follows an account of the European approach to ESG, focusing on key legislation and bodies involved. Section 11.4 analyses the role and place of soft law and self-regulation in relation to ESG, followed by Sect. 11.5 in which Green Corporate Governance is discussed as an evolved form of good business and financial governance, to complement already existing theories of corporate governance. Section 11.6 aims to bring together the preceding sections with a focus on multilevel ESG regulation after which Sect. 11.7 draws a conclusion.

11.2 The System and History of International Financial Regulation

11.2.1 Introduction

To understand the current and future place of ESG regulation within the existing international financial legal system, it is useful to provide a brief sketch of the international financial regulatory landscape (Nelemans, 2018). Financial regulation has traditionally focused on promoting the stability and continuity of financial sectors. In the almost 100 years that financial sectors have been controlled through supervision and regulation, it has evolved into an extremely large and complex system that pursues multiple goals. Modern financial regulation aims to regulate, among other

things, stability, integrity, market access, consumer protection, supervision and enforcement.

11.2.2 The Period of 1929–1933

The main catalyst for the development and gradual expansion of international financial law is the impact of crises. The origins of the current international system of financial regulation can be traced to the crash of 24 October 1929 and the subsequent Great Depression (Gunderson, 2004). In a three-year period, stock market-listed companies lost 90% of their value. Between 1930 and 1933, 9000 banks failed, savers could no longer withdraw their money and the unemployment rate rose to an unprecedented 25% (Brummer, 2015; Field, 2013). The golden age for US investment banking was the previous period, which last from 1896 to 1929 (Heyzer, 2009). There was no legal requirement to separate commercial banking from investment banking. This created a situation where savings on the commercial side of the bank were used to finance transactions on the investment side of the same bank. The practices contributed to a speculative bubble in the US stock markets (Heyzer, 2009). The decade-long crisis negatively affected all Western countries. In particular, European markets depended on an inflow of capital from the United States and were hit exceptionally hard.

The US government's response during the Great Depression, when many banks failed, was aimed at preventing another crisis. The response was swift and sweeping; in 1933, the Emergency Banking Act and the Glass-Steagall Act were introduced. Under these laws, universal banks were no longer allowed to combine risky investments with standard banking businesses such as savings and loans. Banks had to make a choice and were no longer allowed to operate in both areas, either investment banking or commercial banking (Evans, 2016). Banks were no longer allowed to deal in securities and accept savings at the same time. This policy would be maintained for the next 30 years, until the early 1960s (Willmott, 2017).

European countries did not introduce legislation similar to the US after the Great Crash of 1929, although there was the introduction of banking legislation and central banking supervision aimed at restoring public confidence in the financial sector (Benston, 1990). The crisis had exposed the dangers of mixed banking: the combination of traditional

banking and industrial investments (Westerhuis, 2016). In several European countries (Sweden, Switzerland, Belgium and Italy), banks were forced to separate short-term loans from industrial investments (Pohl, 1995a). Belgium went further than other countries and was the first country to prohibit deposit banks from holding industrial shares, because of volatility and risks (Pohl, 1995b). In Belgium, during the mid-1930s, only deposit banks were allowed to use the term 'bank'. Banks in Belgium were also required to hold a minimum share capital and to publish financial data using standards set by the government. Another notable change in the European banking system during the 1930s was the transformation of Banca d'Italia into a public credit bureau with the mandate to control and monitor Italian banks and to prevent the emergence of an over-concentrated financial sector (White, 1997). The legislation introduced in Europe after the Great Depression was mainly aimed at protecting savings, this had the effect of increasing savings banks (Morrison, 2015).

11.2.3 The Period of 1934–1973

During the next four decades, international financial markets were largely influenced by the effects of World War II and post-war government interventions. Government interventions after the war were aimed at bringing back economic prosperity. The International Monetary Fund (IMF) was officially established in July 1944 when the agreement underlying it was signed at the Bretton Woods conference. The IMF's tasks are to support and promote international financial cooperation, ensure financial stability and promote economic growth (Zamora, 1999). The Bretton Woods conference was held in July 1944 with the aim of regulating the global financial and monetary system, after World War II, despite the fact that the war had not yet ended. The World Bank was also established during the Bretton Woods conference. One of the tasks of the World Bank was to identify valuable investments in developing countries and to provide financing. With the creation of the IMF and the World Bank in 1944, a clear legal and institutional basis for the international monetary system emerged; the Bretton Woods system was created during this period (Butler, 2016).

The rigidity of the Bretton Woods system with fixed exchange rates led to its downfall in the 1960s and 1970s (Moffit, 1984). In the 1960s, the central banks of industrialised countries, the IMF and the Bank of International Settlements would try to coordinate bailouts and prevent

large-scale speculation. Apart from rigid exchange rates, the second drawback of the Bretton Woods system was seen as the over-reliance on the US dollar as the leading reserve currency (Rushefsky, 2013). The United States behaved as the global central bank after Bretton Woods, but the system was not set up for the increased growth in the following decades; this development had not been taken into account in the agreement. The system was based on confidence that the United States could exchange debt securities for gold. However, gold reserves had shrunk due to the international activities of the United States. The gold standard was finally abandoned in the period 1971–1973 (Woods, 2007). After this period, a system of more flexible exchange rates was introduced. The role and function of the IMF and the World Bank changed in the late 1970s (Helleiner, 2015). From that period on, European states focused more on their regional monetary project and were focused on achieving unification. The OECD-EU system also operated separately from the IMF which contributed to its diminished role in the international financial architecture. The creation of the G10, G7 and OECD all contributed to the changed international financial landscape (Buckley, 2016; Schwarcz, 2009).

11.2.4 1970s to Current Times

Over the last decades, the financial sector has changed dramatically and, increasingly, the old architecture of financial regulation is no longer sufficient. From the 1960s onwards regulators would again allow commercial banks to engage in securities trading. The Great Financial Crisis that started in 2007–2008 exposed the problem of systemic risk and 'too big to fail' in a profound and destructive way. The complexity of financial markets and large international financial companies made it impossible to identify structural vulnerabilities in the global financial system in time.

Deregulation and flexibilisation of regulation led to the formation of large international financial conglomerates. These large financial corporations—universal banks and large insurers—are so intertwined with other financial institutions that they cannot be allowed to fail. The complexity and interconnectedness of financial institutions is not easy to reduce, for this reason, in 2022—almost 15 years after the crisis—too big to fail is a (seemingly) politically condoned phenomenon. The structure and architecture of the financial sector have not changed substantially compared

to the pre-crisis period. Requirements for capital, liquidity and leverage ratios have become stricter, mainly because of the third Basel Accord. Comprehensive legislation has also been introduced on both sides of the ocean, aimed at increasing the stability of the financial sector, protecting consumers and investors and increasing confidence in financial companies and the sector as a whole.

The 2008–2012 financial crisis put financial stability and continuity from a micro- and macro-prudential perspective at the centre of financial supervisory law (Barwell, 2017). The Banking Union, the establishment of specialised sectoral supervisors and standard-setters and the bail-in mechanism were introduced to avert another financial crisis. The ECB's financial and monetary policy in the post-crisis years has also mainly focused on post-crisis recovery and averting a repeat. The Corona pandemic can be seen as a real-life stress test of the financial sectors, a test that the banking sector seems to have passed relatively well, given the absence of bankruptcies and large-scale insolvencies of financial institutions.

11.3 The European Regulation of ESG

11.3.1 Introduction

Financial regulation has changed significantly over the past decade. The creation of the Single Rulebook, the European Banking Union and the European System of Financial Supervision, with ESMA, EBA and EIOPA (European Commission, 2010a; European Commission, 2010b; European Commission, 2010c) serve as prime examples of the increase and expansion of European financial supervision. This development can directly be traced back to the financial crisis of 2008–2012. Initially, the European Union did not envision a Banking Union or a unified European financial market. Financial services were traditionally regulated by Member States, with the exception of the regulation of stocks and securities which are traded on international markets. Before the financial crisis, the main legal instrument of financial regulation was the EU directive, which is implemented in national legal systems. One of the critical findings during and after the crisis was that there was too great divergence in the implementation of directives in the member states, for this reason, the European legislator is increasingly opting for legislation through EU

regulations (Nelemans, 2018). Besides stability and prudential supervision, sustainability, future-proofing and effectively implementing green finance can be seen as the next big challenge for the European legislator, supervisor as well as the financial sectors themselves.

11.3.2 The Taxonomy Regulation and Sustainable Finance Disclosure Regulation

At the heart of European ESG regulation are the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation. In doing so, the European Legislator clearly wanted to create a level legal playing field in the EU. With regard to supervision, enforcement and sanctions, this is defensible, as the choice of directives would have meant creating diversity within the member states. This implementation diversity is undesirable if material and formal standards are set from a European level with an accompanying supervision and enforcement system (Garcia Rolo, 2022). The choice of EU regulations as preferred legal instrument also underlines the great importance, from a political, legal and social point of view, given to sustainable, green and socially responsible financial and listed companies.

On the grounds of the Taxonomy Regulation, an economic activity will be deemed 'environmentally sustainable' when it makes a substantial contribution to a predefined environmental objective and it doesn't harm any individual environmental objective, while complying with minimum safeguards as well as specified performance thresholds aka technical screening criteria. Goals under the Taxonomy Regulation include the identification of ecological and sustainable economic activities involving six environmental objectives: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, waste prevention and recycling, pollution prevention and control and protection of healthy ecosystems (European Commission, 2020).

Transparency is required at the entity level on how the company deals with sustainability risks. A sustainability risk is an environmental, social or governance event or circumstance that, if it materialises, has a negative impact on the value of the investment. Examples of environmental risks include physical risks such as extreme weather conditions that reduce the value of the underlying investment, or a transition risk such as the introduction of a carbon tax that could affect an investment

in a carbon-intensive sector (European Commission, 2019). In addition to the two regulations, a European Non-Financial Reporting Directive (European Commission, 2014) has also been issued and a proposal for a Corporate Sustainability Reporting Directive has been published (European Commission, 2021). This European legislation forms the block of 'hard law' aimed at the future-oriented regulation of the financial sectors and pursuing, among others, the goals laid down in the European Green Deal. There is also an extensive body of soft law in the form of ESMA, EBA, EIOPA standards and policies, UN Sustainable Development Goals, Basel Committee on Banking Supervision, Principles for the effective management and supervision of climate-related financial risks, OECD, ESG Investing and Climate Transition.

11.3.3 Balancing ESG Compliance with Other Legal Obligations

Banks and financial institutions are required to comply with a broad spectrum of, increasingly, European laws and regulations. The main regulations relate to market access and licensing, liquidity and capital requirements and governance, compliance and product supervision. This includes tough legislation on market manipulation, competition, privacy and anti-money laundering. How do the pre-existing legal obligations relate to ESG legislation and how should financial institutions act when transparency and taxonomy obligations might clash with rules from competition law and with regard to market abuse?

Another question concerns the case in which a company is in trouble. Is it, under specific circumstances, permissible to adhere to less stringent ESG standards with the aim of prioritising the continuity of the company? If the European banking sector is taken as an example, it can be argued that the Banking Union and related laws and regulations are aimed at managing systemic risks and shocks, promoting sound liquidity and capital standards, and preventing government support for failing banks through a bail-in mechanism paid for by the banking sector itself (Boogaard, 2021; Maddaloni & Scardozzi, 2022). The extensive European financial supervisory legal system was created mainly in response to crises, especially the major Financial Crises of 2008–2012. A similar development has taken place with regard to corporate governance. Because of accounting scandals at the turn of the century, notably Enron, Parmalat and Word Online, corporate governance codes have gained significance

and authority, with the aim of promoting better control, internal supervision, reliable reporting and long-term value strategy (Dobson, 2006; Kokkinis, 2015). In this respect, financial supervisory law and corporate governance are both reactionary in nature. ESG law can also be seen as reactionary, namely due to climate change and major economic, financial and societal challenges of the twenty-first century. Responding to these challenges is not only a matter and responsibility of national and European governments but also of private parties and public–private partnerships (Vecchi et al., 2022).

Within the EU, the regulations ensure a level playing field and the directives will also achieve a large degree of harmonisation, albeit in a form implemented in the national legislation of the member states. The question that can be asked is what impact European sustainability legislation will have on competitiveness vis-à-vis non-EU markets and companies. Regulatory arbitrage, where companies deliberately settle in a jurisdiction with more lenient rules, is a factor to be taken into account when discussing hard European legislation that is lacking or less stringent in other parts of the world. Responding to sustainability, future-proofing and climate change are challenges that are not limited to the borders of the European Union. For this reason, it is important to evaluate the results, positive or negative, of European legislation, including the effects on the competitive position of European companies vis-à-vis non-European market participants.

11.4 What Role Remains for Soft Law and Self-Regulation?

11.4.1 Introduction

The core of sustainable legislation in the EU is enshrined in hard law legislative instruments. In line with traditional financial regulation, the issuing of additional technical standards and further formal and substantive regulation will set further material norms for companies that fall within the scope of the sustainability legislation. Nevertheless, the question of the place and meaning of soft law regulations and initiatives in relation to ESG objectives for the financial sector remains relevant. The arguments for preserving ESG soft law largely converge with the arguments for preserving corporate governance and self-regulation in the

financial sector, in addition to formal financial supervisory law (Krug, 2015; Pacces, 2012).

11.4.2 Hard Law vis-à-vis Soft Law

Before zooming in on the positioning of soft law and self-regulation in relation to ESG goals, it is desirable to outline the advantages and disadvantages of soft law in relation to hard law (Nordhausen, 2008; Soppe, 2016).
Advantages of hard law:

- Legal certainty
- Legal protection through access to the courts
- Predictability
- In principle democratically legitimised.

Drawbacks of hard law

- In rules-based legislation, the rules may become outdated
- In principle-based legislation, further standardisation must take place
- It is less possible to respond promptly and adequately to developments that require attention
- Compliance can possibly result in 'box-ticking'
- Less input from the sector, usually a tight formal framework.

Advantages of soft law

- Flexibility, due to quick adoption and easier adaptation.
- Easier to fit into political, economic and legal systems
- Low transaction costs in the negotiation phase (as compared to hard law)
- Preservation of the sovereignty of Member States.

Drawbacks of soft law

- Non-binding status in principle

- Lesser legal protection (but see Court of Justice of the European Union—Judgement of the Court (Grand Chamber) of 15 July 2021 (ECLI:EU:C:2021:599)
- Democratic status and legitimacy of the drafting body may not be optimal
- Liability for breach of standards is not straightforward
- Supervision of compliance with soft law poses greater challenges compared to hard law.

Regulation of ESG objectives from a purely hard law perspective limits financial markets, industry associations and market participants in the ability to formulate and introduce rules and best practices from within that are appropriate and proven effective. Active and meaningful participation, based on a shared commitment to sustainability goals, has a good chance of increasing compliance and the pursuit of successful integration into corporate cultures and commercial strategies (Ferrarini, 2021). The basis of taxonomy, transparency and reporting is laid down in hard law, equipped with an oversight apparatus in which non-compliance is threatened with future sanctions. The ESG regulatory system however does not require complete governmental regulation and standard-setting. The empirical data concerning impact (positive and negative), market developments and innovation, best practices within and outside Europe and the impact of ESG compliance on the competitive position of European companies should (at least partly) come from the financial sectors (Pagano et al., 2018).

11.4.3 ESG Objectives Through Soft Law Arrangements

Soft law remains in a relevant place within sustainability regulation and the pursuit and safeguarding of ESG targets. Technical standards and policies are being issued by ESMA, EBA and EIOPA that give substance to the broadly formulated provisions in hard law (Batliner & Konzett, 2016; Gortsos, 2020). From the perspective of legal certainty, it is defensible that the European financial supervisors issue these standards and policy documents, as this makes it clearer to supervised institutions what is required of them in terms of compliance. The United Nations is a great catalyst and inspiration in terms of global priority for climate, sustainability and ESG goals. The UN Sustainability Goals have no force of formal law but are nevertheless leading in terms of content and the

recommendations and goals of the UN can be converted into hard law, so that through this transformation process they can be given hard law status in the second instance. An example of such a transformation is the way the Basel accords for banks have been transformed into formal European legislation. Basel III has been the main source for the CRDIV package that forms the basis of the European Banking Union (European Commission, 2013a; 2013b).

For financial institutions, reputation, trust and a good relationship with the regulator and supervisor are very important. Political, social and legal opinions in the EU have evolved in a way that financial institutions are expected to be committed to long-term value creation, sustainable and socially responsible business practices and finance (Sun et al., 2011). Long-term value creation, internal control and compliance with laws and regulations not only to the letter but also to the spirit of the law are priorities that are here to stay (McBarnet, 2010). Just as the tightening of financial supervisory law was aimed at preventing another crisis and increasing the shock resistance and financial health of banks and other financial institutions, ESG legislation is aimed at making financial sectors an active part of responses to climate change, sustainability goals and other pressing social and economic concerns. Leveraging soft law to complement the hard law basis offers a number of distinct advantages. These include the possibility of standardisation and certification by branch organisations. If certain sustainable and green products or services can only be offered after they have been approved by a branch organisation, this will achieve a goal that converges with government objectives in this area.

11.5 Towards Green Corporate Governance

11.5.1 Introduction

Corporate governance basically regulates the relationship between actors within a company, in particular, shareholders, directors and commissioners (Nelemans, 2018). Corporate governance initially took shape in codes of conduct resulting from self-regulation. The formulation of principles and best practices expressed desirable views on good corporate governance. The actions of the management board, supervisory board members and shareholders of companies are standardised in codes, in addition to the

provisions of formal laws and regulations. Governance codes are generally operationalised through the use of the 'comply or explain' principle. The principles of Corporate Governance codes should be considered in conjunction with international, European and national formal laws and regulations, jurisprudence and codes.

Corporate Governance Codes in European member states do, in general, not themselves have provisions dealing with the legal consequences of non-compliance. Non-compliance with corporate governance codes is not threatened with sanctions. A difference can be noted here with the US Sarbanes Oxley Act, especially section four. Research by SEO Economic Research (Conac, 2021; SEO, 2012) shows that in the UK, Germany and Italy, corporate governance regulation is also a combination of public and private regulation. In Ireland, France and Sweden, it is pure private regulation and in the United States public regulation. Monitoring of compliance with corporate governance regulation is exercised in Germany, France, Italy and the United Kingdom, like the Netherlands, by organisations with public and private characteristics. In Ireland and Sweden, a private organisation is in charge of monitoring, and in the United States monitoring is done by a government institution. Supervision and sanctioning do not take place in the Netherlands, Germany, France and Sweden. Ireland has a private supervisor, the United Kingdom a public/private supervisor and the United States and Italy a government supervisor.

11.5.2 Four theories of Corporate Governance

An unequivocal theory of corporate governance cannot be given. Since the development of the principal-agent theory by Jensen and Meckling (1976) three other theories of corporate governance have been developed. Galle (2012) compared and explained the four common theories of corporate governance:

1. In the principal–agent model, the separation of ownership and governance raises problems, as shareholders (principals) depend on the decision-making of directors (agents). The interests and objectives of shareholders do not match the interests of directors at certain points. Shareholders are focused on maximising 'return on investment', both with respect to the value of their shares and dividends, while directors seek high salaries, bonuses or social status.

Classical agency theory focuses on maximising shareholder interests and curbing opportunism by directors.

2. In classical principal–agency theory, shareholders' interests should be maximised and directors' opportunism controlled. Stewardship theory opposes this premise and places more trust in directors. The underlying idea is that people are not only driven by individualistic and opportunistic interests but that collective interests and trustworthiness are also drivers of people. Stewardship theory assumes a more positive approach to executives, with the premise that behaviour that is focused on the collective will be beneficial for organisations and should be preferred to individualistic behaviour focused on self-interest.
3. Corporate governance considered from the perspective of transaction costs economics sees the company as a structure with internal transactions and agreements. Because there are costs associated with using markets and a desire for certainty, contracts are used to optimise these processes and needs. Because of transaction costs, contracts between principals and agents are incomplete and a governance structure is needed to fill in gaps in these contracts.
4. Stakeholder theory is ideologically at the opposite end of the spectrum to principal–agent theory. It takes into account not only the interests of the shareholder but the interests of all stakeholders involved in the company, such as employees, the government and the environment. In the United States and the United Kingdom, corporate governance has traditionally been approached from the interest of shareholders, while in Europe the focus is more on a company's stakeholders; the Anglo-Saxon model vs. the Rhineland model (Sison, 2008; Solomon & Solomon, 2004).

11.5.3 Integrating ESG into the Stakeholder Theory

If one takes the stakeholder theory of corporate governance as a starting point, current and future sustainability and green finance objectives can be projected into it without much hindrance. The governance of financial institutions evolved after the 2008–2012 financial crisis and there is no formal or conceptual limitation that prohibits it from further evolution and incorporating sustainability goals. ESG objectives lend themselves

to integration in corporate governance codes because they allow principles and best practices to be formulated that anchor ESG in the business culture, human resource policy, suitability and fitness criteria for managers, risk management (especially operational and climate risks) and, very importantly, the way in which internal supervision and control are regulated and guaranteed (Luca Riso, 2021). If the annual report, using the comply or explain principle, also explains green corporate governance and how ESG objectives have been met, the market and external regulators can respond and evaluate performance. As is also the case with traditional corporate governance, compliance or problems in this area can have an impact on the share price, market value, competitive position and creditworthiness of institutions. From these viewpoints, ESG and Green Finance lend themselves well to integration into corporate governance systems.

11.6 Integration: Towards Multilevel ESG Regulation

11.6.1 Introduction

Multilevel regulation is not a new phenomenon within the financial sector. International financial regulation largely consists of soft law arrangements, as the issuing institutions do not have formal legislative powers (Mackor, 2018). Within the EU, supranational financial regulation has taken place, especially since the Maastricht Treaty, in the form of directives and regulations. During and after the financial crisis, the European legislator lost some faith in the effectiveness of directives, which is reflected in an increasing use of regulations as a preferred legislative instrument aimed at creating a level playing field in European economic and financial markets (Colaert & Busch, 2019; Moloney, 2014). Alongside the core of hard financial law, there is undiminished scope for soft law and self-regulation. Examples include codes of conduct, disciplinary law, dispute resolution, education and training and self-assessments and reporting.

11.6.2 The Integration of ESG in Multilevel Governance

Green finance and ESG lend themselves well to integration in a multilevel system (Monciardini, 2017), the following arguments can be made for this:

1. there is a need for data and facts on the success or failure of ESG targets. Which measures, investments and market practices have had a positive impact on sustainable and climate-related goals and which a negative one? Legislators and regulators benefit greatly from this data so that policy and supervision can be 'evidence-based' as much as possible. The financial markets are a primary source for this data and the systems needed to collect, process and share this information lend themselves to privatisation and/or public–private partnership.
2. The economic and financial performance of green investments and developing, optimising and possibly making green finance preferable can emerge from sectors bottom-up. As markets and companies move towards standards in sustainable and green investment and business practices, this converges with the objectives of governments and legislators. Self-regulation and soft law arrangements can help set up a system by which a significant contribution can be made, in a way that industry codes, disciplinary law and certification also do.
3. In a system of multilevel regulation, there is room for public–private cooperation and coordination of objectives. If the government, in part, acts in a more horizontal way in partnership with private sectors, fruitful results can emerge from these initiatives. Setting up organisations in which the government and private sectors are both represented, aimed at achieving ESG objectives and high-quality green finance goals, can be a form in which cooperation takes shape.
4. Private cross-border cooperation and exchange of ESG knowledge, networks, best practices and success formulas have the potential to add value compared to strictly national approaches to ESG integration. Such cross-border cooperation should not be hampered by formal rules and should be allowed to develop where opportunity presents itself.
5. The impact of ESG and Green finance regulation on the competitive position (within and outside the EU) and solvency of European companies is valuable information for regulators and legislators and can provide grounds for adapting or strengthening sustainability legislation. Constructive dialogues between financial sectors and the government are important in light of this information exchange.
6. In addition to public laws and regulations, there may be a meaningful role for private law, especially liability law. If the damage caused to the environment and climate becomes apparent and, causally, it can be established who is liable for it, the route of

tort law is open. Companies whose commercial practices or investments cause climate damage would be held liable for this, depending on the national private law of the Member State in question. In particular, collective actions could be envisaged where victims and foundations join together in holding a polluting party liable for the damage (Dooh vs. Shell, 2021).

11.6.3 The Advantages and Vulnerabilities of Multilevel ESG Regulation

First and foremost, within a system of multilevel ESG regulation, effective and efficient action must be taken against abuses such as greenwashing (Rizzello, 2022). This practice leads to unfair competition, undermines ESG objectives and deceives investors, direct stakeholders and society as a whole. The persistent problem of greenwashing will most likely only be effectively addressed through a sufficiently compelling system of supervision, enforcement and sanctions (Nurse, 2022). The temptation to invest in environmentally damaging assets and to assign unjustified green status to assets for accounting purposes is probably too great for some market participants. This should include looking at how legislation on fraud and corruption and economic crimes already contains provisions applicable to failing ESG and Green finance legislation.

An integration of ESG into corporate governance was discussed and the same argument can be made for an integration of ESG and Green finance into traditional prudential supervisory law and integrity supervision. As soon as it becomes apparent for financial sectors that climate risks entail micro and/or macro-prudential risks, this should be anticipated. An example is major climate disasters such as floods and their impact on (re)insurers and banks (Reumers & Nelemans, 2022). If the claims exceed the capacity that an insurer can handle, or a large number of companies go bankrupt, possibly causing banks to default on their loans. Then, apart from serious social and economic damage, there are also prudential risks for financial institutions as a result of a climate disaster. The question of when climate risks can qualify as systemic risks is beyond the scope of this chapter, but merits further investigation (De Sousa, 2022; Hochrainer-Stigler, 2020; OECD, 2022).

It is important for financial companies to know how to act if their own continuity is threatened and solvency and liquidity come under pressure.

If a financial institution comes under pressure, are there possibilities to temporarily relax ESG obligations? This issue needs attention because it represents an unavoidable stance on how integrally and inextricably ESG objectives should be built into companies' financing, governance, products and market practices. This also involves the inevitable question of the competitive relationship between European companies on the one hand and non-European companies on the other, which may be subject to more lenient ESG requirements. What are the options of a financial institution in trouble, when non-green business practices may prove a route to faster recovery of financial health? The role of central banks and a possible sector-funded rescue fund may prove to be viable answers (Baur, 2021; Migliorelli et al., 2020).

11.7 Conclusion

In international financial regulation, soft law has taken a firm foothold. In Europe in particular, the choice has been to transform soft law norms into hard law, combined with the installation of specialised supervisors and the threat of sanctioning for non-compliance. In terms of stability, shock resistance and integrity of European financial sectors, practice has shown this to be a successful legal approach. Within financial supervisory law, not all areas are regulated through hard law. There remains room for regulation through corporate governance, disciplinary law, internal supervision, professional organisations and related self-regulation. The challenge was and remains to identify which issues should be regulated through hard law. In prudential supervisory law, these are liquidity and capital requirements, licensing requirements, transparency obligations, suitability requirements, market behaviour and consumer protection. In the EU, as a response to the climate crisis and pressing social and economic concerns, the traditional spectrum of financial supervision law and regulation has expanded to include sustainability, green finance and ESG legislation. Against this background, this chapter sought to answer the question of which ESG objectives for financial institutions lend themselves to self-regulation and soft law, complementary to the hard law framework.

In a non-ESG setting, the argument can be made that strategy, risk appetite, product development, market-competitiveness, human resources, culture and internal supervision/audits are topics that lend themselves well to self-regulation. Such a dichotomy would also be useful

for a selection of ESG objectives and the furthering of Green Finance, so that the best of both worlds can be achieved. National and European regulators benefit from constructive feedback and reporting from markets and institutions. This information could impact the standard-setting and subsequent integration of ESG into institutions' operations and culture, and the evaluation of whether targets have or have not been met.

The challenges facing a multilevel approach to ESG are not insignificant. Greenwashing understandably gets a lot of attention, as it undermines the status and trustworthiness of ESG and Green Finance initiatives. European legislation aims to effectively identify and combat greenwashing. A robust monitoring system and corresponding sanctions apparatus seem inevitable, especially with regard to those companies that try to use greenwashing to avoid legal and regulatory obligations. Another challenge concerns the imbedding of transparency and taxonomy obligations in relation to already existing extensive financial legislation, especially in the areas of market abuse prevention and competition law. Legislators and regulators on the one hand and private/financial sectors on the other could dialogue with each other to provide an effective and efficient response to these future regulatory challenges. Anticipating potential conflicts between ESG legislation and pre-existing laws as well as the status of ESG compliance in cases of (imminent) insolvency will increase the success and resilience of ESG goals and the realisation of future ambitions.

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CHAPTER 12

Environmental, Social and Governance Criteria in the Netherlands: Interaction Between Government and the Courts

Bastiaan D. van der Velden

12.1 Introduction

Environmental, Social and Governance (ESG) criteria can serve as a standard for companies to measure their performance and the performance of their contracting partners, and for private investors and pension funds to decide if they want to be involved in certain companies. The EU as well as the Dutch government promote ESG as a mechanism to accelerate, for example, the energy transition.[1] Other stakeholders from the industry are more reluctant to use ESG as formal criteria. With the court proceedings establishing liability of companies for damage caused due to their

[1] For example, in the 'Convenant Internationaal Maatschappelijk Verantwoord Beleggen in de verzekeringssector' (5 July 2018) of the Dutch government and the Verbond van Verzekeraars en Zorgverzekeraars Nederland.

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impact on climate change and the obligatory disclosure of information on significant environmental, social and governance aspects of the company's business operations, there might be an incentive to act. In recent years not only the Dutch State in the Urgenda court case, but also private companies are held liable in court for their share in the damage caused due to harmful climate change, and companies non-acting in response to this. The Dutch lawyer Klaas Rozemond calls the use of the courts by NGO's to enforce a breakthrough in the climate debate a 'legal revolution'. When politicians do not set the goals, citizens must go to court in this legal revolution: unite and litigate to protect health of the citizens and nature in the Netherlands (Rozemond, 2022). It must be added that even an impending litigation is an incentive for parties to act.

I will discuss the interaction between the government and the courts in the Netherlands in the past years in the climate change and energy transition debate.[2] How can private law play a decisive role to realize the goals set in the ESG criteria, when government and administrative law are failing?

12.2 Hard Law: The Social of ESG

Social criteria look at the company's business relationships with internal and external stakeholders. Does the company work with suppliers that hold the same values as it claims to hold? Does the company donate a percentage of its profits to the local community or encourage employees to perform volunteer work there? Do the company's working conditions show high regard for its employees' health and safety? Are other stakeholders' interests taken into account? The Social of ESG is hard to define according to several ranking companies: 'A lack of consensus in the industry surrounding what constitutes the "S" makes it harder to incorporate into investment strategies compared to both the "E" and "G"' (Neilan et al., 2020). Several key elements of the Social of ESG are nonetheless mandatory laws. In labor law relations mandatory law protects the interests of vulnerable employees, balancing the strong negotiation power of companies. The fact that online services providers have a new business concept when they create platforms to connect businesses and consumers, does not mean that it is legally sound only because it is a

[2] The research for this paper takes development up to November 2022 into account.

new concept. Uber and other service providers contract with third parties to perform services like taxi transport. These self-employed do not sign an employment contract but work as an independent contractor for Uber.

Cab drivers who have a contract with online taxi services provider Uber and who transport passengers via the Uber app were contracted as 'self-employed' workers, not covered by the Collective Labor Agreement for Taxi Transport, nor were the employers' costs (tax) paid. The legal relationship between Uber and these drivers has nonetheless many of the characteristics of an employment contract. Dutch case law uses several criteria to identify a labor contract, first comes the intent of the contracting parties. In the second place, the question is raised if the employer has the authority to give the person substantive instructions about how the work should be performed (ECLI:NL:HR:1997:ZC2495). Also, facts about how the person is embedded in the organization, to what extent the person's activities correspond to the other employees in the company, can play a role. And finally the social position of the parties.

The Amsterdam court decided on September 13, 2021, that Uber must operate under the same mandatory law rules (Collective Labor Agreement or CAO Taxivervoer) as other technology platforms who employed so-called ZZP self-employed people (ECLI:NL:RBAMS:2021:5029). The legal relationship established between Uber and the taxi-drivers fulfills all the criteria of a labor contract: once the taxi-driver use the Uber app and are logged in to it, they are subject to the operation of the algorithm designed by Uber, and are therefore subject to a 'modern employer authority' of Uber.

In a court case against the online food delivery platform Deliveroo initiated by the trade union FNV, the Amsterdam Court of Appeal ruled in February 2021 that deliverers working for this company are not self-employed and are entitled to an employment contract. The Court not only took into account the legal definitions of labor contracts in its judgment but also the effect of low wages and lack of employment benefits on a group of workers who need extra protection. Unemployment and disability benefits are not provided for and social security contributions are not paid, which is a potential burden on society as a whole (like the pension fund there are aspects of a 'mandatory solidarity buffer' involved as a burden of the freedom of contract). Deliveroo is obliged to pay for overdue premiums since its 'independent ZZP

entrepreneurs' are de facto employees (ECLI:NL:GHAMS:2021:392 see also ECLI:NL:GHAMS:2021:3978 & 3979).

In February 2023, the Advocate General of the Supreme Court advised that the Amsterdam Court of Appeal sentences should be upheld (ECLI:NL:PHR:2023:224 & 225 see also ECLI:NL:PHR:2022:578). Deliveroo has ended its activities in the Netherlands as of November 2022.

Social dumping is another aspect of labor relations. After a long legal procedure, the Arnhem Court of Appeal has confirmed that Dutch labor law applies to the employment conditions of foreign drivers who de facto drive for companies in the Netherlands. This means that the collective labor agreement for professional road transport also applies to them and 'social dumping' is not allowed. The drivers are entitled to 'Dutch wages' instead of the much lower wages that they received via a foreign subsidiary of the Dutch company (ECLI:NL:GHARL:2021:7206). These elements of the Social of ESG are mandatory law, there is no need to discuss a lack of consensus in the industry.

12.3 Urgenda Court Case

The recent court cases in The Netherlands where companies are held liable for environmental damages find their origin in the so-called Urgenda court case. The Urgenda foundation ('Urgent Agenda') started in 2013 a court case to have the Dutch government taking action by implementing policies to reduce the emission of greenhouse gases by at least 25% by the end of 2020 compared to 1990 (Besselink, 2022; Wewerinke-Singh & McCoach, 2021). The goal of the Urgenda foundation is according to its articles of incorporation to stimulate and accelerate the transition processes toward a more sustainable society, starting in the Netherlands. Urgenda argued that under Dutch tort law (art. 6:162, par. 2 BW), the absence of government policies to reach a substantial reduction was a breach of a duty of care as formulated in the tort paragraphs of the BW. There was some support from the side of the government. In his letter of December 11, 2012, the State Secretary for Infrastructure and the Environment shared Urgenda's concerns over the absence of sufficient international action. In 2013 Urgenda and 886 citizens brought their claim pursuant to Art. 3:305a BW, which enables interest organizations to bring class action suits.

The District Court decided in the first instance in 2015 in favor of Urgenda: not developing policies to reduce CO_2 is a breach of a duty of care (ECLI:NL:RBDHA:2015:7196). The District Court applied for their interpretation of the open norm of Art. 6:162, par. 2 BW and the specific criteria laid down in the Supreme Court Kelderluik judgment of 1965 (ECLI:NL:HR:1965:AB7079). The liability under art 6:162 BW can be a conduct against the law, or against unwritten norms. The court now had to formulate a new but unwritten standard; there are not yet laws formulating a norm. To constitute a duty of care, the court used the duty of care standard as formulated in the Kelderluik judgment; these criteria were among others:

1. How likely is non-observance of the required vigilance and caution?
2. What is the chance that this non-observance will lead to an accident?
3. How serious could the consequences of this non-observance be?
4. How difficult is it to take the necessary security measures?

The question to answer in court was what the chance is that this lack of policies will lead to an accident; a question that was answered with a pile of scientific reports, mainly published by the Intergovernmental Panel on Climate Change (IPCC), a scientific body established by the United Nations Environment Program (UNEP) and World Meteorological Organization (WMO) in 1988, under the auspices of the UN. The Netherlands Environmental Assessment Agency (PBL), the Royal Netherlands Meteorological Institute (KNMI), and the Emissions Database for Global Atmospheric Research (EDGAR) supplied additional data with regard to this question. Also, several international law instruments dealing with climate change, like the 1992 UN Framework Convention on Climate Change and Conference of the Parties, the Kyoto Protocol 1997 and its Doha Amendment 2012, and the Treaty on the Functioning of the European Union were taken into account. Furthermore, the question how serious the consequences could be has been answered on the basis of scientific reports.

How difficult would it be for the Dutch state to take the necessary security measures? There were a series of possible policy measures, but the Dutch state stayed inactive with the Calimero-argument that other states had a larger share in the problem, so its little country could not do much. The conclusion of the court was that, given the severity of the

impact of climate change and the significant chance that—unless mitigating measures are taken—dangerous climate change will occur, the State has a duty of care to take mitigating measures. Postponing the mitigation as advocated by the State—a less stringent reduction between now and 2030 and a sharp reduction starting in 2030—will significantly contribute to the risk of dangerous climate change and therefore cannot be deemed a sufficient and acceptable alternative to the scientifically proven and acknowledged higher reduction path of 25–40% in 2020 (para. 4.85).

The Court of Appeal in 2018 also decided in favor of the Urgenda in the court case against the Dutch State (ECLI:NL:GHDHA:2018:2610). In appeal, the argument that there was a breach of Art. 2 and Art. 8 of the European Convention on the Protection of Human Rights and Fundamental Freedoms (ECHR) was accepted as well by the court.

The Dutch state was not willing to accept this judgment and appealed for cassation. The Dutch Supreme Court is a court of cassation and therefore does not decide on the facts of the case but does only consider whether the lower court applied the law correctly. A key question in appeal was to what extent civil society groups can (via a court procedure) impose such a court order upon a state, taking into consideration the *trias politica*-principle and its division of powers. According to the court in the first instance, the reduction order sought by Urgenda does not constitute an order to the State to take explicit legislative or strict policy-making measures. The State and its government will retain full discretion to determine how and in what way to comply with the court order (par. 4.101).

On September 13, 2019, the Procurator General F.F. Langemeijer and Advocate General M.H. Wissink of the Supreme Court advised that the District Court and the Court of Appeal sentences should be upheld (ECLI:NL:PHR:2019:1026). The Supreme Court decided in the same way on Friday, December 20, 2019 (ECLI:NL:HR:2019:2007). Worldwide this was the first successful tort action against a government related to climate change.

12.4 Milieudefensie vs. Shell

Not only the Dutch state but also private companies are held liable for their share in the environmental damage caused by their industry. In a letter dated April 4, 2018, to the CEO of Royal Dutch Shell plc, the Dutch foundation Milieudefensie holds the company liable for the tort.

According to Milieudefensie, Shell's activities are 'a danger to humanity, human rights, future generations and the environment'. Milieudefensie demands that Shell align its policy and investments with the Paris Climate Agreement and therefore reduce its emissions to zero by 2050.

On April 5, 2019, Milieudefensie, together with more than 17,000 co-plaintiffs, handed over a summons at the District Court of The Hague. The first hearing days were on December 1, 3, 15 and 17, 2020. In 2021, the District Court of The Hague held Royal Dutch Shell plc liable (Krommendijk, 2022; Mayer, 2022). Emissions must be reduced by almost half by 2030. According to the Dutch court, Shell must reduce CO_2 emission by 45% by 2030 for every emission that is generated by the production of oil and gas and its processing—in economic terms: scope 1 and 2.[3] Furthermore, it must reduce to the same level also for products they produce, such as gasoline, which fall under scope 3. The Corporate Value Chain (scope 3) Accounting and Reporting Standard allows companies to assess their entire value chain emissions impact and identify where to focus reduction activities. The reactions to this court decision seem manifold, but do not directly result in new policies by Shell. To fulfill the Dutch court decision Shell targets to reduce the CO_2 emissions of their operations (scope 1 and 2) by half by 2030 compared to 2016. Shell is investing in renewable energy, providing homes and companies with wind and solar energy. Globally Shell operates almost 90,000 electric vehicle charge stations and its aim is to increase this to more than 500,000 by 2025. Shell will invest more in renewable sources but has hardly plans to reduce the companies' oil and gas production. Shell is not willing to acknowledge responsibility for the reduction of the CO_2 emissions generated by the products they produce and sell (scope 3).

In the short term, investors on the stock exchange reacted slightly negatively on the day of the verdict in the lawsuit filed by Milieudefensie against Shell.[4] A 220 pages appeal was filed by the lawyers of Shell against judgment on March 22, 2022.

[3] The Scope 2 Guidance standardizes how corporations measure emissions from purchased or acquired electricity, steam, heat and cooling.

[4] 'Shell achteruit op beurs na vonnis', *Telegraaf*, 26 mei 2021. The company also announced they will leave The Netherlands.

12.5 Annual Reports

As a result of the Shell court ruling, it became clear that companies must provide more and trustworthy information about mitigating climate risks and possibly depreciating assets in their annual reports. When companies provide information, accountants must check more closely to what extent such information is correct.[5] Art. 2:293 par. 3 BW indicates the role of the accountant in the annual report. The accountant must examine whether the annual accounts have been prepared in accordance with the law, whether the annual report is in line with the annual accounts, and whether the annual report 'to the extent that he is able to assess' contains material inaccuracies in the light of the knowledge and understanding obtained during the examination of the annual accounts taking into regard knowledge of the legal entity and general knowledge. Next to the mandatory elements of the annual report, companies can decide to accept accountability for higher standards (with regard to climate risks and other ESG criteria).

There is some data on non-financial information in the annual reports of Dutch companies. In the 2019 financial year, 48 of the 50 (number of analyzed reports) of the annual reports of Dutch AEX/AMX listed companies (96%; 2018: 88%) contained sustainability information.[6] Half (52%, 2018: 48%) of the AEX/AMX listed companies included in this survey, provided the auditor with a separate instruction to verify the non-financial information on top of the legal requirement of art. 2:393 BW. Companies that did not provide non-financial information were challenged by institutional investors to provide accountant-verified data. The employment agency Randstad was asked by Stichting Pensioenfonds Rail & Openbaar Vervoer, a pension fund for public transport, whether the company had plans to have the sustainability information in the annual report verified by an external, independent party.[7]

In the 2020 annual report of Shell, the chapter on legal proceedings and other contingencies mentions: 'In the Netherlands a case has

[5] Shell-vonnis dwingt bedrijf en accountant sneller werk te maken van klimaatdoelen, *Financieel Dagblad*, 7 juni 2021.

[6] https://www.nba.nl/dashboard/maatschappij/niet-financiele-informatie-in-de-jaarverslagen-van-beursgenoteerde-bedrijven/.

[7] https://www.randstad.com/s3fs-media/rscom/public/2020-06/randstad-ava2020-vragen-ss_spov.pdf.

been filed against Shell by a group of environmental non-governmental organizations (eNGOs) and individual claimants seeking a court order that emission levels from Shell's activities and sold energy products are unlawful and that by 2030 it should reduce those emissions by least (net) 45%, alternatively 35 or 25% (as compared with 2019 levels)'.[8] The auditor's report of EY auditor Allister Wilson, as included in the Shell 2020 financial statements published on March 11, 2020, points to the increase in risk of misstatements in the financial statements in 2020 compared to 2019 due to increased attention to climate change among investors and regulators. According to the accountant: 'To fulfil the aspirations of the Paris Agreement, Shell's strategy will need to continuously evolve as the world economy transforms itself. For example, for Shell to reach net-zero emissions by 2050, it would also be necessary for Shell's customers to decarbonize. Importantly also, Shell has reported in Footnote 2 to the consolidated Financial Statements that their operating plan and pricing assumptions do not yet reflect Shell's 2050 net-zero emissions target. For these reasons, it is neither possible nor appropriate for EY, as Shell's auditor, to attempt to provide in our audit opinion Paris-aligned assumptions that are not in our remit to determine, and the impact that any such assumptions might be expected to have on the financial statements'.[9]

Greenwashing has become a risk of fraud for the accountant's annual audit, certainly when it concerns uncertainties of long-term risks and opportunities related to systemic challenges (Kaplan et al., 2021). This can include *commitments* made by companies in their Annual Report, for example, that they will be climate neutral in a certain year in the future.[10] Verification of feasibility of the ways this can be achieved is difficult for the accountant. Rules codified in law and accounting standards could help the accountant. Initiatives to include non-financial reporting are manifold in recent years, lets only focus on some EU instruments. The so-called Non-Financial Reporting Directive (NFRD, Directive 2014/95/EU) formulates rules on disclosure of non-financial and diversity information by certain large companies. On December 14,

[8] Annual Report and Accounts for the year ended December 31, 2020, Royal Dutch Shell PLC.

[9] Annual Report and Accounts for the year ended December 31, 2020, Royal Dutch Shell PLC, p. 203.

[10] https://www.accountant.nl/discussie/opinie/2021/3/greenwashing-als-frauderisico-voor-de-jaarrekeningcontrole-van-de-accountant/.

2022, the European Commission adopted a Corporate Sustainability Reporting Directive (CSRD, Directive 2022/2464, entered into force on January 5, 2023), which amends the existing reporting requirements of the Non-Financial Reporting Directive and envisages the adoption of EU sustainability reporting standards.

In the Dutch legal literature, a manifesto has been published by 25 professors in company law, with the aim to introduce a 'responsible corporate citizenship' in Dutch corporate law (Mayer, 2013, 2018; Winter et al., 2020). A broader definition of the purpose or *raison d'être* of the company should be introduced, making it possible for companies to state their goals in the founding paperwork. The objective of the company is mainly or exclusively based on financial objectives for the benefit of shareholders at this moment. In the French *Loi PACTE* such broader objectives are codified (De Jongh, 2020). In the South African King IV-Code it is codified that 'the governing body should ensure that the organization is and is seen to be a responsible corporate citizen'.[11] The way to introduce such broader goals of the company and a responsible corporate citizenship into Dutch law, for example, is an option to include it in the general administrative task (*algemene bestuursopdracht*) of Art. 2:129/2:239 par. 5 BW and the task description of the supervisory board in Art. 2:140/2:250 par. 2 BW.

Since a couple of years, Companies have to show their efforts in this field. An example of a new regulation is the *Non-financial reporting Directive* (2014/95/EU), which applies to annual reports for financial years starting on or after January 1, 2017. This Directive has been implemented in the Netherlands through the Decree on the publication of non-financial information and the Diversity Disclosure Decree.[12] Under this Directive companies with more than 500 employees are required to disclose material information on significant environmental, social and governance aspects (Kloosterman & Kuilman, 2018). The European Commission introduced in February 2022 as part of a Proposal for a Directive on corporate sustainability due diligence (CSDD) a duty of care, fostering sustainability in corporate governance and management systems. Since

[11] Institute of Southern Director, King IV Report on Corporate Governance for South Africa (2016), www.iodsa.co.za/resource/resmgr/king_iv/King_IV_Report/IoDSA_King_IV_Report_-_WebVe.pdf (consulted on May 2, 2020), Principle 3.

[12] Besluit bekendmaking van niet-financiële informatie (Nonfinancial reporting decree) and Besluit bekendmaking diversiteit (Diversity reporting decree).

this must become national law in the EU member states, a first step toward a positive law norm has been set.[13]

When consultancy companies, governments (national & EU) or parts of civil society represented in the Dutch polder model (see below) introduce soft law instruments like ESG norms as a gentleman's agreement, or even as a legislative instrument, next to penal, administrative and private law norms, the administrative burden will rise for companies. Legal uncertainty will govern this field, definitely when those involved in the assessment of the ESG norms give the impression that the set of ESG norms can be mixed like the soundscape on a mixing console.

As of March 2021, the new EU Sustainable Finance Disclosure Regulation [EU-SFDR] came into effect, as a part of the Action Plan on Financing Sustainable Growth of the European Commission, introducing a EU-SFDR Taxonomy.

The transparency obligations follow from the EU-SFDR category chosen by the 'financial market participant'. The EU-SFDR distinguishes between (1) financial products that promote environmental or social characteristics and (2) financial products that aim to make sustainable investments. The third category is financial products that are not promoted as sustainable. It is like an accreditation, the company has to choose goals (certain obligatory, others from a menu) and provide information on how they will fulfill these criteria. Pension funds have problems obtaining reliable ESG reports from their external asset managers. This is particularly difficult in the field of private equity and emerging markets debt (Bfinance, 2021).

In par. 9 the Preambule SFDR states: 'Furthermore, the lack of harmonized rules relating to transparency makes it difficult for end investors to effectively compare different financial products in different Member States with respect to their environmental, social and governance risks and sustainable investment objectives. It is therefore necessary to address existing obstacles to the functioning of the internal market and to enhance the comparability of financial products in order to avoid likely future obstacles'.

A private investor can decide at all times to invest assets in an investment fund or directly in a company based on self-chosen ESG standards. Participation in a pension fund in the Netherlands is mandatory and the

[13] The Dutch parliament is working on a proposal for a law on Responsible and Sustainable International Business.

applicable pension fund depends on the branch one is working in. There is no freedom to decide and choose a pension fund nor the option of choosing a fund applying ESG standards (or better: with ESG standards conform the intention of the investor). Participation is mandatory, and the influence on the investments of the pension fund is limited.[14] The fact that participants in the ABP pension fund cannot terminate their contract is very likely in violation of EU law, argues Hans van Meerten, professor of European pension law at Utrecht University, in the first place because foreign pension providers have no access to the Dutch market of *bedrijfstakpensioenfonds* (branch of an industry pension fund).[15] The mandatory aspect is also contrary to the freedom of contract, although the 'mandatory solidarity buffer' could be a legitimized ground to make participation obligatory, it seems that participants ought to have a vote in the way their assets are invested.

The path chosen by the Sustainable Finance Disclosure Regulation is maybe introducing a level playing field for citizens choosing between financial market participants who offer products, but the completely closed Dutch pension funds world is not a market (probably many do not want to see it as a market), with its mandatory participation in a pension fund due to working in a certain sector, pre-contractual disclosure is useless, and disclosure on websites maybe informative, but in no way changing pension funds in a direction preferred by the participants.

12.6 Influence on ESG Policies of Companies in Annual Meetings

It is possible to exercise a certain influence on the companies by voting in annual meetings. Dutch company law in the Civil Code (BW) prescribes that a general meeting of a limited company must be held at least once a year, within six months after the end of the financial year, in connection with the adoption of the annual accounts (Art. 2:109 BW, for the NV; Art. 2:219 BW, for the BV). All shareholders must be summoned by letter to that shareholders' meeting. The agenda for the shareholders' meeting

[14] When a civil servant has any conscientious objection to any form of insurance, the person can request not to have to participate in the ABP pension scheme. Chapter 11 Pensioenreglement ABP.

[15] https://www.ftm.nl/artikelen/fundament-pensioenstelsel-kraakt; https://www.uu.nl/opinie/blog-vertrek-uit-het-abp; EU Hof zaak 67/96 (Albany).

must be stated in the so-called convocation letter (Art. 2:114 lid 1 BW for the NV; Art. 2:224 lid 1 BW for the BV). The convocation letter must in principle be sent at least fifteen days before the day of the shareholders' meeting. Shareholders who alone or jointly own at least 3% (in the case of an NV) or 1% (in the case of a BV) of the issued capital, have a right to request in writing that a subject is placed on the agenda and must be discussed during the general meeting (Art. 2:114a BW for the NV and 2:224a BW for the BV).

The Dutch company Shell has a long history with activist shareholders. Since the mid-1980, the annual meeting was the sage for shareholders to demand the withdrawal of Shell from Apartheid-dominated South Africa.[16] NGO's like Komitee Zuidelijk Afrika, Novib and Pax Christi were involved.[17]

Since 2016, the six thousand shareholders of Dutch petrol giant Shell, united in Follow This, have been trying to get Shell on a greener path. In 2021 Shell's climate policy is on the agenda for the fifth time in six years at Shell's shareholders' meeting.[18] The ABP pension fund and asset manager Robeco are the only large Dutch investors who still support Shell's own climate policy.[19]

12.7 Industry Opposed to a 'Duty of Care' in Legislation

Large Dutch companies and employers' organizations are resisting legislative projects that aim to lay down a social duty of care in legislation. The employers' organizations and related lobby groups successfully countered a plan of a group of professors to legislate criteria for CEOs to behave as 'responsible citizens'. The committee that reviews the code for good corporate governance proposed to make an amendment, stating that companies must account for environmental effects, inequality, diversity,

[16] 'Shell zoekt steun aandeelhouders voor beleid Zuid-Afrika', *NRC*, 11 May 1988. S.A. Meijer & Kees Leidelmeijer, 'Zuid-Afrika-vrij beleggen', *Economisch statistische berichten*, 1990, 75(3739): pp. 18–19.

[17] Komitee Zuid Afrika was an NGO with an active anti apartheid program, Novib is the Dutch branch of Oxfam, Pax Christi a World Peace organisation.

[18] *Trouw*, 16 mei 2021.

[19] 'De meeste grote Nederlandse beleggers steunen Follow This, behalve pensioenreus ABP', *Volkskrant*, 9 June 2021.

job and income security and the inclusiveness of their policies. A draft version was challenged by stock exchange companies. They fear that such a standard will lead to many lawsuits initiated by interest groups.

For years, the Dutch employers' organization VNO-NCW has been a fervent opponent of the introduction of ICSR legislation. Adhering to international standards for corporate responsibility was important to the lobby club, but binding rules were definitely not the right way to achieve this. The position of VNO-NCW on its website in 2021 was clear: 'Acceleration of sustainable or corporate social responsibility cannot be achieved through legislation'. According to VNO-NCW, it would be better to invest in voluntary covenants and gentleman agreements. According to VNO-NCW legislation would not be the right way to make companies invest in responsible business in their whole production chains.

Legislation and regulation are coming, but the Shell court case made it clear that without positive law action within the framework of annual reports and the mandatory inspection by accountants is needed. In the professional press and on websites where the issue is discussed, as well as in annual reports accountants made their statements, not fully supporting the *data* in the reports.

12.8 Milleudefensie in April 2022

In April 2022 the Dutch NGO Milieudefensie did choose another form of protest and asked the general public to write the Shell board members personally and send them a postcard urging the company to comply with the court decision.

ClientEarth, a British environmental NGO that uses the legal means to protect life on earth, follows the path the Dutch courts have laid out in the Urgenda case. On June 8–9, 2022, the first hearing was scheduled in a case of ClientEarth taking the UK government to court over its net-zero strategy. A second case was filed by ClientEarth in March 2022 against all 13 top executives of Shell. It is the first time that directors and supervisory board members are held personally liable for the conduct of the company they work for. In the view of ClientEarth, the Shell Board members are in a position to change policies, and by not doing so they breach their duties under sections 172 and 174 of the UK Companies Act, paragraphs that require board members and directors to act in a way that promotes the company's success, and to exercise reasonable care, skill and diligence.

Milieudefensie soon followed the path chosen by ClientEarth, leaving the old-style protest methods of snail mail behind. On April 25, 2022, Milieudefensie informed Shell that they will hold Shell directors personally liable for possible damage when the company does not comply with last year's judgment in the climate case. According to the Milieudefensie lawyers, the letter also is of great importance for Shell's shareholders. The letter has been sent in April, since companies lay out policies for the next year at their annual shareholders meetings in May.[20] Milieudefensie tries to influence large institutional investors, such as pension funds, investing for example in Shell, and draws attention to the responsibility of these institutional investors to enforce climate policy in the companies in which they invest. In the letter, Shell is urged to change policies and 'no longer inform stakeholders incompletely and incorrectly about the consequences of Shell's current energy strategy'.

The letter from Milieudefensie accelerated a debate in the media on the question of to what extent the members of the board of directors have an obligation to act.[21]

12.9 Loans, Banks and Farmers

Farmers use manure to ensure better plant growth and higher crop yields. During this process, nitrogen evaporates from the animals' manure as ammonia and is set free into the air, or it can leach into the groundwater. On the basis of the Nitrogen Approach Program (Programma Aanpak Stikstof/PAS), farmers could receive a permit to continue their practice, when they envisage projects to reduce nitrogen. In anticipation of future positive consequences of future measures to protect existing highly endangered natural areas, permits were issued by local governments to continue activities that nowadays have turned out to be harmful to the surrounding areas.

Such a permit 'in advance' is not allowed (anymore), following the decision of the Administrative Law Division of the Council of State. The Administrative Law Division decided on May 29, 2019, in procedures

[20] *NRC*, 25 April 2022.

[21] '*Niet alles is acceptabel voor winstmaximalisatie*', *NRC*, 29 April 2022; '*Milieudefensie wil bestuurders Shell persoonlijk …*', *Volkskrant*, 25 April 2022.

initiated by Werkgroep Behoud de Peel, Mobilization for the Environment and Vereniging Leefmilieu, that the governmental PAS-Program may not be used as a legal basis for a permit authorizing the continuation of harmful activities. This Dutch legislation is contrary to the Habitats Directive (European Union Council Directive 92/43/EEC) on the conservation of natural habitats and wild fauna and flora.[22] On December 17, 2020, the Dutch Parliament approved a new law that aims to reduce nitrogen emissions in the Netherlands.

In September 2021 the District Court of Midden-Nederland on an appeal by the organizations Mobilization for the Environment and the Vereniging Leefmilieu annulled the PAS-related permits of 17 agricultural companies and a slaughterhouse in the province of Utrecht, issued by the province of Utrecht. This means that the legal framework of these companies to operate is uncertain, since they are all located near protected and nitrogen-sensitive Natura 2000 areas.

In the case of the slaughterhouse in IJsselstein, this company made a notification in 2015 under the Nitrogen Approach Program (PAS) for its nitrogen emissions. It followed the rules valid at that date. In 2019, the Council of State cancelled the PAS-legislation with retroactive effect, as a result of which PAS-reporting companies still need a nature permit (*natuurvergunning*) for their low-level nitrogen emissions. The province of Utrecht was not willing to shut down the company, because the consequences for the slaughterhouse were considered to be too great. However, the court was of the opinion that the province should not have looked at this factor alone. Although the slaughterhouse acted in good faith and in accordance with the rules applicable at the time, the environmental importance of the surrounding nitrogen-sensitive area also had to be taken into account. The province had to reevaluate the permit. At the request of the House of Representatives, the Minister of Agriculture, Nature and Food Quality is working on a regulation to legalize all PAS reporting companies, but until now, that draft is not yet sufficiently concrete.

About 3500 companies in the Netherlands operate without a nature permit. For 90%, these are farms keeping animals. All these companies evaporate nitrogen into the air, although they don't have a permit for it. The farmers meant they could continue their practices, since the

[22] Annex 2 of the PAS, art. 2 of the *Besluit grenswaarden* and art. 2.12 *Besluit natuurbescherming* were declared not binding.

provincial governments were not acting against it, a typical aspect of the Dutch system of 'gedogen'.[23] The NGO Coöperatie Mobilization for the Environment (MOB) is challenging that policy by submitting enforcement requests, fifty at a time. MOB asks the provinces to check whether the farmers have their permits and if not, to take measures. If a province refuses to do so, the MOB can challenge that decision in an administrative court. On May 11, 2022, the administrative branch of the District Court of Overijssel declared 29 appeals in the so-called 'nitrogen cases' of MOB and Vereniging Leefmilieu (VL) against the province of Overijssel to be well-founded. This means that the province must now reconsider these nitrogen permits. MOB and VL have filed several cases about issued nature permits (*natuurvergunningen*), while having cows and cattle grazing in the fields without such permits is illegal. Although farmers liked to continue their practices, the banks stepped in. Banks are obliged to fulfill all 'know your client' criteria, banks refuse loans to farmers who do not have their red tape papers in line with the legislation. Banks tell these farmers: 'You are not properly licensed, so we cannot lend you any money'.[24]

Here we see that where the national government is not willing to act on short notice (there was a nationwide farmers' uproar 3 years ago) and local governments are not willing to maintain the law, and administrative courts take some hardly effective action, the private law relation between the banks and farmers when it comes to loans is stepping in and fills the '*lucke*' or legal gap left by the administration, with banks denying loans to companies that act against the law, thus forming a risk for the repayment of the loan. The 'know your client' criteria now fulfill an important role in the transition process.

[23] '450 boeren zonder vergunning: provincie wil wet niet handhaven', https://www.omroepbrabant.nl, 20 April 2022.

[24] Bakker and Timmer, 'Wat er mis is met de stikstofaanpak?', *De Limburger*, 23 April 2022. There is one main bank in the agricultural sector in The Netherlands, the Rabo bank.

12.10 Final Remarks

The use of private law to influence the policies of government and companies in the field of climate change is a good example of tort law as a '*vangnet*', a last safety net. The *trias politica*, as a longstanding cornerstone of the states' rule of law is challenged in these recent developments (Spijkers, 2021). Governments do not take the lead, making courts interfere in issues where policymaking ought to set the standard, but then, parts of government neglect the court decisions. Maybe national law standards are lacking, but international and EU law do provide clear standards. In the previously described cases of Urgenda and Deliveroo as discussed, we see that politics is not acting, necessitating the courts to interfere. But even on the outcome of the court decisions there is no action by directly involved companies or the government. Appeal procedures delay action, companies deny the court decision or even leave the country, and local administrations do not keep up legislation but prefer a policy of '*gedogen*', of tolerance.

Court rulings are important, but most probably the most important route to change is an innovative climate policy of the government.[25] In the meantime, a less expected intervener starts to play a role, where not public but private law takes the lead. The banks refuse companies loans when their legal paperwork is not at pace with the law, new techniques and new forms of contracts regulating labor relations are bound to mandatory private law, and accountants put environmental hazards as legal hazards in the annual reports, and by doing so both necessitate their clients to contribute to environmental and climate improving measures.

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[25] Jaap Tielbeke, 'Het Shell-vonnis heeft gevolgen voor grootvervuilers wereldwijd'. *De Groene Amsterdammer*, 2 June 2021.

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CHAPTER 13

The Language of the European Union About SRI: A Diachronic Linguistic Analysis (2002–2022)

Alice Martini

13.1 Introduction

The debate about a shared and standardized definition of the acronym SRI is already old and well-populated in academic literature.[1] What has been observed recently, however, is a quite different phenomenon that is probably moving the problem towards new 'horizons'. The substantial difficulty in retrieving a unanimous definition of SRI is in fact coupled nowadays with the slight but constant shift of the meaning of the acronym

[1] The scientific literature about the phenomenon and—more specifically—the definition of SRI is already rich and with some history. For the sake of brevity, here I only use the following basic references, pointing also at the many that are therein contained: Purcell (1980), Domini (1984), Cowton (1994), Anderson (1996), Sparkes (2001), Mill (2006), Sandberg et al. (2009), Richardson and Cragg (2010), Puaschunder (2016), Rizzi et al. (2018), OECD (2020), Martini (2021).

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itself: from "socially responsible investment(s)", as it was originally meant to be, towards "sustainable and responsible investment(s)". Scholars are still researching around many crucial questions: "Is sustainable finance about making money by realising opportunities presented by sustainability challenges and preserving financial value by addressing the risks? Or is it about tackling sustainability challenges as goals in themselves? Is it about financial value or pursuing wider outcomes that align with core social values?[2]" The possibility of relying on a common and universally accepted definition of SRI is not an exercise of pure philological nature, but a crucial moment to avoid—at least—the so-called greenwashing activities, that have for a long time hindered the possibility of SRI to grow and impact the finance industry.[3]

Almost 70 years ago an Italian writer described words as "stones",[4] and the importance of the choice of words (the "wording" as it is commonly labelled today), is not decreased since then. The purpose of this work is to attempt to test the terminology adopted by some European institutions in relation to the semantic field connected to the notion of the socially/sustainable responsible investments. I will also try to verify if the expected change in the expressions used is measurable over time and towards which direction it points.[5].

This attempt will be performed with the support of a dedicated IT tool (an online linguistic software) applied to a corpus of texts selected among the official documents issued by the European institutions (the Commission, the Parliament, and the Council) and published in the "Official Journal of the European Union".[6] The IT tool that is used is *Sketch Engine*, "an online text analysis tool that works with large samples of language, called text corpora, to identify what is typical and frequent in a language and what is rare, outdated, going out of use or what new words or grammar are beginning to be used. In a nutshell, Sketch Engine is a

[2] Chiu et al. (2022).

[3] See Reinhardt et al. (2008), de Freitas Netto et al. (2020), Quirici (2020).

[4] Levi (1955).

[5] The reader can find useful references and a pioneering example of a similar research technic in Chevalier and Hudson (2001).

[6] https://eur-lex.europa.eu/oj/direct-access.html.

tool to learn how language works".[7] This tool allows to perform corpus-based studies, that is "empirical analyses of how language is used",[8] so it seems to be very well fitting the needs of our research question. The tools that *Sketch Engine* offers are described briefly in each paragraph and span from the simple counting of occurrences of words in the set of texts that I created to a more sophisticated analysis of collocations and historical trends. The construction of the corpus is naturally of paramount importance. The one that has been used for the tests whose results are described in this section is composed of the documents retrieved from the legal database of the European Union by adopting the following search criteria[9]:

Collection: "Legal Acts", "Case law"
Text search: "investment" in title and in text
Document reference: All
Author of the document: All
Date range: from 01/01/2002 to 31/12/2022

The result of this query summed up to approximately 2000 entries. A 'discretionary' screening of the documents was performed and those dealing with issues not actually related to the regulation of the investing sector were ruled out. To this bulk of documents, I added those explicitly related to the theme of sustainable finance that were available on the dedicated website of the European Union. The text of the home page of this website has been added, too, and dated as the only document representing the

[7] https://www.sketchengine.eu/what-can-sketch-engine-do/.

[8] Goldschmidt and Szmrecsanyi (2007, p. 340). Given the limited scope of this paragraph, I narrow the references about corpus-based studies down to a few works that should give the necessary introduction to the non-specialized reader: Conrad (1996), Biber et al. (1998), Baker (2012) and Heine and Narrog (2015). Many other useful and more specialistic references can be found in the scientific journals that deal specifically with corpus linguistics (e.g., *International Journal of Corpus Linguistics*, *Corpus Linguistics and Linguistic Theory*, *Applied Corpus Linguistics*).

[9] https://eur-lex.europa.eu/advanced-search-form.html.

year 2023.[10] The final number of the documents uploaded in Sketch Engine is 346 amounting to 5,669,078 words.[11]

It is worth noting that as regards the legislative acts a clear and predictable tendency has been noted: the number of documents eligible in each year has risen—though not constantly and regularly—over time. However, I have the impression that the balance of the corpus has not been biased by this feature that reflects the simple fact that the issue of investing activities has been legally regulated more and more recently and especially after the 2015 Paris Agreement. Given these premises, the corpus made up of legislative texts (directives or regulations)—because public bodies and official institutions use the legal language to express their stances—together with the press release and technical reports (officially commissioned by the European Commission), is thought to reflect the language of the European Union of the last twenty years in relation to investing practises.[12]

13.2 A General Overview of the Corpus

I started the analysis of my corpus (so-called "focus corpus", named "eu_invest_2002_2022") by comparing it with some generic corpora (called reference corpora).[13] I selected the following preloaded corpora in Sketch Engine:

[10] https://finance.ec.europa.eu/sustainable-finance_en.

[11] The corpus has a total number of 7,021,482 tokens. "A token is the smallest unit that a corpus consists of. A token normally refers to: a word form (*going, trees, Mary, twenty-five*…), punctuation (*comma, dot, question mark, quotes*…), digit (*50,000*…), abbreviations, product names (*3M, i600, XP, FB*…), anything else between spaces. There are two types of tokens: words and nonwords. Corpora contain more tokens than words" (https://www.sketchengine.eu/guide/glossary/?letter=T).

[12] I decided to exclude documents issued by the European Central Bank mainly for the purpose of simplicity. However, the dedicated section of the ECB website covers only the issue of "Climate change and the ECB" and the environmental and "green" factors are the only mentioned and tackled. The exclusive focus on these aspects in contrast with the aim of the present work that is considering also the social and governance elements seemed to support the choice of the exclusion.

[13] "Sketch Engine can compare corpora in the same language by comparing attributes (usually word forms or lemmas) in the corpora. A score is computed indicating to which extent the corpora are similar or different. A score of 1 indicates identical corpora. The higher the score, the more different the corpora are" (https://www.sketchengine.eu/guide/compare-corpora/).

1. British Academic Written English Corpus (BAWE)
2. Timestamped JSI web corpus 2014–2021 English
3. English Web 2020 (enTenTen20)
4. EUR-Lex 2/2016 parallel—English
5. Europarl spoken parallel—English
6. United Nations Parallel Corpus (UNPC)—English

As shown by Fig. 13.1, the focus corpus differs at most from BAWE and at least with EUR-Lex 2/2016 parallel—English. This last result seems to be quite predictable, as many texts in my corpus were legislative ones, as those comprehended in the "Eur-Lex 2/2016 parallel—English" corpus, that is composed of legislative acts of the EU issued in English until 2016. The "United Nations Parallel Corpus (UNPC)—English" ranks second in terms of similarity with the focus corpus, though the score is not indicating a strong closeness in the language. "Europarl spoken parallel—English" corpus starts to differ significantly from "eu_invest_2002_2022" corpus, as well as "English Web 2020 (enTenTen20)" and "Timestamped JSI web corpus 2014–2021 English" do: my hypothesis is that the peculiarity of a collection of texts built only around the language connected to investments narrows down the possibility to have huge intersections with more "generalist" corpora. On the other side, knowing that the EU has been the first body to adopt a taxonomy for sustainable investing, one can assume also that maybe it—and particularly the Commission—is a 'front-runner' in the issues of SRI, so that its language about investing activities is not yet shared thoroughly by 'average' users (as represented by "Timestamped JSI web corpus 2014–2021 English" and "English Web 2020 (enTenTen20)"), nor by members of the European Parliament.[14] Of course, one can also infer, probably more correctly, that the public attention towards environmentally sustainable themes is surely risen, but not as much as the consideration of these issues by the European Commission.

[14] It is surely worth offering a comment to the score resulting from the comparison of my corpus with the one created out of Euro-parliamentary speeches. The 'distance' that is registered between the two sets of documents in fact seems to point to the fact that the Commission and Parliament do not 'speak the same language'. While the Commission was strongly committed to implement guidance for SRI, it appears that the MEPs' debates were evidently little focused on the same issue.

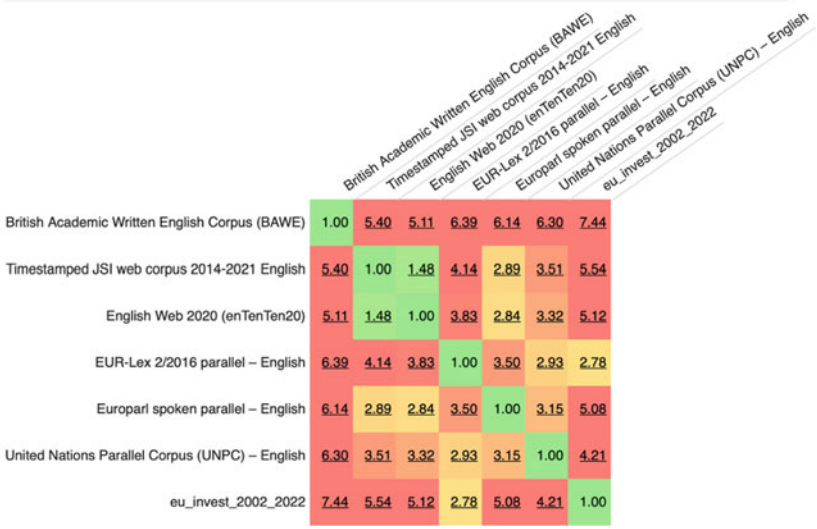

Fig. 13.1 Corpora comparison. The figure is generated by the "compare corpora" tool in Sketch Engine

The highest differing score is anyway with the "British Academic Written English Corpus (BAWE)", indicating that the language of the European institutions about investing practices is—as it could have been expected—far from the one used in literary and scientific prose.

13.3 Wordlist

Next, I performed a *wordlist* query. "The wordlist tool generates frequency lists of various kinds"[15]; I chose the option "lemma" and Table 13.1 shows some selected results among the first 1000 lemmas. The column "frequency" indicates the absolute frequency, i.e., how many times the item was found in the corpus. The "relative frequency" shows "a number of occurrences (hits) of an item per million tokens".[16] The "DOCF" column and the "Relative DOCF" one indicate, respectively, the document frequency, i.e., how many different documents contain the

[15] https://www.sketchengine.eu/guide/wordlist-frequency-lists/#toggle-id-1.

[16] https://www.sketchengine.eu/my_keywords/freqmill/.

item and the percentage of documents that contain the item. As obvious, the most recurring item is the article "the", that I included simply to show how the count is made.[17] Other very frequent lexical words are generic technical terms which have little relevance to my analysis (e.g., "financial", "regulation", "European"), so they are not listed in Table 13.1, which seems to indicate anyway that the vocabulary of EU institutions about investing activities is standardized towards the "working" language of the sector (e.g., "requirement", "liability", "derivative", "prospectus", "compliance" …). However, it is interesting to note that many words of the "new wave" of sustainable finance not only appear among the first 1000 lemmas of the corpus but seem to have a certain impact on the lexicon of the EU institutions. "Climate", for instance, ranks before "portfolio".

13.4 Keywords

Subsequently, I run the *keywords* tool to extract "words (single-token items), that appear more frequently in the focus corpus than in the reference corpus. They can be used to identify what is specific to one corpus […] in comparison with another corpus".[18] The results of both single-word (lemma) and multi-word terms that ranked in the first 250 positions are shown in Table 13.2.

The column "score" refers to "the keyness score calculated using the simple math method".[19] It is worth noting that "esg" is resulting as a keyword in the language of the EU institutions about investing practices, though the first occurrences of the word begin in 2018. This feature seems to indicate that after that date the word has acquired a strong connection with the European lexicon about investment regulation, as well as with wording related to "sustainability".

Figures 13.2, 13.3 and 13.4 are added to give an indication of the distribution of some words that are thought to be significant in the language of investing practices.

[17] The so-called "grammatical words" (articles, conjunctions, prepositions, negating adverbs, modal verbs, etc.) are naturally more frequent in written texts but they are actually insignificant and—exactly for this reason—have been excluded from the list.

[18] https://www.sketchengine.eu/guide/glossary/?letter=K. The reference corpus that was chosen is "English Web 2020 (enTenTen20)", because it is temporally closer to one of the largest and most significantly part of the documents included in the focus corpus.

[19] https://www.sketchengine.eu/documentation/simple-maths/.

Table 13.1 Wordlist (frequency list)

Rank	*Item*	*Frequency*	*Relative frequency*	*DOCF*	*Relative DOCF*
1	the	458,696	65,327.519	345	99.710
26	risk	26,241	3,737.2452	260	75.144
74	requirement	12,712	1,810.444	315	91.040
106	liability	8,214	1,169.838	163	47.109
153	derivative	5,783	823.615	163	47.109
201	climate	4,632	659.689	50	14.450
219	economic	4,298	612.121	227	65.606
257	reporting	3,615	514.848	213	61.560
305	benchmark	3,156	449.477	112	32.369
321	sustainable	3,008	428.399	67	19.364
338	portfolio	2,820	401.624	141	40.751
364	prospectus	2,581	367.586	70	20.231
389	green	2,378	338.674	49	14.161
403	energy	2,315	329.702	68	19.653
418	sustainability	2,223	316.599	48	13.872
486	environmental	1,824	259.774	83	23.988
554	compliance	1,501	213.772	162	46.820
622	prudential	1,272	181.158	138	39.884
656	risk-weighted	1,189	169.337	15	4.335
730	governance	998	142.135	104	30.057
762	taxonomy	942	134.159	31	8.959
767	gas	929	132.308	72	20.809
784	transparency	905	128.890	139	40.173
790	water	890	126.753	39	11.271
805	stakeholder	874	124.475	167	48.265
817	responsibility	863	122.908	116	33.526
911	recovery	730	103.966	95	27.456
946	carbon	692	98.554	34	9.826
993	forest	640	91.148	16	4.624

The word “prudential” (Fig. 13.2) has been chosen as representative of a ‘classical’ term associated with the management of investments: its distribution shows in fact that it is used commonly and regularly throughout the corpus. The expression “non-financial” (Fig. 13.3) appears also to be disseminated quite evenly in the corpus, but it shows also a peak and then a growing trend close to the last years that have been examined; it is reasonable to infer that the rising interest towards issues and problems of non-financial nature had a solid reflex in the language used. Finally, Fig. 13.4 shows that the acronym “ESG” has a very recent, tough

Table 13.2 Keywords (terminology extraction)

Rank	*Item single-words (lemma)*	*Frequency (focus)*	*Frequency (reference)*	*Relative frequency (focus)*	*Relative frequency (reference)*	*DOCF (focus)*	*DOCF (reference)*	*Score*
18	risk-weighted	1,189	2,601	169,33,746	0,06,031	15	1,473	160,648
24	esg	2,479	70,698	353,05,939	1,63,937	25	18,926	134,146
31	non-financial	1,251	27,134	178,16,753	0,62,919	104	18,864	109,973
47	prudential	1,272	56,830	181,15,834	1,31,779	138	33,209	78,591
105	climate-related	421	18,387	59,95,885	0,42,636	22	12,935	42,737
134	taxonomy	942	117,150	134,15,971	2,71,651	31	67,324	36,367
164	benchmark	3,156	566,085	449,47,775	13,12,655	112	339,916	31,889
241	taxonomy-aligned	146	59	20,79,333	0,00,137	8	26	21,764
Rank	*Item multi-word terms*	*Frequency (focus)*	*Frequency (reference)*	*Relative frequency (focus)*	*Relative frequency (reference)*	*DOCF (focus)*	*DOCF (reference)*	*Score*
13	regulatory technical standard	2,140	586	304,77,896	0,01,359	149	370	301,68
16	risk weight	2,103	2,538	299,50,943	0,05,885	24	786	283,807
42	esg risk	1,032	1,869	146,97,752	0,04,334	12	1,014	141,831
49	climate risk	1,127	15,472	160,50,743	0,35,877	10	9,589	118,863
66	technical screening criterion	721	97	102,68,488	0,00,225	18	56	103,452
78	physical climate risk	659	233	93,85,483	0,0054	2	158	94,345
127	green bond	635	11,139	90,43,674	0,25,829	18	3,743	72,667
139	sustainable investment	539	5,522	76,76,442	0,12,805	37	4,280	68,937
232	climate projection	370	4,753	52,69,543	0,11,021	2	3,489	48,365
236	sustainability reporting	353	3,176	50,27,429	0,07,365	11	2,140	47,757

Reference Corpus: English Web 2020—enTenTen20

impacting, 'history' in the corpus, confirming what has been just stated above in general about keywords.

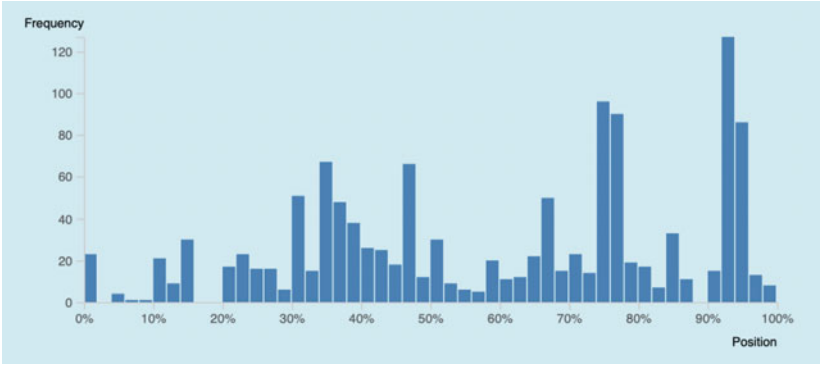

Fig. 13.2 Distribution of the word "prudential" in the corpus (the percentage on the axis "position" refers to the dates of the documents, e.g., 0% = 2002, 100% = 2023). The chart shows the parts of the corpus where KWIC (Keyword in context) was found. This shows whether the KWIC is distributed evenly or only in certain places or documents. The figure is generated by the "keywords" tool in Sketch Engine

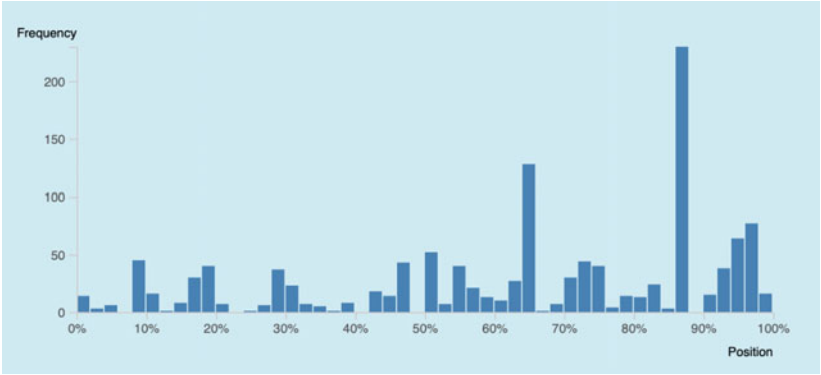

Fig. 13.3 Distribution of the word "non-financial" in the corpus (the percentage on the axis "position" refers to the dates of the documents, e.g., 0% = 2002, 100% = 2023). See the legend of Fig. 13.2

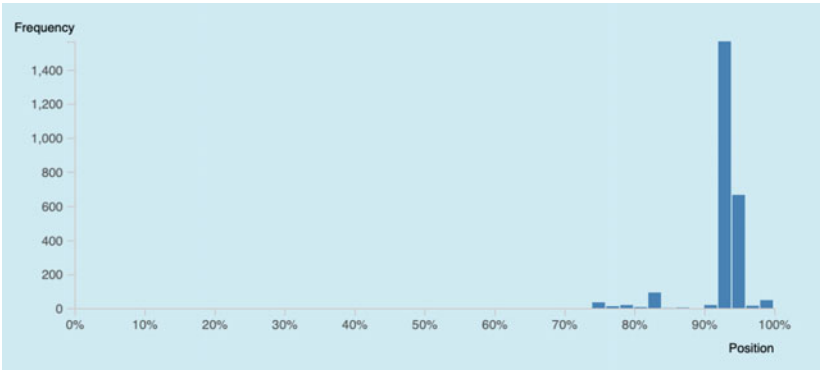

Fig. 13.4 Distribution of the word "ESG" in the corpus (the percentage on the axis "position" refers to the dates of the documents, e.g., 0% = 2002, 100% = 2023). See legend of Fig. 13.2

13.5 Thesaurus

Let's move to another interesting tool that Sketch Engine offers: the *thesaurus*. I thought to use it to verify an interpretation of the data that I started to formulate while collecting them. I had in fact the impression that, notwithstanding the original meaning of the acronym "SRI" for "socially responsible investment", the European Union may have significantly contributed to the above-mentioned shifting of the meaning not only towards "sustainable and responsible investment" but also with the progressive understanding of "sustainability" and "responsibility" as a main protection of natural environment. The tool *Thesaurus* generates automatically a "list of synonyms or words belonging to the same category (semantic field). The list is produced based on the context in which the words appear in the selected text corpus".[20] Table 13.3 offers the first 10 results that the tool extracts for the lemma "social", with the column "score" indicating "a similarity score […], the percentage of collocates the synonym has in common with the search word".[21] The column "Freq" stands for the number of occurrences of the word in the corpus. Figure 13.5 should help in understanding the table, as it explains

[20] https://www.sketchengine.eu/guide/thesaurus-synonyms-antonyms-similar-words/.

[21] See https://www.sketchengine.eu/wp-content/uploads/ske-statistics.pdf.

Table 13.3 Thesaurus results chart (query word: "social")

Rank	*Thesaurus result*	*Score*	*Freq.*
1	environmental	0.33	1,726
2	sustainable	0.26	3,008
3	long-term	0.26	760
4	green	0.26	1,616
5	corporate	0.24	1,095
6	new	0.24	2,388
7	key	0.23	1,810
8	own	0.22	7,346
9	financial	0.22	29,785
10	global	0.21	623

visually that "environmental" is the closest word to "social", i.e., the word that the European institutions conceive as more "interchangeable" with the latter. A result that seems to confirm my first impression and that is corroborated by the presence of "green" in the fourth place of the rank.

13.6 Word Sketch

Given the topic of the study and the results of the *Thesaurus* tool where "sustainable" ranked as second, I ran the tool *Word sketch* in Sketch Engine for this word, so to have a vision of its collocations.[22] "A collocation is a sequence or combination of words that occur together more often than would be expected by chance. […] Collocations can have different strengths",[23] measured by the LogDice score (column "score" in Table 13.4). The latter is "a statistic measure for identifying co-occurrence (= two items appearing together)".[24] The higher the score, the more the combination of the two words (also called *node*, e.g., "sustainable", and *collocate*, e.g., "environmentally", as per the column "collocate" in Table 13.4) is typical: "a high score means that the collocate is often found together with the node and at the same time there are not very many other nodes that the collocate combines with or it does not combine with them too frequently. The bond between the node and

[22] See https://www.sketchengine.eu/guide/word-sketch-collocations-and-word-combinations/.

[23] https://www.sketchengine.eu/guide/glossary/?letter=C.

[24] https://www.sketchengine.eu/guide/glossary/?letter=L.

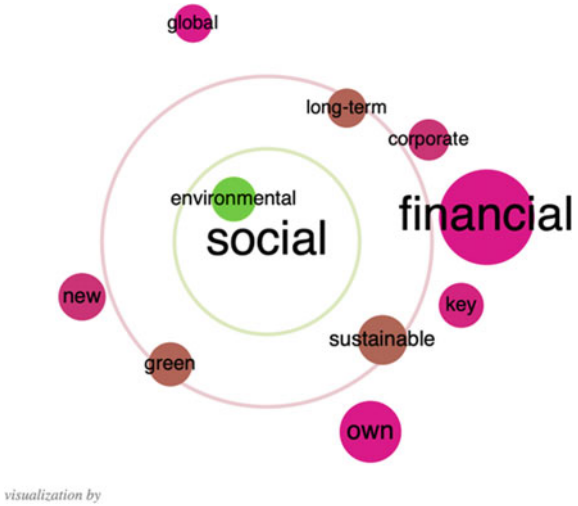

Fig. 13.5 Thesaurus results' image. The visualization contains information about frequency and similarity score. The circle sizes refer to frequency: "financial" is more frequent than "environmental". The distance from the centre indicates the similarity score: "environmental" is more similar to "social" than "financial" is. *The figure is generated by the "thesaurus" tool in Sketch Engine*

the collocate is very strong",[25] i.e., characterizing the use of the *node* ("sustainable") in the corpus. To complete the explanation of Table 13.4, the column "Gramrel" stands for the grammatical relation of the *node* and the *collocate*, while the column "Freq" indicates how many times the collocate was found.

The results seem to confirm that the European institutions are inclined to associate the idea of sustainability with that of a "physical" and natural environment to protect; however, the table shows that they have not at all ruled out the more "socio-political" nuances of the theme of the sustainability of economic development as created by financial investments: not only the terms related to economics, in fact, rank very high (e.g., "finance", "economic", "investment" and "bond"), but also those linked to a more "wide-ranging" understanding of "sustainability" are placed

[25] https://www.sketchengine.eu/guide/word-sketch-collocations-and-word-combinations/#toggle-id-4.

Table 13.4 Word sketch of "sustainable" in the focus corpus ("X" stands for "sustainable")

Rank	*Gramrel*	*Collocate*	*Freq.*	*Score*
1	modifiers of X	environmentally	415	11.9
2	nouns modified by X	finance	271	10.9
4	X and/or …	economic	191	9.81
5	nouns modified by X	objective	144	9.62
6	nouns modified by X	investment	385	9.28
7	nouns modified by X	activity	254	9.27
8	nouns modified by X	goal	51	8.94
9	nouns modified by X	growth	52	8.91
10	nouns modified by X	economy	52	8.72
11	nouns modified by X	development	56	8.45
13	X and/or …	inclusive	32	8.4
14	nouns modified by X	bond	51	8.11
15	X and/or …	green	35	7.95
18	nouns modified by X	strategy	28	7.62
21	nouns modified by X	future	21	7.52

in very important positions (e.g., "goal"—echoing the UN principles—, "growth", "development", "inclusive" and "future"). One conclusion that can be inferred is that the EU is striving to integrate the need to preserve and protect the environment with the possibility of directing economic progress towards an actual 'wellbeing' of all its inhabitants, without leaving behind the historical roots of the European continent and the funding principles of the Union itself for which social justice, solidarity and inclusion have always been reference points.

13.7 Trends

Finally, I used Sketch Engine to try to measure the degree of change of the lexicon of the EU over the twenty years that are included in this research. I ran the tool *Trends*, "a feature for detecting words which undergo changes in the frequency of use in time (diachronic analysis).

Trends identify words whose use increases or decreases in time".[26] Table 13.5 shows the results of this query.[27]

The "Trend" column gives the order to the table and contains the results of the absolute value of the change for each word, ranking at the top those that experienced the biggest change. It is worth precising that the trends calculated by Sketch Engine might be positive (in case of an increase in the use of a term) or negative (in case of a decrease in use). The trends of the focus corpus are all positive and show a sharp increase in their use. The "*P*-value (degree of change)" column shows "the probability of obtaining test results at least as extreme as the result actually observed, under the assumption that the null hypothesis is correct. A very small *p*-value means that such an extreme observed outcome would be very unlikely under the null hypothesis".[28]

As it could be easily predicted, between 2002 and 2022 the vocabulary of the EU relating to investment practices 'acquired' the whole terminology linked to tackling climate change and environmental preservation and protection. However, the presence in the list of terms as "social", "stakeholder" and "inclusive", besides—of course—"sustainable", can lead to the confirmation of the impression laid out above that the prominence of environmental issues among the new top topics that EU wants to tackle is surely shadowing the more social and political issues, but is not ruling out anyway those themes from the European institutions' agenda.

13.8 Conclusions

This section has offered some initial and preliminary findings about the language of some institutions of the European Union concerning investing activities. I tried to test, using text analysis software (*Sketch Engine*), if the terminology adopted by those actors in relevant legislative acts and more specific documents recently issued about "responsible finance" is actually embedding and reflecting the huge change that the

[26] https://www.sketchengine.eu/guide/trends/#toggle-id-6-closed.

[27] I set the value of the minimum frequency to 65, of the maximum *p*-value to 0.05 and I used the "linear regression (all)" method to run the query.

[28] https://en.wikipedia.org/wiki/P-value. I use the Wikipedia page as reference because that is the one to which Sketch Engine links the definition of "*p*-value" in the dedicated page, that has already been mentioned.

Table 13.5 Significant words in the trends in the focus corpus among the first 300 words (sharp increase in use)

Rank	*Item (word)*	*Trend*	P-*value (degree of change)*	*Frequency*
1	mass	5.145	0.019	70
2	bioliquids	5.145	0.018	65
4	crowdfunding	5.145	0.027	83
5	certification	4.705	0.043	227
6	sustainability	4.705	0.005	1,975
7	screening	4.705	0.034	833
11	metrics	4.705	0.002	338
12	promoted	4.705	0.010	65
13	emissions	4.705	0.001	1,277
14	fuels	4.705	0.001	309
15	carbon	4.705	0.000	525
17	decarbonization	4.705	0.012	112
18	fossil	4.705	0.001	137
19	biomass	4.705	0.012	219
20	biofuels	4.705	0.034	67
21	cities	4.705	0.044	112
22	solar	4.705	0.021	66
23	hydrogen	4.705	0.009	72
24	taxonomies	4.705	0.030	173
25	ecosystem	4.705	0.019	158
28	adaptation	4.331	0.037	907
32	fuel	4.331	0.001	167
33	harm	4.331	0.009	442
36	green	4.331	0.018	1,528
37	climate	4.331	0.005	3,426
38	engagement	4.331	0.007	213
39	circular	4.331	0.017	294
40	environmentally	4.331	0.035	449
59	sustainable	4.0108	0.009	2,175
124	social	3.2708	0.0061	1,293
147	stakeholders	3.2708	0.0002	406
252	inclusive	2.6051	0.0059	87

semantic field created and identified by the socially responsible investments/sustainable and responsible investments and all related activities has brought to finance. The IT tools offered by the software seem to confirm the general and widespread impression that the EU, without forgetting the "classical" lexicon of finance, is not only strongly focused and committed in the battle for environment preservation, but also that

its intention is to use financial tools to fight this battle.[29] Its language, in fact, clearly conveys the idea that the vocabulary linked to the struggle to stop climate change and promote environmental preservation and protection are staunchly embedded in its legislative acts and in its policy recommendations. So much that one can have the impression that the EU is conceiving the "responsibility" of investments and of the deployment of financial resources connected essentially to environmental problems and to the "sustainability" of human actions and presence in the natural ecosystem. In this sense, the EU is surely a front-runner among national and international institutions. It is undeniable that after the 2015 Paris Agreement, the EU has implemented a collection of regulations, studies, and policies to create the conditions to avoid the depletion of natural resources, to fight climate change, to reduce carbon emissions, to protect water and forests etc.

Even the acronym "ESG" has probably started to be related more and more to the first letter ("environment"), rather than to "social" and "governance", with these factors that have been defined with less precision than that one by the texts of the focus corpus. One can argue that the 'measurability' of the process of environmental protection favours this condition. However, it is worth noting, as a final consideration, that the linguistic analysis that has been performed shows also that the EU has not at all ruled out those socio-political themes from the European institutions' agenda. It is instead reasonable to think that the EU is still embracing its funding principles for which social justice, solidarity and inclusion have always been reference points, though in a dimension that is less connected to the financial activities of SRIs, primarily directed nowadays to the protection of the natural environment.

[29] "The Sustainable Finance Action Plan [*launched by the European Union in 2018*, N. o. A.] has created an unprecedented momentum of work and discussion on sustainable finance in the EU, with a level of ambition that, to our knowledge, is unmatched elsewhere, and which has the potential to deliver financial reform producing systemic change" (Department of Economic and Social Affairs—Sustainable Development, United Nations, https://sdgs.un.org/partnerships/european-commission-initiative-sustainable-finance). See also https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/europe-retains-leading-role-in-green-finance-but-other-centers-gaining-8211-z-yen-67170137.

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