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Sustainability due diligence obligations for financial institutions

The role of financial institutions in mitigating supply chain impacts – the case of deforestation

BY CLIMATE & COMPANY, GERMANWATCH AND RECHTSANWÄLTE GUENTHER

Authors:

Louise Simon (Climate & Company) | louise@climcom.org

Dr. Johannes Franke (Rechtsanwälte Günther) | franke@rae-guenther.de

Ingmar Juergens (Climate & Company) | ingmar@climcom.org

Katharina Brandt (Germanwatch) | brandt@germanwatch.org

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EXECUTIVE SUMMARY

This policy brief sheds light on ***why* mandatory sustainability due diligence for financial institutions is key to reach the goals of the EU Green Deal,** while providing a clear and useful framework for financial institutions themselves.

With our analysis, we aim to support EU and national regulatory decision-makers as well as financial institutions who work on the role that the financial sector needs to play in the economic transformation to protect our planet. The policy brief is also useful to civil society and the broader private sector.

We explain the need, from both a sustainability and a profitability perspective, for financial institutions to address the environmental and social impact of their investment and financing decisions, including through their value chains. We discuss how setting **sustainability due diligence obligations for financial institutions** would provide for the appropriate regulatory framework for them to play a substantial role in reducing their direct and indirect impacts on climate change and biodiversity loss, while reducing the related financial risks. **Deforestation** serves as an important example, as it represents a major driver of biodiversity loss and climate change. Furthermore, the rising commitments and practices of financial institutions in eradicating deforestation in their portfolios, as well as its coverage in both the EUDR and (potentially) the CSDDD, underline the policy and market relevance of deforestation in this context.

We identified a concise set of arguments for introducing *mandatory* sustainability due diligence in the financial sector:

- **Voluntary commitments have not been enough.** Due diligence has not yet been sufficiently incorporated in the risk management procedures of financial institutions. Information asymmetries, high search costs and non-disclosure of value chain relationships and sustainability risks and impacts in the supply chain, have minimised incentives for financial institutions to consider their investee companies' negative environmental and social impacts as financially material. These market imperfections can be addressed most efficiently by setting regulatory incentives for FIs to exercise corresponding due diligence.
- **Financial institutions need a level-playing field**. This could be provided by EU legislation which addresses them the same way across Member States and would reduce the uncertainties in liability risks that financial institutions could face. Leaving the inclusion of FIs up to Member States in their national transposition of the Directive would risk significantly distorting competition in the EU's internal market.
- **Policy coherence is key for an effective and efficient framework.** Excluding financial institutions from due diligence obligations would create serious incoherence in the EU legal framework for corporate sustainability due diligence and sustainable finance. This would not only undermine the crucial role of financial institutions in achieving the EU's goal of "shifting trillions [of EUR]" toward sustainable business activities, but it would also create considerable legal uncertainties for them, as they already have sustainability-related obligations under existing law that would benefit from a clear guidance on due diligence.

This policy brief provides **concrete options for improving the CSDDD** to inform the on-going legislative process.

INTRODUCTION

Whether and in how far financial institutions (hereinafter referred to as FIs), including banks, institutional investors, insurance companies, etc., should be covered under a set of EU regulations targeting environmental and/or social impacts and risks associated with companies' value chains is currently a hotly debated topic in Brussels. While also relevant to other legislative files (such as the delegated acts under the Taxonomy Regulation or the Corporate Sustainability Disclosure Directive), this debate has been most prominent in the negotiations of two key EU (draft) regulatory measures: (1) the EU Deforestation-free Products Regulation (EUDR), concluded in December 2022, and (2) the Corporate Sustainability Due Diligence Directive (CSDDD), which is still under negotiation. While the EUDR aims to minimise deforestation and forest degradation by requiring all products to be placed in or exported from the EU internal market to be "deforestation-free", the CSDDD aims to ensure that companies comply with their responsibilities to respect human rights and environmental standards. Both measures require companies in scope to conduct **due diligence**.

While FIs are not included in the scope of the EUDR[i], but will be the subject of an impact assessment for the second review of the Regulation in Spring 2025, the European Commission, the European Parliament and the European Council are still figuring out if and how they want to include them in the CSDDD. An important vote is coming up, where the European Parliament will adopt its position in Plenary on June 1st, 2023. Afterwards, the Trilogue[ii] negotiation will start, and an agreement is expected before the end of the year.

Against the backdrop of these upcoming CSDDD negotiations (as well as the review of the EUDR), this policy brief provides specific analysis and arguments in relation to the role of the financial sector in the economic transformation needed to protect our planet. The brief also aims at informing the public debate. Our analysis sheds light on ***why* mandatory sustainability due diligence for FIs is key to reaching the goals of the EU Green Deal,** while providing a clear and useful framework for FIs, clarifying regulatory expectation about due diligence, and informing their engagement strategy, amongst others. The policy brief is structured as follows:

Firstly, we recall **why it is so important for FIs to consider environmental and social impacts.** We discuss the high relevance of sustainability impacts along companies' entire value chains for their investors' and financiers' risk assessment as well as the link between environmental impact mitigation l for financial market stability.[1] We explain the central role of financial institutions in shifting finances from environmentally harmful investments to activities which contribute to closing the sustainable investment gap. We use deforestation as an important example, as it represents a major driver of biodiversity loss and climate change.

Secondly, we briefly explain the **concept of (sustainability) due diligence and its recent developments** within national and EU legislative frameworks. We show that due diligence is a well-established concept for FIs, that *sustainability* due diligence has been gaining traction for a while across a number of constituencies, and that sustainability due diligence is aligned with FIs' typical risk mitigation strategies, namely stewardship and active ownership (for institutional investors) and engagement (for banks) and divestment/disengagement.

Thirdly, we demonstrate **the need for mandatory due diligence for FIs**, because (1) voluntary commitments are not enough, (2) to ensure that engagement is prioritised over divestment, (3) to create a level-playing field for financial institutions across the EU and (4) to increase policy coherence of the EU legislative framework.

Fourthly, we explain the **specific scope for improving the current CSDDD** "versions" (namely, the European Commission's proposal[2] and the JURI Committee's position[3]). We conclude by proposing options for improving the CSDDD, which we believe could assist the colleagues in the European Commission, the European Council and the EU Parliament throughout the Trilogue negotiations.

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[i] For more information: Climate & Company and Germanwatch (2023), Sustainability due diligence and reporting obligations for financial institutions: the coverage of the financial sector across a sore set of EU regulatory measures, link.
[ii] Trilogues are the negotiations between the three co-legislators (European Commission, the European Parliament and the Council of the European Union) on legislative proposals.

WHY SHOULD FINANCIAL INSTITUTIONS ADDRESS THE SUSTAINABILITY IMPACT OF THEIR FINANCING AND INVESTMENT DECISIONS ?

In this chapter, we explain the different reasons why we need financial institutions (FIs) to care about their and their clients' and investees' impact on environmental and social issues. We distinguish two different issues: (1) the financial risks caused by impact, from both a FI as well as a financial market perspective and ; (2) the central role of FIs in providing the right incentives to "shift the trillions". We also introduce the example of deforestation as a major driver of environmental impact and financial risk. Without tackling deforestation, the Paris climate targets as well as the objectives of the Global Biodiversity Framework agreed in December 2022 in Montreal cannot be reached; and a number of FIs have declared their firm intention to cease financing deforestation.[4]

IMPACTS CAN BECOME FINANCIAL RISKS...

…from a financial institution's perspective

FIs are linked to their environmental and social context in two ways. On the one hand, FIs face financial risks from their dependency on nature and their exposure to, say, climate change impacts. On the other hand, FIs can cause (direct and in particular indirect) impact on the planet, on people and the environmental.

The *dependency* of companies on ecosystem services for their production lines and services leads to major **physical risks** from climate change and biodiversity loss for these companies, resulting in risks for the FIs financing them.[5] Those physical risks can translate into the jeopardy of business continuity, lower business value and the reduced ability to generate profits and repay debts, which all correspond to **market** and **credit risks** for FIs.[6] **Liquidity risks** can also occur, for example if a biodiversity tipping point, such as rainfall cycle disruptions in the Amazon, cause agricultural output to fall dramatically, which could in turn reduce liquidity in soft commodity markets and put trading positions at risk.

The *impact* that investee companies have on biodiversity, the climate and other environmental as well as social goods, exposes the FIs to important **transition or regulatory** and **reputational risks**.[7] In fact, the transition to more sustainable practices and policies, such as the introduction of new national and international regulations to protect biodiversity, carbon pricing policies or changes in consumers' sustainability preferences do already increase the likelihood of stranded assets, default probability on loans and write-off of investments in companies with production processes that negatively impact biodiversity.[8] FIs can contribute or be linked to human rights impacts through the financing of projects such as the construction of a dam that entails serious human rights violations like forced resettlement, damaging their reputation. RepRisk[9], for example, offers a data platform covering ESG related reputational risks and is already widely used by major financial institutions, such as UBS, for example.

Reputational damage and liability claims filed by rights-holders impacted by the consequences of climate change and biodiversity loss can furthermore increase the **operational risks** for FIs.[10] All the risks highlighted above can generate **liquidity risks** for FIs, which increases their probability of defaulting on their own debt obligation and making refinancing harder for them.[11] Reputational risks are also seen as one key motivation for institutional investors to encourage their investee companies to improve their environmental performance[12] and comparably superior environmental performance is indeed associated with foreign institutional ownership[13].

Figure 1 depicts the relationship between biodiversity risks, caused by the dependency and impact of companies, and the financial risks that FIs face from financing them. FIs should consider that, while financial materiality remains the main factor for them, sustainability issues that are classified as primarily material from an impact (or "inside-out") perspective can quickly become financially material to firms and investors; materiality is a dynamic concept.[14] The introduction of new legislation, changes in the environmental and social

impacts of certain industries, changes in societal beliefs and (a/o consumer) behaviour are all factors which influence the materiality of sustainability issues over time.

Even from a pure risk perspective, FIs need to systematically consider their own and their clients' and investee companies' impacts on environmental and social issues, along the entire supply chain.

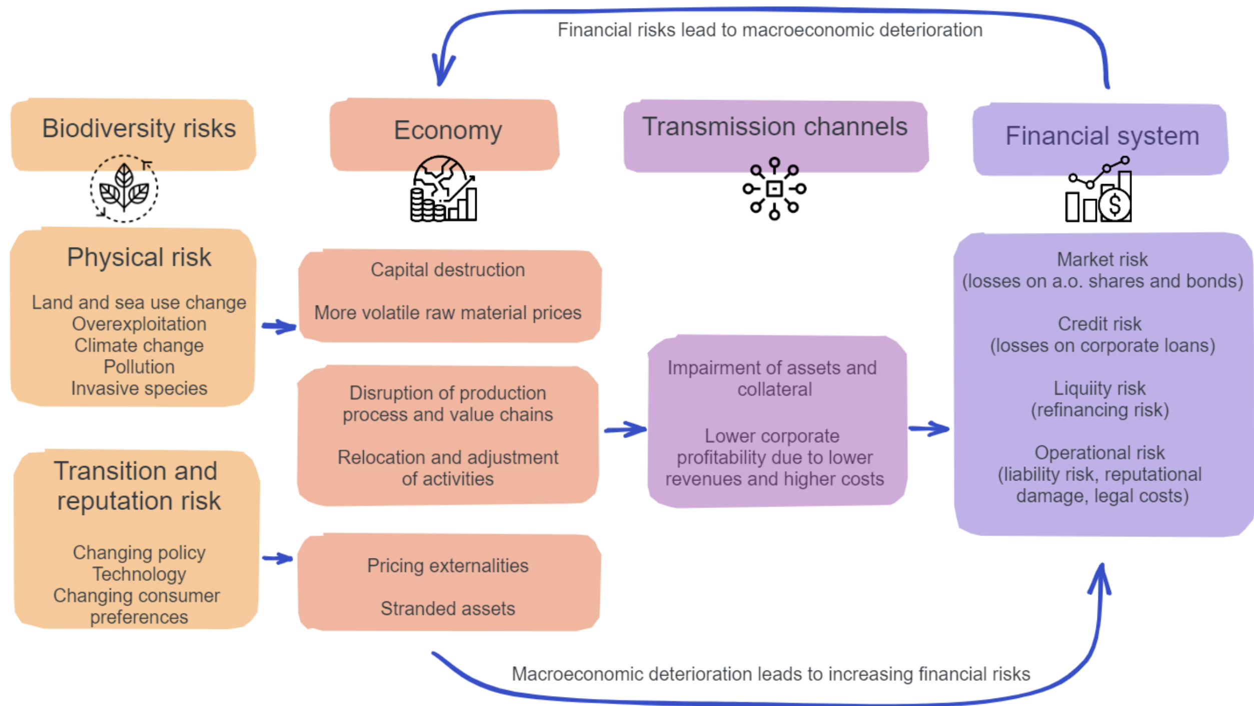

Figure 1: From biodiversity risks to financial risks (Source: DNB & PBL (2020), Indebted to nature: Exploring biodiversity risks for the Dutch financial sector, link)

…from a financial market perspective

The financial risks at firm (i.e. individual FI) level can add up to systemic risks at market level, with potentially significant ramifications for entire economies (and societies). While this fact would not scape anybody since the post-2008 financial crisis for "traditional" financial risks, also the sustainability risk dimension has increasingly been acknowledged as systemically relevant by financial market supervisors, such as the European Central Bank (ECB), the SEC, the French or the Dutch National Banks. Environmental impacts could have significant macroeconomic consequences, and failure to account for, mitigate, and adapt to these is a source of risk for FIs individually, as well as for the long-term stability of our financial markets overall. [15] That is why also environmental risks from **regulatory changes and market dynamics**, such as carbon price changes are already featuring in and make a substantial part of the risk perspective of central banks.[16]

The ECB monitors Member States' financial systems' exposures to climate change from both physical and transition risks.[17] In doing so, it considers possible future paths of, for example, real GDP, carbon emissions and energy prices, both with and without successful climate policy action and assesses the resilience of the national financial systems to different economic and climate scenarios. This step is essential to translate climate impacts and risk into economic and financial risks for the financial system. Assessing the impact of FIs and the overall financial market on the environment is an integrated part of stress testing, which central banks and financial institutions use to better understand and **mitigate physical and transition risks**.[18]

A stress test examines the potential impact of a (set of) hypothetical adverse scenario(s) on the health of the financial system and individual institutions within it. Stress tests allow policymakers to assess the resilience of the financial system and individual institutions to a range of adverse shocks and, if needed, take measures to ensure that FIs are resilient and can continue to supply credit to the real economy even under stress.[19] The ECB's economy-wide climate stress test shows that the impact of climate risks on companies and banks could in some scenarios initiate a collapse of the financial market.[20]

This macro-prudential perspective on environmental impacts translates into incentives and obligations for individual financial institutions in two ways. Firstly, the systemic (aggregate) risks associated with unabated environmental impacts need to be mitigated at firm (FI) level. Secondly, a bad performance in a formal stress test (due to high unabated risks, including environmental reputation and transition risks), has significant potential to harm the reputation of a financial institution.

In conclusion, environmental and social impacts can be extremely relevant for FIs' financial performance; but, the related transition and reputational risks are not (yet) systematically considered in FIs' overall risk assessment and typical due diligence processes.[21] Investing responsibly and considering sustainability factors in risk management and corporate strategies enhances the financial resilience (and hence ultimately, mid- to long-term economic viability) of financial institutions, while achieving positive outcomes for the planet and its people. From a more macro-economic perspective, Member States and the EU as a whole, risk facing various fiscal and macroeconomic imbalances and stability issues if financial markets do not sufficiently reflect the need to reconcile economic and environmental concerns. As we will show below, clear and harmonised environmental and social due diligence obligations represent a crucial tool for addressing this dual concern.

THE CENTRAL ROLE OF FINANCIAL INSTITUTIONS...

...in the much-needed shift of investment

The European Commission talks about a transition to climate-neutral economy[22]; the United Nations refers to the "biodiversity finance gap" of 700 billion dollars per year and the need to align financial flows with the Global Biodiversity Framework[23]. To deliver these objectives, both public and private resources need to be channelled into sustainable investments. In fact, public funds represent only a small, yet very important share of the total finance needed, so the majority will need to be supplied by private sources.

However, as it currently stands, FIs still provide too much funding to economic activities with great risk of environmental harm[24] and do not have sufficient policies in place to mitigate their impact. Forest500[25], an initiative tracking the policies and performance of the 350 most influential companies and 150 FIs linked to deforestation in their supply chains and investments, captured the state of play FIs managing deforestation-risks and impacts of their investee companies. The findings revealed that the FIs under review provided more than USD 5.5 trillion in finance to companies in forest-risk supply chains. Out of those FIs, 57 have a deforestation policy in place, but only about half of them publicly report on their progress in implementing their policy.

So, as part of the solution, FIs, through their financing and investment decision, play a key role and have the potential to be the game changer in the fight against biodiversity loss and the climate crisis, in the EU and beyond. It is crucial that they start taking their impact on environmental and social issues into serious consideration and start shifting their financing and investments to companies and activities which will be able to contribute to closing the investment gap.

...in providing the right incentives for their investee companies to reduce their impacts

Financial incentives are central drivers of economic decision making. When it comes to financial incentives for considering firms' external effects on people and planet, regulatory instruments are essential in correcting associated market failure and generate price signals for, say, contributing to climate change, reflecting the social cost of carbon. The financial sector has a rather relevant role in enhancing expression of these social preferences (for protecting the climate or biodiversity or human rights) and the transmission of the corresponding price signals to the firm level. Financial institutions (and financial market professionals such as analysts or data providers) can do so (and are actually partially doing so) by reflecting the true (social) cost of a firm's activities in firm valuation, the associated risk/return considerations and ultimately, the financing/investment decision. The financial effect of a firm's unabated environmental or social impacts on its bottom line can be captured by the change in the cost of capital (be it debt or equity): a powerful incentive for the board to reduce their company's environmental and/or social footprint.

The impact of investee companies and their value chains on ESG factors can hence be indirectly mitigated by FIs through their financing and investment decision (which in its most extreme form, would result in actual

divestment), but also by engaging with their clients and investees about their ESG performance along their entire supply chain.[26]

The procedure of mitigating ESG risks and impacts within a bank or investment portfolio can take different forms. First, there is a distinction between pre-contractual ESG considerations known as **ESG incorporation**, and post-investment **ESG improvement**. The first concept consists of building a portfolio based on certain ESG criteria, while the latter concerns improving the performance of investee companies and clients.

For investors, the main two processes to respond to risks and impacts in the client's value chains are (1) **stewardship or active ownership** as well as (2) **divestment**. Active ownership and stewardship consist of using influence over clients to maximise the long-term value of assets by for example using their financial influence to talk with the companies' management board Divestment, on the other hand, consists of "*selling a company whose products or practices you don't agree with*"[27], or which are too risky. For corporate lending and securities underwriting by banks, these processes are called (1) **engagement** and (2) **disengagement**.

Through these processes, FIs can provide the right incentives for their investee companies and clients to reduce their impacts and thus contribute to improving the environmental and social performance of many companies. How this can be reflected in due diligence processes (and the corresponding regulation) is discussed in the following chapter.

A particular case is the relationship between banks and (non-financial) small and medium-sized enterprises (SMEs). While the above principles of the financial/non-financial corporates' relationship are equally applicable here, engagement in this "special relationship" is often seen as going beyond expressing concerns to include a more active, supportive role of the bank vis-à-vis the "SME", helping their client in tackling the (here: environmental) challenges of concern. The influence of FIs on their SMEs clients is discussed in the Chapter "What are the flaws of the CSDDD with regard to the inclusion of financial institutions?".

DEFORESTATION: A SERIOUS ENVIRONMENTAL IMPACT AND THUS RISK FOR FINANCIAL INSTITUTIONS

A specific key area where the financial sector has significant impact is deforestation. The financial sector contributes indirectly to deforestation by financing e.g. investments in agricultural expansion at the expense of forests or by promoting consumption patterns that cause deforestation.

Between 1990 and 2020, an estimated 420 million hectares of forest (representing more than 10% of total forest area) were lost due to conversion to other land-uses.[28] With at least two thirds of the earth's terrestrial biological diversity concentrated in tropical forests, loss of primary forests results in the extinction of numerous species. Home to many indigenous and forest communities, deforestation also threatens their traditional use of forests, integral part of their culture and livelihoods. The depletion of forests, which are crucial CO_2 sinks, reduces carbon absorption capacity and contributes to overall GHG emissions. Deforestation also affects climate conditions such as rainfall and therefore impacts rain-fed agriculture. Climate change additionally increases vulnerabilities to fire, pests and drought.

Deforestation can not only massively harm the environment, but also lead to major financial risks: as a significant share of terrestrial biodiversity is harboured by forests, and as these are disappearing, so is the availability of ecosystem services on which many economic activities depend. In terms of the reputational risks, the Dutch Central Bank reports that Dutch FIs alone are exposed to businesses with heightened reputational risks due to products or activities related to deforestation for a total of EUR 97 billion.[29] The new EUDR, which is to enter into force in June 2023, which introduces mandatory due diligence rules for companies that want to place high deforestation-risk commodities on the EU market, makes deforestation financially material. Furthermore, it will increase reputational and transition risks for FIs financing companies trading those commodities.

Deforestation activities may not be identified as risks under the narrow financial materiality approach because deforestation is frequently not happening within direct operations of FIs and may in some cases not be traceable back to the FIs. The traceability problems thus allow deforestation impacts to remain externalities, which cause substantial welfare losses. Double materiality approaches to disclosures and due diligence can increase transparency about firms' direct and indirect links to deforestation and enable the internalisation of

deforestation-related externalities. This rightly increases the range of issues considered as material for FIs and allows them to avoid future important financial risks that they are exposed to.

CONCLUSION

To conclude, it becomes clear that financial institutions have a significant impact on and dependency from environmental and social aspects that cannot be ignored if we want to make the EU Green Deal work. Financial institutions need to systematically consider environmental impact in terms of their financial risks and the market risks. Furthermore, they need to use this assessment to inform how they address impacts with their investee companies and clients. In the following chapter, we will focus on where these aspects are best placed in existing FIs decision-making processes, by highlighting the key role of due diligence in this context.

HOW CAN FINANCIAL INSTITUTIONS ADDRESS THEIR ENVIRONMENTAL AND SOCIAL IMPACT THROUGH SUSTAINABILITY DUE DILIGENCE?

In this chapter, we explain why sustainability due diligence is the key approach for financial institutions (FIs) to systematically consider impacts of clients and investee companies and their supply chain on environmental and social issues. We do this by first showing that financial due diligence is a well-established element of financial institutions' risk management, and consequently the right process for addressing (risks associated with) sustainability impact. We discuss the dynamic growth of voluntary schemes but most importantly the development of mandatory legal frameworks, which is building on the concept of *sustainability due diligence*. We show how two key steps of conducting sustainability due diligence are aligned with the general risk mitigation strategies of FIs.

Our main motivation for this paper is the ongoing negotiations of the CSDDD proposal, which could make due diligence mandatory for companies and FIs.

DUE DILIGENCE: THE PRIMARY APPROACH TO RISK MITIGATION

Risk mitigation is not a new concept to FIs, it is at the core of their daily decision-making procedures. FIs have to assess and mitigate their financial risk on a continuous basis, to ensure their own and contribute to the financial system's stability. The corresponding process is called **due diligence**. There are multiple types of due diligence, but the principle stays the same: it consists of identifying the risks an institution faces, analysing and quantifying their severity, taking the necessary measures to mitigate them, and monitoring the success of the mitigation strategy. It basically ensures that FIs are aware of all the details that might raise exposure to risks; and make financing and investment decisions accordingly.

While most types of due diligence, such as the assessment of the economic viability of an investment (and the corresponding entity, such as the equity or bond issuer or loan applicant), are part of the standard risk management processes of FIs (and in the sense "voluntary" that they are essential parts of FIs self-interest in understanding the risk/return profile of an investment), FIs also face certain **due diligence duties**. Prominent examples are the obligations to identify and mitigate any risks of money laundering and corruption.

In the financial sector, due diligence is thus the primary approach to risk mitigation. It is a well-established concept which works well for FIs. Due to its wide implementation across different issues, from legal to commercial and financial objectives, it provides a coherent framework and is therefore also an obvious approach to deal with sustainability risks and address sustainability impacts caused by investee companies and activities taking place in their supply chains.

SUSTAINABILITY DUE DILIGENCE: A GROWING CONCEPT

Sustainability due diligence works the same way as other types of due diligence explained above, with an important differentiation: it concerns the environmental and social impacts and the need to mitigate those. As explained in the previous chapter, identifying and mitigating impact of their clients and investees and their supply chains will, in turn, enable FIs to reduce their own financial risks as well as the risks posed to the stability of the financial system. By conducting sustainability due diligence, FIs will be able to better understand the environmental and social harm caused by their investment and financial services and shift their financing to contribute to closing the sustainable investment gap.

Increasingly, companies and FIs are **voluntarily** considering negative impacts on sustainability issues, particularly in the fossil fuel industry. Progress is being made by FIs who engage with and support their clients to produce and implement emissions reductions plans.[30] The European Central Bank highlighted good practices for environmental risk management, where due diligence appears to be used by some FIs.[31] New technical guidelines and frameworks have also recently emerged to help companies and FIs incorporate ESG

due diligence in their decision-making, some of which will be referred to below. However, more action is required, especially in promoting efforts to prevent the loss of biodiversity and ecosystem services.

Legislative action to introduce **sustainability due diligence** is being taken across different constituencies. A few countries in Europe, such as France, Germany and Norway, have adopted, or are proposing, national corporate due diligence laws with different scopes and obligations.[32] Sustainability due diligence is furthermore necessary to comply with new sustainability-related reporting obligations, as will be explored in more detail below. At the core of many debates right now is the Corporate Sustainability Due Diligence Directive (CSDDD), still under negotiation. Early in December 2022, the European Parliament, European Council and European Commission came to an agreement on the Regulation on Deforestation-free Products (EUDR). Those laws and legislative proposals mandate due diligence for companies and for some also FIs (not within the EUDR and still under debate for the CSDDD) and try to clarify the steps required from those targeted entities in exercising due diligence on human rights and/or environmental norms.[iii]

Figure 2 below gives an overview of sustainability due diligence procedure as in the OECD Guidelines and the proposal for the CSDDD[iv]. It shows the 6 main steps to be taken:

Figure 2: Due diligence process and supporting measures (Source: OECD Guidelines, link)

The first step consists of integrating due diligence into internal policies and putting in place a specific due diligence policy. Step 2 involves identifying actual or potential adverse environmental and human rights impacts arising from their own operations, those of their subsidiaries and those of their business relationships, where these relate to their value chains. The third step is **to prevent and mitigate potential adverse impacts**, as well as to **bring actual adverse impacts to an end and to minimise their extent**. The fourth step consists of monitoring the effectiveness of the due diligence actions and the fifth step is to publicly communicate on the due diligence actions. Lastly, companies are also required to establish and maintain a complaints mechanism for stakeholders to submit concerns regarding actual or potential adverse impacts, and they must provide remediation, or cooperate in the provision of remediation, where appropriate.

The following sections dive deeper into Step 2 and Step 3, potentially most contentious aspects of sustainability due diligence. Step 2 is directly related to disclosure framework, while Step 3 is linked to the role of financial institutions in redirecting financing and investment.

Step 2: Identify and assess adverse impacts

The second step requires FIs to be aware of the (potential) impact their financial service causes, directly or indirectly through their investees and clients and their supply chains. For this purpose, disclosures are crucial. In the EU, the Corporate Sustainability Reporting Directive (CSRD) will serve as a reporting framework for sustainability information regarding a wide array of ESG issues. The disclosed information will directly inform companies and FIs under the CSDDD about their own and their clients' risks and impacts on a variety of ESG

[iii] The material scope of each law differs from one another.
[iv] The CSDDD bases its due diligence requirements on the due diligence principle introduced by the OECD Guidelines, although the order of steps slightly differs.

topics throughout their supply chains and will thus allow them to prevent, mitigate and bring to an end those risks by shedding light on where they happen.

Furthermore, the obligations arising from the CSDDD will ensure that many companies are covered by the same due diligence obligations and communicate their policies and impact publicly. FIs providing financial services to those companies will thus be able to make use of that information and to assess whether enough actions are being taken or whether they should engage with them more. Thus, EU legislation currently being elaborated will provide a framework for FIs to have easier access to data on value chains impacts and the due diligence processes put in place by their clients.

For FIs to comply with their due diligence duties and in particular the identification and assessment of adverse impacts under "step 2", it will be extremely important that regulators around the world:

(1) swiftly adopt mandatory sustainability disclosure standards;

(2) that these standards take a **double materiality approach to disclosure**, thus obliging companies to report annually on:

(a) sustainability risks to the company (from an "outside-in" or **financial materiality perspective)**, and

(b) sustainability impacts by the company (from an "inside-out" or **stakeholder/impact materiality perspective**).[33]

The EU has already adopted respective legislation (the Corporate Sustainability Reporting Directive) and is in the process of adopting the corresponding reporting standards.

Step 3: Cease, prevent or mitigate adverse impacts

The third step of sustainability due diligence requires FIs to **mitigate the potential impact and bring to an end adverse impacts** of investee companies or corporate clients and their value chains on ESG factors. This corresponds to the processes described in the previous section, stewardship/active ownership/engagement and divestment/ disengagement (as explained, the names varying depending on the type of FI, for example between institutional investors and banks). Due diligence as prescribed by the European Commission's proposal for the CSDDD is equivalent to a combination of (1) and (2) for both banks and institutional investors. **Box *2*** addresses a few differences between FIs and what this means in terms of the sustainability due diligence process to be conducted. The takeaway is that FIs, even if slightly differing in their risk mitigation practices and ultimate capacity to influence, can still apply the same main elements of due diligence.

Box 1: Consequences of sustainability risk assessment on capital adequacy

One important consequence for banks of identifying and assessing additional (sustainability) risk within their risk assessment processes is the need to increase **capital adequacy**. Capital adequacy refers to a certain amount of capital that banks must hold, corresponding to a percentage of the risk-weighted assets, determined by the capital adequacy ratio which is defined by regulators. This amount serves to avoid banks from becoming insolvent in case risks materialise. By including sustainability issues within their financial risk assessment, the risk-weight will increase due to the proper assessment of reputational, transition and physical risks that sustainability impacts can raise.[34] This, in turn, increases the capital adequacy, which for banks is money that they cannot use elsewhere. This can represent an additional cost for banks. However, due diligence as in the CSDDD and OECD Guidelines would require banks and other FIs to prevent and mitigate *potential* impact and bring to an end *actual* impact (Step 3). So, the risk-weight of the asset will as a result decrease and so will the capital adequacy. Therefore, it even serves FIs' interests to be more extensively aware of the risks that they face through adding sustainability impact in their risks assessment, as well as to conduct due diligence in order to mitigate and bring to an end the impact, avoiding some liquidity risks from higher capital adequacy.

While stewardship/engagement and divestment/disengagement are sometimes seen as two distinct strategies working separately, they should be seen as mutually supportive and thus complementary.

As represented in Figure 3, Engagement and divestment make up a two-step approach. While engagement should be the first step, to incentivise and require investee companies to change their behaviour and business practices (the carrot), divestment serves as a threat in case engagement is not successful and actions are not taken (the stick)[35]: "*divestment, or at least the possibility of divestment, is even a prerequisite for effective engagement, as the absence of the threat of divestment would render engagement toothless*".[36] The European Commission also recognises the importance of trying to exercise influence on unsustainable practices before disengaging or divesting.[37]

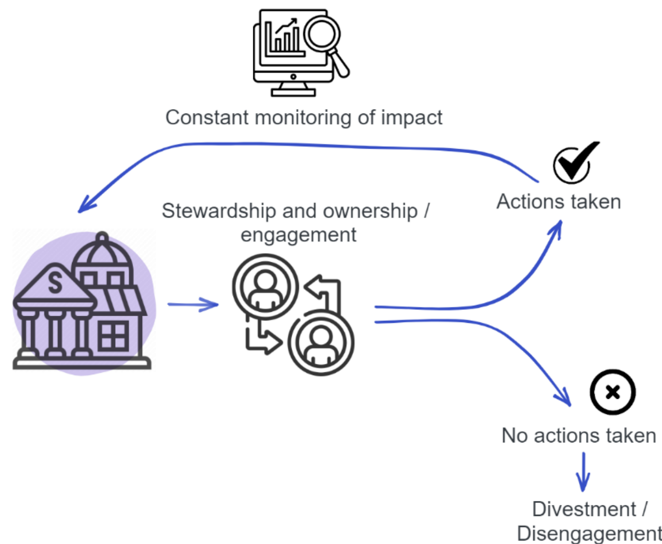

Figure 3: A two-step approach to mitigating and bringing to an end impact in investees' supply chains

Box 2 : Different strategies for institutional investors and banks

Regarding the different set-ups of financial institutions, the OECD has already published guidelines per sector, differing between institutional investors,[38] banks[39] and for project and asset finance transactions.[40] In the context of the CSDDD, the JURI Committee of the European Parliament has introduced a new provision (Article 8a[41]) to reflect the specific case of institutional investors (see Section "

Define measures to be taken by institutional investors and asset managers") and the European Commission is expected to provide sector-specific guidelines to comply with the requirements of the Directive.[42] However, the principles of due diligence stay the same and all kinds of FIs should be able to take the above six steps, even if differing in the exact procedure to be used.

In the case of institutional investors, while there are no direct operational or contractual ties between investor and investee companies, the investor can seek to influence the practices of the investee through active ownership, but also by taking and shifting equity stakes. "*The approaches investors can employ to use their leverage to influence companies they invest in are broad in scope. These are not limited to direct engagement with investee companies but could also involve, as appropriate, directing capital towards responsible investee companies over time, involvement in industry initiatives targeting certain Responsible Business Conduct risks, collective action on specific geographic or company-specific issues, etc.*"[43]

For banks, their disengagement strategy can differ from other FIs: "*Because banks cannot unilaterally stop disbursements or request an early prepayment of a loan unless this is expressly provided for in the financing documentation; disengagement in certain circumstances may involve avoiding additional provision of services to clients in the future.*"[44]

As mentioned earlier, a number of **guidelines on how to engage** with clients to address impacts happening throughout the supply chain already exist, which the European Commission could build on when elaborating

sector-specific guidelines for FIs within the context of the CSDDD[v]. For the specific case of deforestation, examples are the Accountability Framework initiative (AFi)[45] and the very recent Deforestation Due Diligence Guidelines for FIs from Global Canopy.[46] For example, Global Canopy's due diligence guidance provides recommendations on best practice actions that FIs can take through engagement, public communication of expectations, exercising stewardship and ownership rights or contractual requirements for the robust implementation of commitments towards deforestation.[47]

CONCLUSION

In this section, we discussed the importance of conducting due diligence with regard to sustainability impacts. Due diligence enables FIs to identify the problematic practices of clients and investee companies and put in place the right framework, including for stewardship/engagement and divestment/disengagement, to prevent and mitigate potential impacts, and bring to an end actual impact. Sustainability due diligence will allow FIs to reduce the financial risks that they face, as well as create the right incentives for and influence on companies to drive change. But why do we the CSDDD for this approach to work? The next chapter describes the key arguments to consider in relation to mandatory sustainability due diligence provisions.

[v] The UN PRI has already produced quite a few reports on stewardship, managing ESG risk in the supply chains of private companies and assets, active ownership, etc. The OECD, as explained earlier, also produced a few sector-specific guidelines.

WHY IS MANDATORY DUE DILIGENCE FOR FINANCIAL INSTITUTIONS KEY TO DELIVERING THE EU GREEN DEAL?

This section addresses the key reasons why sustainability due diligence needs to be made mandatory for financial institutions (FIs) to make the EU Green Deal work. We also explore the crucial role that sustainability due diligence obligations for FIs can play in reducing uncertainties in complying with EU sustainable finance legislation.

VOLUNTARY ACTIONS HAVE NOT BEEN ENOUGH

Experience shows that voluntary commitments by FIs to mitigate their impacts on, and risks from, environmental and social factors have so far not been implemented to a sufficient degree. For the case of deforestation, Forest 500 reports: "*Just seven (12 percent) of the 58 FIs with a deforestation policy have a commitment to engage with non-compliant clients/holdings to bring them into compliance for all commodities. 30 (52%) of the 58 FIs have this for at least one commodity*".[48] Many reports are being published to continue raising awareness about the need to systematically consider and address physical, transition and reputational risks that are and will emerge from sustainability impact, because those impacts are not yet addressed for many FIs.[49] Studies conducted as part of the elaboration of the EUDR have shown that mandatory measures are more effective than voluntary measures such as voluntary due diligence, labelling or private certification.[50]

The insufficient amount of impact mitigation measures by FIs on sustainability issues, such as tackling deforestation, has been argued by some to be caused by the **lack of guidance and data**. [51]

Regarding the **availability of data**, the issue is raised because the growing voluntary disclosure scheme has also showed similarly insufficient results as voluntary due diligence. The lack of mandatory supply-chain disclosures has especially caused corporate actors to underinvest in improving traceability of their supply chains or to managing their deforestation impacts. Studies provide evidence that voluntary approaches to disclosure have not sufficiently contributed to a reliable, comparable set of data on companies' impacts and risks, [52] while mandatory disclosure has a positive influence on the quality of information and ESG performance.[53] This is the reason why the EU has adopted the CSRD and is developing mandatory **European Sustainability Reporting Standards (ESRS)** based on the principle of **double materiality**, requiring companies and FIs to report on the same metrics in the same format.

Regarding the **need for guidance**, the European Commission, by including mandatory provisions for a targeted group, is responsible of ensuring that its legislation is feasible, and that guidance is provided to the affected audience on how to comply with its obligations. This responsibility is reflected in Art. 13 of the European Commission's CSDDD proposal[54], which highlights the European Commission's competence to issue guidelines, including for specific sectors or specific adverse impacts, in consultation with Member States and stakeholders, the European Union Agency for Fundamental Rights, the European Environment Agency, and where appropriate, with international bodies.

So, the inclusion of FIs in mandatory due diligence such as in the CSDDD, and the development of mandatory supply chain disclosures are two important milestones which will create an easier framework for FIs to conduct sustainability due diligence in the context of their financing and investment decisions.

CREATING A LEVEL-PLAYING FIELD FOR EU FINANCIAL INSTITUTIONS

EU legislation aims to ensure barriers to competition are removed in the internal market by creating a level-playing field across Member States. This is the case for disclosure regimes such as the CSRD and the SFDR, in which FIs and companies across the EU are faced with the same obligations. With common sustainability due diligence obligations through the CSDDD, the European Commission aims to create a level playing field for companies and FIs operating in the EU market.[55] The issue raised by FIs regarding the lack of guidance on how to conduct sustainability due diligence (see above) would be facilitated by specific due diligence steps

prescribed in law. However, a few EU Member States pushed against the inclusion of FIs in the CSDDD, which is reflected in the EU Council general approach.[56] The EU Council proposes to make the application of the Directive to FIs purely *voluntary* and leave it entirely to Member States whether to include FIs in the scope. This goes against the idea of creating a level playing field for companies and FIs across Member States, who would still be faced with different requirements depending on the countries in which they operate, leading to substantial liability risks, uncertainties and the distortion of competition within the EU.

INCREASING COHERENCE WITH EXISTING EU LEGISLATION

Mandatory due diligence obligations are as much needed for the financial sector as they are for real economy industries. Leaving FIs out of the scope of the CSDDD and future revisions of the EUDR would lead to significant incoherence in the EU legal framework for corporate sustainability due diligence and sustainable finance. This would not only be detrimental and potentially fatal to the EU's ambition to steer financial flows into sustainable business activities, due to the crucial role of FIs here. It would also lead to considerable legal uncertainties. FIs already have comprehensive sustainability-related obligations, particularly to gather information and evaluate sustainability risks, and they would therefore benefit from clear guidance on how to handle those risks once they have done the work of identifying and assessing them. The following sections explain the need of coherence from both to enhance the effectiveness of EU legislation, as well as to reduce legal uncertainties for FIs.

Coherence and ambition of overall EU legislation

The European Commission aims, as part of the European Green Deal, to mobilise at least EUR 1 trillion in sustainable investment from public and private actors between 2020 and 2030. The Renewed Sustainable Finance Strategy,[57] adopted in 2021, aims to create an enabling framework for the private and public sectors to facilitate sustainable investment. Regarding sustainable land use and forests, the European Green Deal reinforced the 2019 commitments on Stepping up EU Action to Protect and Restore the World's Forests.[58] Its priorities are, among other things, to: (1) reduce the footprint of EU consumption of land and encourage the consumption of products from deforestation-free supply chains; (2) redirect finance to support more sustainable land use practices; (3) support the availability and quality of information on forests and commodity supply chains. Further relevant EU strategies of the European Green Deal are the Farm to Fork Strategy,[59] the Biodiversity Strategy for 2030[60] and the new EU Forest strategy for 2030.[61]

With all these targets and commitments in place, concrete actions from FIs are necessary. Without their inclusion in due-diligence-related regulatory measures, the EU risks missing most of its targets from the EU Green Deal. Ambition in each regulatory measure, as well as coherence between them, are the crucial components of an efficient EU legislative framework which achieves a maximum level of implementation and impact.

Leaving FIs out of the scope of due diligence obligations may also weaken and even counter the effectiveness of due diligence obligations in the real economy. If companies in the real economy have to adhere to the CSDDD (and to adapt their behaviour accordingly) while FIs do not, the interests of the real economy and the financial sector are not aligned. It could be in the interest of FIs providing credit or loans, for instance, that financed companies neglect sustainability due diligence in favour of profits; also, FIs may have an incentive to shift investments to companies outside the EU that do not have to comply with due diligence obligations. Companies may therefore be tempted to conduct their due diligence less rigorously. If FIs, however, have due diligence obligations themselves, it is likely to strengthen sustainability due diligence in the real economy as well, as (non-financial) companies there would know that their sustainability performance will also have to be taken into account by FIs.

In this context, it is important to keep in mind that reporting obligations for the real economy under the CSRD are expressly designed to provide information that the financial sector needs to comply with its own existing obligations.[62] As FIs are provided with the necessary information about actual and potential risks anyway, it would be counterproductive to the sustainable finance framework not to derive any obligations of conduct for FIs under the CSDDD from these risk assessments. This incoherence is detrimental from a public policy

perspective, but it is also not in the interest of FIs themselves given their already existing due diligence duties, as will be shown in the following sub-sections.

Coherence with and guidelines for existing sustainability due diligence duties in the EU legislative framework

Recently, the EU has brought forward important legislative acts that address the financial sector and aim to facilitate and incentivise the transformation to a sustainable economy. These include, most notably, the **EU Taxonomy Regulation**[63], the **Sustainable Finance Disclosure Regulation**[64] (SFDR) and the **Corporate Sustainability Reporting Directive**[65] (CSRD). All these legislative acts address the financial sector (the Taxonomy Regulation and the CSRD apply to both the real economy and FIs).

In early 2023, Climate & Company and Germanwatch published an analysis of the current sustainability due diligence and reporting obligations for FIs across a core set of EU legislation.[66] Although not addressed comprehensively, the financial sector arguably already is required to comply with certain due diligence duties regarding the impact of their activities on sustainability matters under the mentioned regulatory measures, particularly with regard to gathering information on and evaluating adverse impacts. However, as far as the resulting duties of conduct are concerned, existing provisions share one thing in common: they lack the concretisation provided for by the CSDDD, thus leading to legal uncertainty:

The **SFDR** requires FIs to provide information regarding their investments and investment decision-making not only on the product level[67], but also on entity level[68]. Financial market participants have to disclose a statement on due diligence policies with respect to the principal adverse impacts of their investment decisions on sustainability factors, taking due account of their size, the nature and scale of their activities and the types of financial products they make available.[69] This due diligence statement is strictly mandatory (no "comply-or-explain") for financial undertakings with more than 500 employees (Art. 4 (3) SFDR) and is further concretised in the "Disclosure Delegated Regulation".[70] The obligation covers the description of the principal adverse impacts of investment decisions (including, e.g., scope 1-3 GHG emissions), of the policies to identify and prioritise those risks and of the engagement policies to reduce those adverse impacts.[vi] **In order to comply with these disclosure obligations, sustainability-related due diligence processes and policies must first be in place**.

The necessity to report on scope 1-3 GHG emissions shows that, at least with respect to climate impacts, the supply chain of investee companies must be taken into account. However, the inclusion of the value chain is incomplete and depends on the specific sustainability factor listed in Annex I of the "Disclosure Delegated Regulation".[71] For biodiversity, the reporting (and therefore the due diligence) obligation only refers to the share of investments in investee companies with sites and operations located in or near to biodiversity-sensitive areas where activities of those investee companies negatively affect those areas. This limitation to only direct investee companies' activities thus does not reflect the bulk of impact on biodiversity, such as caused by deforestation, which is highly concentrated in the upstream supply chain, in producing countries.

Insofar as adverse impacts and respective due diligence policies have to be reported under the SFDR, it is also clear that the policies described must actually be implemented by investors. It can be assumed that the general public rely on the information, so that false or incomplete information might lead to liability. In short: when it comes to investment decisions, the financial sector is already obliged to comply with certain due diligence obligations under the SFDR. However, there is a lack of concrete guidance on how to perform the necessary due diligence processes.[72] The thorough inclusion of FIs in the CSDDD would thus provide clarity and reduce legal uncertainty in the interest of FIs and end investors alike.

The **CSRD** applies to both the real economy and the financial sector. It expands and concretises the existing sustainability reporting obligations in Art. 19a and 29a, 29b of the Accounting Directive.[73] The upcoming ESRS[74] drafted by the European Financial Reporting Advisory Group (EFRAG)[75] will further concretise these disclosure obligations. FIs have to provide, inter alia, a description of their sustainability-related due diligence processes, principal actual or potential adverse impacts connected with their own operations and within their value chain

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[vi] A template for the statement is provided in Annex I of the Delegated Regulation EU/2022/1288.

as well as any actions taken to prevent, mitigate, remediate or bring an end to actual or potential adverse impacts, and the result of such actions.[76] **In general, the reporting requirements refer to the undertaking's entire value chain**.[77] Disclosure obligations are not limited to past performance but must include forward-looking information in the short, medium and long term.[78] The CSRD gives no specification on **how** exactly to perform sustainability-related due diligence, but delegates this to the ESRS. According to the CSRD, due diligence requirements should be specified in greater detail there, making reference to the UN Guiding Principles and OECD guidelines.[79] The current EFRAG Draft of the ESRS 1 on General Principles[80] emphasises that due diligence processes inform the assessment of material impacts and thus determine what needs to be reported.[81] Therefore, while the CSRD directly only concerns *disclosure* of the respective due diligence processes conducting the **first and second step of sustainability due diligence (identification and assessment of risks) is an integral prerequisite for fulfilling reporting obligations**. FIs have to assess "*principal actual or potential adverse impacts connected with the undertaking's own operations and with its value chain*"[82] to meet their disclosure obligations. Arguably, the CSRD implicitly requires sustainability-related *action* as well, as it has to be reported "how" (not: "if") an undertaking's strategy takes into account stakeholder interests and has been implemented with regard to sustainability matters.[83] In any case and generally speaking, knowledge of risks and adverse impacts will often lead to a legal expectation to deal with those risks. But the CSRD provides no framework for how this should be done. This puts FIs in a difficult position, as ignoring known risks and impacts, or not handling them appropriately can lead to liability towards stakeholders as well as shareholders (if there are financial consequences). The CSDDD would provide a clear legal framework for how to deal with known risks and impacts, thus mitigating FIs' liability risks.

Financial due diligence duties

The above-described implicit due diligence duties of FIs concern the impact of their activities on sustainability matters. This "inside-out-perspective" corresponds to the one taken by the CSDDD. Distinct from, yet closely related, to this is the obligation of FIs to consider the environmental and social impacts of their investments and clients as a financial risk in the context of their **financial due diligence** ("outside-in-perspective"). Both perspectives are closely connected because sustainability impacts increasingly translate into financial risks. Investments in unsustainable assets, for instance, carry both transition risks and reputational risks (See Section "Impacts can become financial risks…"). It is therefore paramount for FIs to include such risks in their financial due diligence. This duty exists irrespective of changes in the legal framework regarding sustainability reporting, as highlighted in in the SFDR (see Box 3).

Box 3: Sustainable Finance Disclosure Regulation (SFDR), Recital 12.

This Regulation maintains the requirements for financial market participants and financial advisers to act in the best interest of end investors, including (…) the ***requirement of conducting adequate due diligence prior to making investments****, provided for in Directives (…), and Regulations (…), as well as in national law governing personal and individual pension products.* ***In order to comply with their duties under those rules****, financial market participants and financial advisers should* ***integrate in*** *their processes, including in* ***their due diligence processes****, and should assess on a continuous basis not only all relevant financial risks but also including* ***all relevant sustainability risks that might have a relevant material negative impact on the financial return of an investment or advice****. (…)."*

Although the immediate point of reference is different (impact on sustainability vs. impact on financial expectations), the inclusion of FIs into the CSDDD would also facilitate compliance with their financial due diligence obligations. As FIs have to gather and report comprehensive information on sustainability risks and adverse impacts under the SFDR and the CSRD anyways, they cannot claim that they were unaware of those risks, once they turn out to be financially relevant as well. Yet, they are currently left without any clear guidance on how to manage these risks. The proper implementation of impact due diligence under the CSDDD would provide a basis for evaluating financial risks stemming from the identified sustainability risks as well as disclosing how these risks are dealt with (in terms of engagement and/or divestment/disengagement). Without such guidance, however, there is considerable legal uncertainty on the level of financial due diligence as well.

CONCLUSION

In conclusion, because voluntary commitments by FIs to mitigate impacts of their clients and investee companies are not sufficient to address the climate change, biodiversity loss and related financial risks, mandatory sustainability due diligence provisions are needed. From a policy coherence perspective, as well, obligations for FIs in the CSDDD would resolve a lot of uncertainties and unclarities in legal requirements across regulatory measures and create a more secure and helpful framework for FIs to address their impact, based on clearer guidelines. However, as we demonstrate in the next chapter, the CSDDD, as proposed by the European Commission and as amended by the JURI Committee, is currently not including FIs in a way which will sufficiently address sustainability impacts.

WHAT ARE THE SHORTCOMINGS OF THE CSDDD WITH REGARD TO THE INCLUSION OF FINANCIAL INSTITUTIONS?

Considering the crucial potential of financial institutions (FIs) to mitigate impacts on the environment and on human rights through their engagement and capital allocation strategies; the benefits of mandatory provisions for the efficiency of EU legislation ; and the reduction of legal and administrative uncertainties for FIs, the policy brief recommends that EU decision-makers "in charge of" the CSDDD, as well as FIs themselves, push for due diligence obligations of FIs under the CSDDD, to the same extent as the due diligence obligations for non-financial corporates.

As explained above, the basic steps for "the real economy" exercising due diligence can be applied to the provision of financial services as well. FIs have strong leverage in relation to human rights and environmental impacts but are not yet using this leverage sufficiently. Furthermore, conducting sustainability-related due diligence will help FIs in managing their financial risks, especially over the long term (see Section "How can financial institutions address their environmental and social impact through sustainability due diligence?"). Mandatory due diligence is needed in the interest of both stakeholders and FIs themselves. As explained in the previous chapter, having no, or only inadequate inclusion in the CSDDD would not only undermine the EU's sustainability disclosure framework for the green transition but also expose FIs to legal uncertainties as they are effectively already (directly and indirectly) obliged to conduct sustainability-related due diligence under several bodies of EU law.

Therefore, the exceptions for financial market actors in the CSDDD proposal should essentially be abolished. Some of the issues are at least partially addressed in the JURI Committee's report[84]. In detail:

DEFINITION OF THE VALUE CHAIN

The definition of the "value chain" for FIs as per Art. 3 lit. g) European Commission proposal – unchanged by the JURI Committee report in this respect – only extends to:

a) the clients receiving such loan, credit, and other financial services and of other companies belonging to the same group whose activities are linked to the contract in question.
b) excluding small or medium-sized companies (SMEs), households and natural persons receiving financial services.

This means that the due diligence obligations of the respective FIs effectively only extend to the actual and potential adverse effects arising from the operations of the direct recipients of financial services and exclude the remaining tiers of their value chains. Furthermore, SMEs are generally excluded. Regarding deforestation, this would mean that only where the (non-SME) entity that receives the financial service from the FI is itself involved in or causing significant deforestation would potentially be covered by the due diligence obligations of the FI. Any deforestation further down the value chain would not be covered.

These limitations are not appropriate for several reasons. From a stakeholder perspective, they run counter the purpose of the Directive to mitigate potential and bringing to an end actual adverse impact on the environment and human rights. At the same time, they are not helpful for FIs either, as the exceptions are incoherent with existing due diligence duties for FIs and do not support FIs in assessing and mitigating the financial risks that they face from those adverse impacts.

As for the **limitation to direct suppliers**, many risks and adverse impacts to human rights and the environment will not be covered as they happen upstream in the supply chain. This is why the CSDDD is also called the "EU Supply Chain Law" and covers the whole value chain of non-financial companies. Figure 3 below shows that, for the high-risk sectors, such as food and beverage, construction and materials, the automotive and the financial sector, the bulk of impact is located in the supply chain, and thus cannot be mitigated by looking solely at the own operations of those clients. The financial risks, even if assessed from a double materiality perspective, will be highly undermined if only looking at their direct clients' operations.

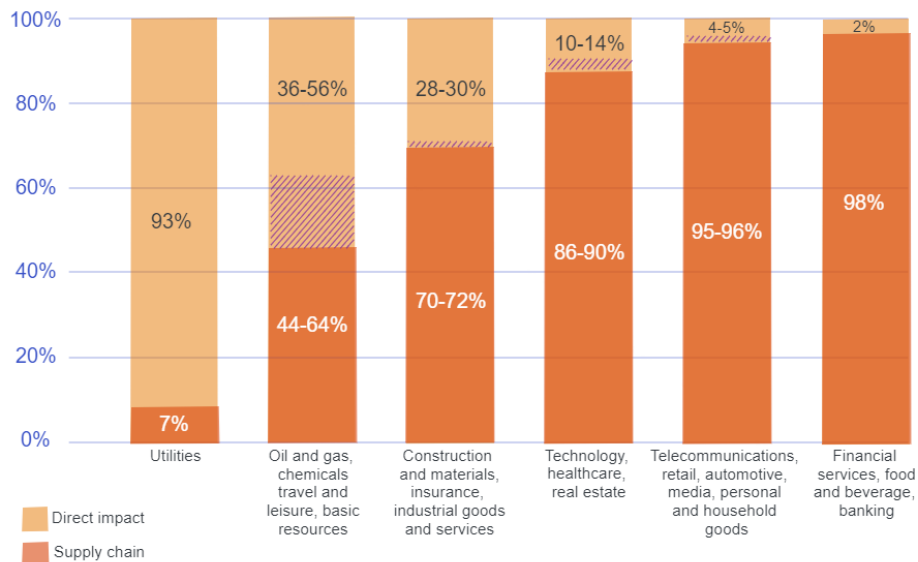

Figure 4: Share of a sector's environmental impact located in the supply chain (Source: UN Principles for Responsible Investment, 2017, link)

Secondly, the exclusion of SMEs from the value chain of FIs is not coherent with the approach chosen for non-financial corporates. Aimed at avoiding additional costs on those companies who might have less capacities to conduct due diligence, the same argument would apply to real economy value chains, where SMEs are included nonetheless. There is no apparent reason, for instance, why a contractual assurance of compliance with an FI's code of conduct or prevention action plan (cf. Art. 7 CSDDD proposal) should be less feasible than in the real economy. At the same time, FIs leverage in relation to adverse environmental and human rights impacts is particularly valuable with regard to SMEs, which constitute the large majority of companies in certain high-risk sectors, such as agriculture and construction.[85] Excluding them from the scope of companies for which FIs have to conduct due diligence under the CSDDD means that a bulk of impacts on the environment would not be accounted for. As sustainability risks can easily translate into financial risks (particularly so in high-risk sectors), an exclusion of SMEs would furthermore inhibit the timely identification of such risks for FIs.

In the self-interest of FIs, a more comprehensive definition of the value chain and therefore, due diligence duties, is recommended. From a coherence perspective, the limitation to direct clients is inconsistent with other EU laws already obliging FIs to consider the entire value chain when conducting sustainability-related due diligence in order to comply with their reporting obligations (SFDR for GHG emissions, CSRD) and when conducting financial due diligence in order to identify, e.g., transition risk. The very limited definition of the value chain in the CSDDD therefore leads to frictions with other EU legislation and to legal uncertainty.

Therefore, the value chain for FIs should generally include the entire upstream value chain. SMEs should be covered as well as households and natural persons because the use of financed products by households and customers has to be taken into account, particularly with a view on climate change and scope 3 emissions (resulting, e.g., from the use of fossil fuels). We appreciate that this might constitute a challenge for FIs. It would require considerations of phase-in periods and government support for FIs in tackle issues related to getting access to data on SMEs' supply chain impact. We thus encourage European and national decision-makers to consider data challenges, particularly in the context of the current decisions on the EU disclosure framework.

ONLY PRE-CONTRACTUAL IDENTIFICATION OF ACTUAL AND POTENTIAL ADVERSE IMPACTS

According to Art. 6 (3) of the European Commission's CSDDD proposal, when FIs provide credit, loan or other financial services, the identification of actual and potential adverse human rights impacts and adverse environmental impacts shall be carried out only **before** providing said financial service. This is unlike all the other companies covered by the proposal which are required to carry out this identification on a continuous

basis. This would mean that FIs do not have to reassess the impacts that their clients might have on environmental norms and human rights throughout the financial services period.

Limitation to pre-contractual due diligence should be abolished. It is incoherent with the concept of **dynamic materiality** (see Section "Impacts can become financial risks…"), as well as the core purpose of sustainability due diligence, which is to prevent and mitigate potential impact as well as bring to an end actual impact. Those might vary over the years depending on, for example, changes in the production lines. The OECD is very clear: "*Due diligence is an on-going, proactive and reactive, and process-oriented activity; it is to be carried out throughout the entire life-cycle of operations, products and services because circumstances change and so will adverse impacts*"[86]. Continuous monitoring is also demanded from the real economy under the CSDDD proposal. There is clear incoherence, for instance, if a company receiving a loan must conduct ongoing due diligence with regard to its activities and its supply chain, while the FI providing the financing can ignore the results of this analysis. The need to abolish this limitation is further supported by the fact that due diligence obligations of FIs that are (directly or indirectly) rooted in other legislation are ongoing and not limited to the conclusion of the contract. This is true, e.g., for the due diligence processes necessary for compliance with reporting obligations under the CSRD and the SFDR, as well as for financial due diligence.

The JURI Committee report[87] partially addresses the shortcomings of the European Commission's proposal in this respect, adding an obligation for FIs to also identify and assess risks "before subsequent financial operations, and, if notified of possible risks via the procedures in Art. 9, during the provision of the service." This is certainly a step forward. However, there is no reason to limit the necessity to perform a continuous risk assessment with regard to continuing investments and contractual relationships such as loans, especially since the report of the JURI Committee brings its own uncertainties (what constitutes a "subsequent financial operation?").

OBLIGATION TO TERMINATE BUSINESS RELATIONSHIPS

The (backup) obligation of companies to terminate a business relationship with respect to the activities concerned in case of (potential) severe impacts, is severely weakened for FIs in the European Commission's proposal. According to its Articles 7 (6) and 8 (7), FIs are not required to terminate the credit, loan or other financial service contract, when this can be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided.

This special provision for FIs is unwarranted and counterproductive. First of all, termination of a contract or divestment is an important backup in case engagement attempts fail, as discussed in Section "Step 3: Cease, prevent or mitigate adverse impacts". FIs' leverage with regard to mitigating adverse impacts is severely weakened if there is no credible threat of terminating a business relationship or selling assets ("divesting") if needed. While it makes sense to prefer engagement over divestment, both strategies are complementary, as discussed above. Furthermore, the limitation "reasonably expected to cause substantial prejudice" is very open and vague. FIs potentially face liability risks from both directions (stakeholders and contractual relationships) as they are put in a position where it is unclear whether termination of a contractual relationship is mandated or not.

The wording of the JURI Committee report (Articles 7 (6) and 8 (7)) is an improvement as it limits the exception to cases where continuation of the contract is strictly necessary to prevent bankruptcy of the entity to whom that service is being provided. This provides more clarity and keeps termination as a last resort in most cases. However, even this limitation remains counterproductive and unnecessary. There is no reason to establish special rules for the financial sector with regard to termination, as the risk of bankruptcy might as well be present when terminating a contractual relationship in the real economy. The same is true for the additional sentence proposed by the JURI Committee that a decision to terminate a financial service may only be taken as a last resort, if all other leverage efforts have failed. The proposed JURI Committee's amendments already stipulate as a general rule that suspending and terminating a business relationship is only "a last resort, in line with responsible disengagement". Repeating this for FIs is unnecessary.

DEFINE MEASURES TO BE TAKEN BY INSTITUTIONAL INVESTORS AND ASSET MANAGERS

The JURI Committee proposes a new Art. 8a to the CSDDD that specifically targets institutional investors and asset managers. Those FIs have to induce their investee companies to bring actual impacts to an end (Art. 8a (1)) or at least to minimise such impacts (Art. 8a (2)). For those purposes, institutional investors and asset managers shall be required to engage with investee companies, e.g. by exercising voting rights. This specific provision is to be welcomed as it provides guidance for investors and recognises the leverage that they have regarding the behaviour of investee companies.

However, the provision should be extended to the prevention of potential adverse impacts (Art. 7). The leverage large investors have should not only be mobilised retroactively to past violations but also to prevent potential adverse impacts. Furthermore, divestment should be explicitly mentioned as a last resort where (potential) adverse impacts are severe, and engagement has ultimately failed.

OPTIONS FOR IMPROVING THE INCLUSION OF FINANCIAL INSTITUTIONS IN THE SCOPE OF MANDATORY DUE DILIGENCE IN THE CSDDD

The above comparison of the different texts reveals that the compromise passed in the JURI Committee of the European Parliament, despite a number of considerable and regrettable shortcomings, provides the most coherent, and most specific proposal for a framework on due diligence duties for FIs, so far. However, the below recommendations remain extremely pertinent and ought to be reflected in the final outcome of the political process involving the EU Commission, Council and Parliament.

EU Commission proposal	JURI Committee report	Our options for improvement
On the definition of value chain:		
Art. 3 (g) […] As regards companies within the meaning of point (a)(iv), 'value chain' with respect to the provision of these specific services shall only include the activities of the clients receiving such loan, credit, and other financial services and of other companies belonging to the same group whose activities are linked to the contract in question. The value chain of such regulated financial undertakings does not cover SMEs receiving loan, credit, financing, insurance or reinsurance of such entities;	Art. 3 (g) […] As regards companies within the meaning of point (a)(iv), 'value chain' with respect to the provision of these specific services shall include the activities of the clients ***directly*** receiving such ~~loan, credit, and other~~ financial services *provided by financial undertakings pursuant to point (iv)* and of other companies belonging to the same group whose activities are linked to the contract in question. The value chain of ~~such~~ regulated financial undertakings *within the meaning of point (a)-(iv)* does not cover *households and natural persons or* SMEs ~~receiving loan, credit, financing, insurance or reinsurance of such entities.~~	Art. 3 (g) […] As regards companies within the meaning of point (a)(iv), 'value chain' with respect to the provision of these specific services shall include the activities of the clients directly receiving financial services *as well as the value chain of this client that relates to the financial service in question*.
On the limitation to pre-contractual due diligence		
Art. 6 (3) When companies referred to in Article 3, point (a)(iv), provide credit, loan or other financial services, identification of actual and potential adverse human rights impacts and adverse environmental impacts	Art. 6 (3) When companies referred to in Article 3, point (a)(iv), provide credit, loan or other financial services, identification of actual and potential adverse human rights impacts and adverse environmental impacts	*Art. 6 (3) of the European Commission proposal to be deleted entirely.*

shall be carried out only before providing that service.	shall be carried out only before providing that service *and before subsequent financial operations, and, if notified of possible risks via the procedures in Article 9, during the provision of the service*.	
On termination of financial services		
Art. 7 (6) By way of derogation from paragraph 5, point (b), when companies referred to in Article 3, point (a)(iv), provide credit, loan or other financial services, they shall not be required to terminate the credit, loan or other financial service contract when this can be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided. Art. 8 (7) By way of derogation from paragraph 6, point (b), when companies referred to in Article 3, point (a)(iv), provide credit, loan or other financial services, they shall not be required to terminate the credit, loan or other financial service contract, when this can be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided.	Art. 7 (6) By way of derogation from paragraph 5, point (b), when companies referred to in Article 3, point (a)(iv), provide ~~credit, loan or other~~ financial services *to entities that cause or contribute to potential adverse impacts within the meaning of paragraph 1*, they shall not be required to terminate the financial service contract ~~when this can be reasonably expected to cause substantial prejudice~~ *if this is strictly necessary to prevent bankruptcy* to the entity to whom that service is being provided. *In addition to paragraph 5, second subparagraph, a decision to terminate the financial service contract in derogation from paragraph 5, first subparagraph, point (b) may only be taken, as a last resort, if the leverage efforts of companies referred to in Article 3, point (a)(iv) have ultimately failed to influence the entity to whom that service is being provided to prevent or adequately mitigate adverse potential impacts.* Art. 8(7) By way of derogation from paragraph 6, point (b), when companies referred to in Article 3, point (a)(iv), provide ~~credit, loan or other~~ financial services *to entities that cause or contribute to actual adverse impacts in the meaning of paragraph 1*, they shall not be required to terminate the financial service contract, *if this is strictly necessary to prevent*	*Articles 7 (6) and 8 (7) of the European Commission proposal to be deleted entirely.*

	bankruptcy ~~when this can be reasonably expected to cause substantial prejudice~~ to the entity to whom that service is being provided. *In addition to paragraph 6, second subparagraph, a decision to terminate the financial service contract in derogation from paragraph 6, point (b) may only be taken, as a last resort, if the leverage efforts of companies referred to in Article 3(1), point (a)(iv) have ultimately failed to influence the entity to whom that service is being provided to bring actual adverse impacts to an end or to minimise their extent.*	
On appropriate measures by institutional investors and asset managers to induce their investee companies to bring actual adverse impacts caused by them to an end		
	Art. 8a (new) - A Appropriate measures by institutional investors and asset managers to induce their investee companies to bring actual adverse impacts caused by them to an end *1. Member States shall ensure that institutional investors and asset managers take appropriate measures as described in paragraph 3 of this Article to induce their investee companies to bring actual adverse impacts to an end that have been, or should have been identified pursuant to Article 6.* *2. Where the adverse impact cannot be brought to an end, Member States shall ensure that institutional investors and asset managers induce their investee companies to minimise the extent of such an impact.* *3. Where relevant, institutional investors and asset managers shall be required to engage with the investee company and exercise voting rights in line with Article 3g (1), point (a), of Directive 2007/36/EC [SRD2], in order to induce the management body of an investee company to bring the actual impact to and*	*Art. 8a (new)* *(1)* Member States shall ensure that institutional investors and asset managers take appropriate measures as described in paragraph 3 of this Article to induce their investee companies to bring actual adverse impacts that have been, or should have been, identified pursuant to Article 6 to an end *and to prevent potential adverse impacts,* in accordance with Article 2, paragraphs 2 to 6. (2) Where the adverse impact cannot be brought to an end, *or a potential adverse impact cannot be prevented,* Member States shall ensure that institutional investors and asset managers induce their investee companies to minimise the extent of such impact *or to mitigate potential adverse impacts.* 3. Where relevant, institutional investors and asset managers shall be required to engage with the investee company and exercise voting rights in line with Article 3g (1), point (a) of Directive 2007/36/EC [SRD2], in order to induce the management body of

	end or minimise its extent. The action sought from the investee company shall be proportionate to the significance and scale of the adverse impact and to the contribution of the investee company's conduct to the adverse impact. Likewise, the actions required from institutional investors and asset managers shall be proportionate and commensurate, and shall take due account of the degree of control they have over the investee company.	an investee company to bring the actual impact to and end or minimise its extent. The action sought from the investee company shall be proportionate to the significance and scale of the adverse impact and to the contribution of the investee company's conduct to the adverse impact. Likewise, the actions required from institutional investors and asset managers shall be proportionate and commensurate, and shall take due account of the degree of control they have over the investee company. *(4) Where measures pursuant to paragraphs 1 to 3 of this Article have ultimately failed to bring the adverse impact to an end or to at least meaningfully minimise the extent of such impact, or where measures pursuant to paragraphs 1 to 3 of this Article have ultimately failed to prevent potential adverse impacts could or to meaningfully mitigate such potential impacts, institutional investors and asset managers shall, as a last resort, withdraw their investments in investee companies.*

CONCLUSION

This policy brief demonstrated the need for financial institutions (FIs) to consider and address the impact of their clients and investees on people and planet along their entire supply chains. The financial risks that are facing individually, as well as financial markets on aggregate, require a systematic inclusion of sustainability impact in their risk mitigation strategies. Furthermore, FIs play a key role in influencing their investee companies and clients into mitigating their harmful practices and activities. FIs have the potential to be the game changer in the fight against biodiversity loss and the climate crisis, in the EU and beyond.

In this context, sustainability due diligence is key. As a comprehensive process which enable FIs to identify, prevent, mitigate and account for external harm caused by social and environmental impacts, sustainability due diligence works very similarly to the well-established risk mitigation strategies of FIs. For a company or FI to be able to exercise sustainability due diligence in its activities, it must be aware of the (potential) impacts that it causes, directly or indirectly through its clients and supply chains. In this regard, the implementation of the Corporate Sustainability Due Diligence Directive (CSDDD) and other potential due diligence requirements would be significantly facilitated by solid and mandatory value chain disclosure, which reflects the concept of double materiality.

For the effectiveness of EU legislation and to ensure that actions are being taken by the financial sector, mandatory sustainability due diligence provisions for FIs are crucial.

First, ***voluntary commitments are not enough***. Due diligence has not yet been sufficiently incorporated in the risk management procedures of FIs due to dissuasion caused by information asymmetries, high search costs and non-disclosure of value chain relationships and sustainability risks and impacts in the supply chain.

Furthermore, ***FIs need a level-playing field***, which could be provided by EU legislation which addresses them the same way across EU Member States. This would reduce the uncertainties in liability risks and compliance requirements that FIs face across different regulatory measures. Leaving the inclusion of FIs up to Member States in their national transposition of the Directive would risk significantly distorting competition in the EU's internal market.

Finally, ***policy coherence is key for an effective and efficient framework***. Excluding financial institutions from due diligence obligations would create serious incoherence in the EU legal framework for corporate sustainability due diligence and sustainable finance. This would first undermine the crucial role of financial institutions in achieving the EU's goal of "shifting trillions [of EUR]" toward sustainable business activities. It would also create considerable legal uncertainties for FIs, who would benefit from clear guidance on how to comply with their existing sustainability-related obligations in EU legislation.

To create the right framework for the issues stated above to be addressed, the CSDDD, currently under negotiation, needs to be formulated in a way as to include FIs in a complete and comprehensive manner. We recommend the European Commission, European Council and European Parliament to consider the following most important aspects:

The definition of the value chain of FIs. It should generally include the entire upstream value chain of FIs' clients and investee companies, due to the bulk of impact happening upstream, in producing countries, such as deforestation.

The limitation to pre-contractual identification of actual and potential adverse impacts, which should be abolished to the dynamic nature of materiality, which can only be rightly reflected in risk mitigation strategies if based on continuous assessment of impacts and thus risks.

The obligation to terminate "business relationships", which the JURI Committee improves but which should still not differ from the real economy.

The specific measures to be taken by institutional investors and asset managers, which is a first step in the elaboration of guidelines for different types of FIs.

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Climate & Company - The Berlin Institute for Climate Training and Research gGmbH

Louise Simon, Ingmar Juergens

Ahornallee 2 | 12623 Berlin

www.climateandcompany.com | hello@climcom.org

Rechtsanwälte Günther

Dr. Johannes Franke

Mittelweg 150 | 20148 Hamburg

www.rae-guenther.de | post@rae-guenther.de

Germanwatch e.V.

Katharina Brandt

Stresemannstr. 72 | D-10963 Berlin

Tel. +49 (0)30 / 57 71 328-0

www.germanwatch.org | info@germanwatch.org

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