ClientEarth

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Corporate Sustainability Due Diligence Directive in trilogue negotiations

Due diligence obligations for the financial sector

As trilogues negotiations on the proposal for a European Directive on Corporate Sustainability Due Diligence (**CSDDD**) gather pace, this briefing explains **why** full inclusion of the financial sector is essential to ensure that the CSDDD is effective in human rights and environmental terms, and that it aligns with and does not undermine existing international standards on human rights and environmental due diligence. This briefing then provides key recommendations on **how** the financial sector can be included in the Directive in the ongoing trilogue negotiations.

1 Why include the financial sector?

Financial institutions are integral to preventing human rights and environmental impacts and must be brought fully within the scope of the CSDDD. This applies equally to financial institutions of all shapes and sizes – including banks, insurers, institutional investors, asset managers and other sources of financial capital – without exception. Excluding all or part of the financial sector or activities from the scope of the CSDDD would be unjustified and inconsistent with other EU sustainable finance regulation. It would undermine both the reach and objectives of the CSDDD, and the internationally recognised human rights responsibilities established under UN Guiding Principles on Business and Human Rights (UNGPs) and the OECD's Guidelines for Multinational Enterprises on Responsible Business Conduct.

Size: The sheer size of the European financial sector underscores the need for its inclusion in the CSDDD. By the end of 2021, for instance, asset management companies operating in Europe had an estimated EUR 32.2 trillion in assets under management, equating to 170% of European GDP.[1] In 2021, EU monetary financial institutions had EUR 26 trillion in loans outstanding and EUR 25 trillion in deposit liabilities.[2] In 2022, total financial assets of all financial corporations in the EU were valued at €81 091 billion (5.6 times GDP),[3] as compared with only €22 059 billion for the EU's non-financial corporations.[4] Omitting financial institutions from scope would exclude a colossal part of the European economy from meaningful due diligence obligations.

Contribution and linkage: The (positive or negative) impact of financial institutions on human rights and the environment through their financing, underwriting and advisory activities cannot be overstated.[5] By the same token, as the UN has recognised[6], financial institutions wield unparalleled ability to influence companies to act responsibly and respect human rights and the environment.

Recent communications from the UN expressing concern to the banks financing Saudi Aramco demonstrate that financial institutions can be directly linked with, and in some cases contribute to, adverse human rights impacts,

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[1] See EFAMA, '*Our industry in numbers*': Our industry in numbers | EFAMA. Of the EUR 32.2 trillion, around 56.6% AUM was on behalf of investment funds.
[2] See EBF, 'Banking in Europe: EBF Facts & Figures 2022': Banking-in-Europe-EBF-Facts-and-Figures-2022.-Updated-February-2023.pdf.
[3] See 'Financial corporations: statistics on financial assets and liabilities' (26 October 2023)
[4] See 'Non-financial corporations - statistics on financial assets and liabilities' (26 October 2023)
[5] See, for example, the many case studies available on the Fair Finance International website, which demonstrate the role of financial institutions in financing companies and projects causing human rights violations and environmental damage: Case Studies | Fair Finance International (fairfinanceguide.org).
[6] See para. 77 of the Human Rights Council of the UNGA's 2021 stock take on business and human rights: A/HRC/47/39 (undocs.org).

including those related to climate change, perpetuated by the companies they finance or advise – in this case the "*adverse impacts on human rights caused by activities such as the exploitation of fossil fuels which contribute to climate change*."[7] The communications confirm unequivocally that financial institutions have their own responsibilities to respect human rights and conduct human rights due diligence.[8]

Coherence with existing standards and laws: The UN has stated time and again[9] that, under existing human rights standards, all financial institutions are subject to human rights obligations just like any other business, and that carve-outs and exemptions for the sector are unjustified and damaging, stating recently that "*all financial institutions, of every type, have the same responsibility to respect human rights, and creating carveouts or presumptions for the financial sector in the draft Corporate Sustainability Due Diligence Directive would be inconsistent with international standards on business and human rights*".[10] Excluding the financial sector (or parts of it) from due diligence obligations under the CSDDD would therefore create a gulf between compliance with the CSDDD, and compliance with existing human rights due diligence standards (the UNGPs and OECD Guidelines), exposing EU financial institutions and adhering Member States to legal and reputational risks as a result.

Moreover, certain financial institutions are already required to report the adverse impacts of their investment activity and disclose their due diligence policies under the Sustainable Finance Disclosure Regulation (**SFRD**). Others will be required to disclose not only how their business model and strategy takes account of sustainability matters, but also the implementation actions (including due diligence) they are taking with regard to those matters, in order to meet their sustainability reporting obligations under the Corporate Sustainability Reporting Directive (**CSRD**). However, these rules do not provide financial institutions with concrete conduct requirements on how to undertake an effective due diligence process. At the same time, the CSRD and the EU Taxonomy will provide financial institutions with a wealth of sustainability data, but without a legal obligation to act when impacts are identified and disclosed. Not only would omitting financial institutions from the CSDDD be inconsistent with these rules, it would also deprive financial institutions of a substantive framework for conducting the due diligence they require and acting on the results.

2 How to include the financial sector?

All financial institutions (including banks, insurers, institutional investors and asset managers) can be directly linked with, and in certain circumstances contribute to, the human rights and environmental harms of the companies they finance or advise. **Financial institutions should therefore be subject to the same fundamental due diligence obligations – to identify, prevent, mitigate or end and remedy their adverse impacts – in the CSDDD as other companies, even if the means by which they meet their responsibilities might vary.**

- ✓ **Scope and definitions:** Financial institutions (including institutional investors and asset managers) must be clearly included in the scope of the CSDDD, and key definitions (such as "Value Chain" and "Business Relationship") must adequately reflect the operation of financial businesses in reality, and where they have most impact and leverage. This means financial institutions must be explicitly in scope in respect of their financing, investment and advisory activity, and their linkages with the companies downstream in their value chains that that they finance, invest in and advise. This should be mandatory and not left to the discretion of Member States.

- ✓ **Differentiate, but don't dilute, obligations:** The definitions and provisions of the CSDDD may need to be differentiated to apply appropriately to different financial businesses. However, it is essential that, where specificities of particular financial institutions (such as banks or institutional investors) are acknowledged and addressed in the CSDDD, the fundamental obligations which apply to them are not diluted. For instance, the CSDDD could:
    - acknowledge that institutional investors may have less leverage over investee companies than a bank typically has over a significant borrower-client, and provide specific guidance on the use of stewardship,

[7] See, for example, the UN's communication to Societe General, available here: AL OTH (80.2023) (ohchr.org).
[8] See UN warns Aramco and its financiers over their role in driving climate-fuelled human rights violations | ClientEarth (25 August 2023).
[9] See, for instance, the Office of the High Commissioner for Human Rights position on the financial sector: Financial Sector | OHCHR.
[10] See the statement of the UN Working Group on Business and Human Rights on *'Financial Sector and the European Union Corporate Sustainability Due Diligence Directive*' (12 July 2023): Statement-Financial-Sector-WG-business-12July2023.pdf (ohchr.org).

engagement and voting rights to encourage investee companies to address their environmental and human rights impacts;
- clarify that banks are not expected to supervise the entire value chain of each of their clients, but must assess their client's respect for human rights and the environment overall;
- explain that financial institutions will generally be directly linked to the adverse impacts caused by the companies they finance, invest in or advise, unless specific factors and circumstances indicate mere contribution to those harms (for example failing to act when they become aware of an adverse impact).

✓ **Avoid carveouts, presumptions and other pitfalls:** The CSDDD must acknowledge the reality of the financial sector's role in causing and enabling human rights and environmental impacts, as well as how it can address them, and how it operates. Whereas some differentiation may be appropriate, excluding the investment and financing activities of institutional investors and banks from the scope of the CSDDD or key provisions and duties altogether would be to ignore that reality, and would not be justified. Similarly, unwarranted carveouts and presumptions would blunt the CSDDD's effect and should be avoided. For instance:
- Financial institutions can cause, contribute or be directly linked to adverse impacts – this is dependent on circumstances and, as the UN makes clear, there should be no general presumption to the contrary.
- It is well established that due diligence is an ongoing process, adverse impacts emerge, develop and evolve over time and can be influenced by the flow of finance – the responsibility of financial institutions should not be limited to the pre-financing stage so that impacts can be identified and addressed at any stage of a financial arrangement.
- Much like the UNGPs, the due diligence obligations in the CSDDD can be proportionate and acknowledge that the means by which business of different types and sizes meet their obligations may vary – without any need to exclude important institutions from scope.

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