March 2023

Version 4.0

Sustainability due diligence and reporting obligations for financial institutions

The coverage of the financial sector across a core set of EU regulatory measures

THE CASE OF DEFORESTATION, BY CLIMATE & COMPANY AND GERMANWATCH

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EXECUTIVE SUMMARY

The purpose of this briefing is to provide for a clear understanding of the **obligations to expect for financial institutions (FIs)** under each of the relevant recent EU regulatory measures related to sustainability disclosure and due diligence. This will be done by illustrating the respective obligations by drawing on the case of **deforestation-related risks and impacts**. This brief also aims to discuss the consequences that the inclusion or exclusion of FIs in each regulatory measure could lead to.

To date, the financial sector plays a significant role in funding investments that contribute to deforestation. Therefore, FIs have a crucial role to play in curbing deforestation and associated land-use change, which are key drivers of climate change and biodiversity loss. The aim of some recent EU regulatory measures is to impose sustainability due diligence or reporting obligations for FIs (or businesses more generally), based on the idea that such legislation could shift capital away from investments that contribute to deforestation. However, this overview shows that it is currently far from certain that such comprehensive duties will indeed be included in these files.

The briefing is structured as follows: first, the role that FIs play in causing deforestation is highlighted, followed by an in-depth explanation of the coverage of FIs as it can be expected based on the current status of the below-mentioned regulatory measures and an analysis of their obligations. This briefing explains each measure's a) main content, b) potential impact on deforestation, c) current status, and d) reporting/due diligence obligations for FIs, elaborating on the final or draft texts of the files. This last section addresses four key points: i) the kind of FIs included in the scope, ii) the proposed obligations for FIs, iii) specific sustainability due diligence/disclosure requirements for FIs, and iv) date of application of the disclosure and/or due diligence requirements for FIs.

The five key regulatory measures which are covered in this briefing include:

1. **Regulation on Deforestation-free Products** (EUDR),
2. **Corporate Sustainability Due Diligence Directive** (CSDDD)
3. **Corporate Sustainability Reporting Directive** (CSRD)
4. **EU Taxonomy Regulation**
5. **Sustainable Finance Disclosure Regulation** (SFDR)

Three additional regulatory measures are covered due to their potential relevance for FIs' reporting obligations:

6. **Solvency II**
7. **Markets in Financial Instruments Directive II** (MiFID II),
8. **EU Banking Package – Capital Requirements Directive** (CRD) **and Regulation** (CRR)

The four main takeaways of this briefing are as follows:

1. While deforestation as a (potential) adverse impact is in principle covered by some of the regulatory measures addressed here, **none of the EU regulatory measures include thorough sustainability due diligence requirements for FIs**, particularly regarding deforestation. The EUDR and CSDDD could be suitable instruments to prescribe such requirements but do not comprehensively do so in their current (draft) texts.
2. **Ambitious mandatory disclosure on sustainability risks and impacts would greatly facilitate the exercise of due diligence**. Particularly for FIs, the implementation of the CSDDD and EUDR would be significantly facilitated by solid and mandatory value chain disclosure requirements.
3. For the mandatory disclosure of companies' sustainability risks and impacts to be useful to FIs, **the specific requirements of the EU disclosure regulatory measures will need to enter into force as soon as possible** (and realistically feasible).
4. **Guidance from the Commission would help FIs to comply with their disclosure and sustainability due diligence requirements**.

OVERVIEW OF OBLIGATIONS OF FINANCIAL INSTITUTIONS

<table>
<tr><th rowspan="2">Regulatory measure</th><th rowspan="2">Types of FIs covered</th><th colspan="2">Types of obligations</th></tr>
<tr><th>Disclosure obligations</th><th>Environmental due diligence obligations</th></tr>
<tr><td rowspan="2">Regulation on Deforestation-free Products (EUDR)
Prohibits the import of products such as cattle, cocoa, coffee, oil palm, soybean, charcoal and printed products, rubber and wood which were produced on land deforested after 31 December 2020</td><td colspan="3">None.</td></tr>
<tr><td colspan="3">Two years after the entry into force of the EUDR, the EU Commission will publish an impact assessment for the review of the Regulation, where it evaluates the role of financial institutions in preventing deforestation through their capital allocation and assess the need to provide for additional obligations in EU legislation. This does not guarantee that the Commission will conclude that financial institutions need to be added to the scope of the EUDR.</td></tr>
<tr><td rowspan="2">Corporate Sustainability Due Diligence Directive (CSDDD)
Requires undertakings to conduct human rights and environmental due diligence to prevent and bring to an end adverse impacts</td><td colspan="3">Commission proposal:</td></tr>
<tr><td>FIs with more than 500 employees on average and a net worldwide turnover of more than 150 million euros in the last financial year</td><td>Publication of annual statement describing due diligence measures taken (only for companies not covered by CSRD)</td><td>FIs are required to conduct human rights and environmental due diligence:
– only before a contract is concluded,
– only with regards to direct contractual partners and only where these are not SMEs.
FIs are never required to terminate a business relationship where this termination can be expected to cause “substantial prejudice” to the business partner.</td></tr>
</table>

Regulatory measure	Types of FIs covered	Types of obligations	
		Disclosure obligations	**Environmental due diligence obligations**
arising from their own operations and their supply chains			Potential or actual adverse impacts that companies (including FIs) are required to address through their due diligence procedures do only explicitly include deforestation if linked to a human rights impact.
	Council position:		
	Application of the Directive to FIs on a purely **voluntary** basis	New exception introduced: companies (including FIs) that are included in a consolidated management report under the CSRD will not need to report under the CSDDD.	Where member states decide to apply the Directive to FIs, only banks and insurers would need to conduct human rights and environmental due diligence with regards to their (direct) clients. Investments and other financial services are exempted. Exceptions for FIs introduced by the Commission proposal are maintained.
	No **Parliament position** yet		
Corporate Sustainability Reporting Directive (CSRD) *Establishes a sustainability reporting framework*	Small, medium and large listed entities[1], credit institutions and insurance undertakings	Double materiality assessment: – The due diligence process implemented with regard to sustainability matters; – The principal, actual or potential adverse impacts connected with the undertaking's value chain, including its own operations, its products and services, its business relationships and its supply chain;	None[2].

[1] "*governed by the law of a Member State and whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point (14) of Article 4(1) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments*" (Art. 2 (1) (a) of Directive 2013/34/EU)

[2] While the implicit expectation for entities covered by the CSRD is that they carry out sustainability due diligence processes, it does not expressly oblige them to do so

Regulatory measure	Types of FIs covered	Types of obligations	
		Disclosure obligations	**Environmental due diligence obligations**
		– Any actions taken, and the result of such actions, to prevent, mitigate or remediate actual or potential adverse impacts. – A description of the principal risks to the undertaking related to sustainability matters and how these risks are managed. – Plans to ensure that the business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement	
EU Taxonomy Regulation *Establishes a classification framework that defines when an economic activity can be considered sustainable in the EU*	FIs in scope of the CSRD	Disclose the proportion of their financial activities that are taxonomy-eligible and -aligned	None.
Sustainable Finance Disclosure Regulation (SFDR) *Aims to improve the transparency of sustainability-related disclosures in the financial services sector*	FIs which sell and manage investment, pension, and portfolio products	Financial products which claim to take the impact of sustainability & environmental factors on their investment decisions into account **must disclose** how this impact is considered. Disclosure is mandated based on the principle of **double materiality** (financial & impact materiality)	Sustainability due diligence is **not mandated** but FMPs should include a due diligence disclosure on their website where they 'consider principal adverse impacts (PAIs) of investment decisions on sustainability factors'.

Regulatory measure	Types of FIs covered	Types of obligations	
		Disclosure obligations	**Environmental due diligence obligations**
Solvency II *Outlines regulatory requirements for the EU insurance sector*	Insurance and reinsurance undertakings with their head office in the EU.	FIs need to manage and report on the sustainability risks and impacts of their investments.	None.
MiFID II *Improves financial market transparency and protects investors*	Credit institutions, investment firms, trading venues, data reporting services providers, and third-country firms providing investment services or performing investment activities through the establishment of a branch in the Union	No public data disclosure required, but information on sustainability performance of the financial instruments to be made transparent with the client.	No due diligence duties. Covered entities must consider the sustainability performance preferences of their clients and potential clients before proposing them financial instruments.
EU Banking Package – Capital Requirements Directive (CRD) and Regulation (CRR) *Regulates credit institutions*	Credit institutions and investment firms	Credit institutions need to publicly disclose information on exposures to ESG risks in their annual supervisory report for competent authorities.	None. Only assessment of financial risks.

BACKGROUND

DEFORESTATION AND RELATED LAND-USE CHANGE ARE KEY DRIVERS OF CLIMATE CHANGE AND BIODIVERSITY LOSS

Worldwide, 1 million species face extinction[1], in part because deforestation is destroying the habitats of terrestrial biodiversity. In fact, around 80% of terrestrial biodiversity[2] is found in forests. Since 1990, an estimated 420 million hectares of forest have been lost due to land-use conversion and the area of primary forests has decreased by over 80 million hectares.[3] There cannot be a solution to climate change without a solution to deforestation. Agriculture, Forestry and other Land-Use (AFOLU) sectors contributed 22% of global emissions in 2019, half of which come from deforestation driven by commodities providing food, fibre, feed and fuel[4].

The massive loss of biodiversity associated with deforestation can lead to **major financial risks**, as it threatens the normal functioning of ecosystem services (such as pollination, climate regulation, and carbon sequestration)[5], on which countless economic activities depend. As the Dutch central bank stated in its 2020 report: "*by financing companies that depend on ecosystem services, financial institutions are exposed to physical risks. The loss of ecosystem services can threaten companies' production processes and this can translate into a deterioration in their financial position. […] Financing assets (corporate or sovereign) with a negative impact on biodiversity and ecosystem services also exposes financial institutions to transition and reputational risks*"[6].

THE ROLE OF FINANCIAL INSTITUTIONS IN DEFORESTATION

Despite international and national pledges, the level of global deforestation is consistently high[7]. If the world is to meet internationally agreed-upon climate, biodiversity, and land-use targets, for example Action Point 6 of the Glasgow Leaders' Declaration on Forests and Land-Use, financial flows need to be better aligned to reverse forest loss and degradation[8]. The financial sector plays a key role in the needed financial transformation both inside and outside of the EU. Progress is being made by FIs who engage with and support their clients to produce and implement emissions reductions plans[9]. However, more action is required in promoting efforts to prevent the loss of nature. If FIs forget to consider biodiversity and focus solely on climate change adaptation and mitigation, this can lead to unintentional harmful consequences on land-use and financial stability by underestimating the double materiality risks of biodiversity loss. This is why FIs need to have an in-depth overview and understanding of the impacts of their and their investees' policies and activities on land-use and on deforestation in particular. To achieve this, coordinated actions are highly necessary, "*policymakers, regulators, clients and investee companies need to make considerable changes to incorporate nature into policy, business activities and disclosure that involve climate so that capital can be mobilised to support the protection and restoration of nature*"[10].

Facts and figures on deforestation and financial institutions

To date, the Environmental, Social and Governance (ESG) policies of some of the largest banks and investors in high deforestation-risk sectors are assessed as not ambitious enough to effectively stop deforestation[11]. Since signing the Paris Agreement in 2015, FIs have provided **USD 267 billion** in credit to 300 companies operating in the three largest tropical forest regions in the world and handling commodities with a high deforestation risk[12]. Legally binding due diligence obligations for FIs, such as obligatory risk analyses and measures that reduce deforestation risks are non-existent. Avoiding financing deforestation remains entirely dependent on voluntary initiatives by financial actors.[13]

The Forest500[14] (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 regarding FIs' management of 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.

COVERAGE OF FINANCIAL INSTITUTIONS IN THE MOST RELEVANT REGULATORY MEASURES

The EU is currently in the process of adopting and/or implementing five key pieces of legislation which have the potential to decrease and – if designed in the right way – ultimately halt deforestation in Europe and in non-EU countries linked to the EU economy's supply chain. These five legislative proposals can be separated into two categories: (1) **regulatory measures for due diligence**, which aim at preventing deforestation by imposing traceability and due diligence obligations on companies trading certain commodities or operating in certain sectors; (2) **regulatory measures for disclosure and transparency**, which intend to stop greenwashing and shift finance toward sustainable activities by boosting transparency about companies' and FIs' environmental impacts throughout supply chains. Three additional regulatory measures are covered due to their potential relevance for FIs' reporting obligations.

This briefing dives into these key legislations and legislative proposals and, for each policy, provides a short explanation on a) main content, b) potential impact on deforestation, c) current status, and d) reporting/due diligence obligations for FIs, elaborating on the final or draft texts of the files.

REGULATORY MEASURES FOR DUE DILIGENCE

Regulation on Deforestation-free Products (EUDR)

What is it? The EUDR[15][iii] aims to minimise the EU's consumption of products linked to deforestation and forest degradation, as existing voluntary and market-based measures at national and regional levels in the EU have failed to shift EU consumption towards 'deforestation-free' commodities and products.

How does it address deforestation? This Regulation targets seven forest-risk commodities: cattle, cocoa, coffee, oil palm, rubber, soy, and wood[16] and certain derived products including charcoal and printed products such as books listed in Annex I of the Regulation. These can only be placed on the EU market or exported from the EU to third countries if they are i) deforestation-free [17], ii) have been produced in compliance with relevant legislations of the producer country and iii) the operators submitted a due diligence statement to the competent authorities. The extent of the due diligence obligation depends on the size of the entity.

What stage is it at? The European Commission, Council and Parliament reached an agreement on the EUDR on 6 December 2022[18]. In spring 2023, the Regulation should be formally adopted by the European Parliament and the Council and enter into force. Once the EUDR is in force, large and medium-sized enterprises have 18 months - and micro and small enterprises 24 months - to implement the new rules. One year after entering into force, the Commission will provide recommendations as to whether and how to extend the scope of the Regulation on to other ecosystems. No later than two years after the EUDR enters into force, the Commission must present an impact assessment where it (1) evaluates the role of FIs in preventing financial flows contributing directly or indirectly to deforestation and forest degradation and ; (2) assesses the need to provide for any specific obligations for FIs in EU legislation, considering relevant existing horizontal and sectoral regulatory measures. The EU executive will also assess whether to include other commodities in the scope. The Commission will conduct a general review after five years, where adjustments and improvements might be made to further strengthen the EUDR and its implementation in the future.

Table 1: Inclusion of FIs in the EUDR

The agreed text on the EUDR does not foresee any obligations for FIs. Nevertheless, two years after entering into force, the Commission will present an impact assessment on the role of FIs in preventing financial flows

[iii] The final legislative text will be published beginning of 2023.

contributing, indirectly or directly, to deforestation and forest degradation. The impact assessment will also assess whether specific deforestation due diligence obligations are needed for the financial sector in EU legislation. This does not guarantee that FIs will be added to the scope of the EUDR in the review in two years.

Corporate Sustainability Due Diligence Directive (CSDDD)

What is it? The CSDDD[19] aims to ensure that companies comply with their responsibilities to respect human rights and environmental standards. The overall objectives of the EUDR and the CSDDD are mutually supportive – both aim at ensuring that companies conduct human rights and/or environmental due diligence. Unlike the EUDR, however, the obligations arising from the CSDDD are not limited to specific types of products or sectors. The CSDDD is thus, in principle, much broader in scope.

How does it address deforestation? The Commission proposal's list of the "adverse environmental impacts" that companies are required to prevent, mitigate or bring to an end does not explicitly mention deforestation. It does, however, refer to Article 10(b) of the Convention on Biological Diversity and the obligation to "take the necessary measures related to the use of biological resources in order to avoid or minimize adverse impacts on biological diversity"[20]. In addition, the list of adverse human rights impacts covered by a company's due diligence duties contains the prohibition to cause any "measurable environmental degradation" that affects ecological integrity, such as through deforestation[21]. This obligation is however tied to a narrow list of human rights from international conventions. This means that there is only an explicit obligation to prevent deforestation where it poses threats to human rights, which is unlikely to capture all instances of deforestation.

What stage is it at? A proposal was presented by the European Commission in February 2022. The Council adopted its general approach on 1st December 2022[22]. The European Parliament is expected to adopt its position in the first half of 2023, before the file is set to move into Trilogue. EU Member States are given two years to transpose the provisions of the CSDDD into national law after its entry into force.

Table 2: Inclusion of FIs in the CSDDD

Commission proposal:

A. [WHO] Which kind of FIs are in scope:

The proposal includes obligations only for FIs with more than 500 employees on average and a net worldwide turnover of more than 150 million euros in the last financial year. It sets a lower threshold for companies in certain risk sectors to be covered but does not define finance as a risk sector (contrary to its classification by the OECD[23]).

The Commission also sets out an extensive list of the types of financial undertakings covered. These include credit institutions, investment firms, investment funds, insurance companies, pension institutions, payment institutions, crowdfunding service providers and crypto-asset service providers, among others.

B. [WHAT] What are the proposed obligations for FIs:

The Commission proposes that the covered FIs be obliged to conduct specific human rights and environmental due diligence actions. These include:

1. **Integrating due diligence** into all their policies and putting in place a specific due diligence policy;
2. **Identifying actual or potential adverse environmental and human rights impacts** arising from their own operations, those of their subsidiaries and those of their established business relationships, where these relate to their value chains. Unlike all other companies covered by the proposal, which are required to carry out this identification on a continual basis, FIs providing a financial service are only required to identify potential or actual adverse impacts **before** they provide the service.
3. **Preventing and mitigating** the identified potential adverse impacts, as well as **bringing** the identified actual adverse impacts **to an end** and **minimising** their extent;
4. Establishing and maintaining a **complaints procedure** for stakeholders to submit "legitimate concerns" regarding actual or potential adverse impacts;
5. **Monitoring the effectiveness** of their due diligence actions;

6. Publicly **communicating** on their due diligence actions.

Unlike for any other companies covered by the proposal, the **definition of "value chain" for FIs** that provide financial services, as per Commission proposal, only extends to:

a) the direct recipients of these services,
b) where these recipients are moreover no 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 these recipients of financial services and exclude the remaining tiers of their value chains. Regarding deforestation, this would mean that only where the entity that receives the financial service from the FI is itself involved in or causing significant deforestation, this would potentially be covered by the due diligence obligations of the FI. Any deforestation further down the value chain would not be covered.

C. [HOW] Specific reporting/due diligence requirements for FIs:

The proposal specifies that when **identifying actual or potential adverse impacts**, companies (including FIs) are entitled to draw on independent reports and information gathered through their complaints procedure. They are also required, where relevant, to consult with stakeholders.

Regarding the obligation to **prevent and mitigate potential adverse impacts** (such as deforestation-linked human rights impacts) as well as **to bring to an end and minimise actual adverse impacts**, the proposal lists several measures that companies (including FIs, where covered) are required to take, where relevant. These include:

- Developing and implementing a prevention and/or corrective action plan;
- Seeking contractual assurances from business partners;
- Making necessary investments, e.g. into management or production processes and infrastructures;
- Collaborating with other entities, including to increase their ability to bring the adverse impact to an end;
- Neutralising or minimising the actual adverse impacts, including by paying damages;
- Where impacts cannot be brought to an end or minimised, temporarily suspending or, where the impact is severe, terminating the business relationship with respect to the activities concerned. Unlike any other types of companies, **FIs providing financial services are not required to terminate the financial service contract "when this can be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided**"[24].

With regards to the **monitoring** of the effectiveness of their due diligence, companies (including FIs, where covered) shall carry out periodic assessments to this effect, based on qualitative and quantitative indicators, at least every 12 months and whenever there are significant new risks that adverse impacts may arise.

In order to fulfil their obligations regarding **communication** on due diligence, only companies not covered by the CSRD are required to publish an annual statement. Companies covered by the CSRD are assumed to have fulfilled these obligations.

D. [WHEN] Date of application of the Directive for FIs:

The Directive can be expected to be adopted no earlier than late 2023 or 2024. After the entry into force of the Directive, Member States have 2 years to transpose it into national law. FIs would only be obliged to comply with their respective due diligence obligations once the Directive has been transposed.

Council general approach:

A. [WHO] Which kind of FIs are in scope:

The Council proposes to make the application of the Directive to FIs purely voluntary and leave it entirely to Member States.

In addition, the following FIs are **excluded** from the scope of the Directive (when compared to the Commission proposal): investment firms (as defined in Directive 2014/65/EU), certain pension institutions, alternative investments funds (AIFs) and Undertakings for Collective Investment in Transferable Securities (UCITS).

B. [WHAT] What are the proposed obligations for FIs:

The sustainability due diligence requirements introduced by the Commission proposal remain unchanged in principle. As in the Commission proposal, the definition of the value chain (now called "chain of activities") for FIs only extends to direct business relationships and only where these are not SMEs.

In addition, the Council proposes that FIs only need to conduct sustainability due diligence with regards to their clients where these receive lending, provision of guarantees, commitments, insurance or reinsurance. This would mean that due diligence on clients would be restricted to banks and insurers, while excluding any types of investments or other financial services. While some asset and fund managers would technically be in scope, they would thus not need to exercise due diligence with regards to their clients, but only with regards to other aspects of their business or other types of business partners, particularly "upstream" (e.g. the sourcing of their office materials). They will not need to conduct any sustainability due diligence on the risks linked to the companies they directly finance.

C. [HOW] Specific reporting/due diligence requirements for FIs:

The ways in which companies, including FIs (if they are covered), are required to conduct due diligence follow, in principle, the requirements of the Commission proposal.

An additional exception introduced is that companies included in a consolidated management report under the CSRD would not need to submit annual reports under the CSDDD.

D. [WHEN] Date of application of the Directive for FIs:

The Council is proposing that the Directive applies to companies with more than 1000 employees and a turnover of more than 300 million euros **3 years after its entry into force**. For companies with more than 500 employees and turnover of more than 150 million euros, it is to apply **4 years** after its entry into force. For companies operating in a risk sector and with more than 250 employees and a turnover of more than 40 million euros, it is to apply **5 years** after its entry into force.

REGULATORY MEASURES FOR DISCLOSURE AND TRANSPARENCY

Corporate Sustainability Reporting Directive (CSRD)

What is it? The CSRD[25] is the new EU directive on sustainability reporting. Compared to its predecessor, the Non-Financial Reporting Directive[26] (NFRD), it significantly expands the scope of who will have to disclose sustainability information regarding a wide array of environmental, social and governance (ESG) issues. Specific novelties include the obligation for companies to provide "forward-looking" (as well as retrospective) information and plans compatible with the Paris Agreement's 1.5°C goal. For its implementation, the CSRD foresees a set of European Sustainability Reporting Standards (ESRS). Draft standards are being prepared by EFRAG[iv], as a basis for the delegated acts the Commission will write to formally adopt these standards as part of the corresponding level-2 legislation. These ESRS spell out in detail what companies and FIs under the scope of the CSRD will have to report.

How does it address deforestation? Deforestation is addressed in several of the draft standards, most comprehensively in the (draft) topical standards **ESRS E4 on Biodiversity and ecosystems**[27]. Whenever deforestation is assessed as material (relevant) in a company's own operations or value chain (details are still under discussion), detailed reporting will be required. Relevant sector standards (Agriculture, Food, Forestry, Mining among others) are expected to set more specific reporting requirements regarding deforestation. However, at the time of writing, it is still uncertain whether and to what extent the final ESRS will be as detailed as the draft, subject to changes from the Commission when adopting the Delegated Act.

[iv] European Financial Reporting Advisory Group (EFRAG)

What stage is it at? A provisional political agreement between EU legislative bodies on the CSRD proposal was found in June 2022[28]; formal completion of the legislative process is expected before the end of 2022[29]. The private association EFRAG[30] has been put in charge to develop the draft ESRS standards, through the involvement of external experts and a series of consultation processes. The detailed reporting rules in the "ESRS standards" are scheduled for phased completion in 2023 (cross-cutting and topical standards) and 2024 (sector standards). EU Member States must transpose the Directive into national law within 18 months after its entering into force.

Table 3: Inclusion of FIs in the CSRD

Compromise between European Commission, European Parliament and European Council:

A. [WHO] Which kind of FIs are in scope:

Article 1 point (3) puts credit institutions[31] and (re)insurance undertakings[32] that are large or listed SMEs in scope of sustainability reporting. Article 19a also include other FIs that are large or listed SMEs in scope of sustainability reporting obligations.

The reporting requirements do not apply to financial products referred to as alternative investment funds (AIF) and UCITS under the Sustainable Finance Disclosure Regulation (SFDR).

B. [WHAT] What are the proposed obligations for FIs:

FIs under scope need to include in their management report information necessary to understand their double materiality impact. This shall include:

a) a brief description of the undertaking's business model and strategy, including:

(i) the resilience of the undertaking's business model and strategy to risks related to sustainability matters;

(ii) the opportunities for the undertaking related to sustainability matters;

(iii) the plans of the undertaking to ensure that its business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement;

(iv) how the undertaking's business model and strategy take account of the interests of the undertaking's stakeholders and of the impacts of the undertaking on sustainability matters;

(v) how the undertaking's strategy has been implemented with regard to sustainability matters;

b) a description of the targets related to sustainability matters set by the undertaking and of the progress the undertaking has made towards achieving those targets;

c) a description of the undertaking's policies in relation to sustainability matters;

d) a description of:

(i) the **due diligence process implemented** with regard to sustainability matters;

(ii) the **principal actual or potential adverse impacts** connected with the undertaking's value chain, including its own operations, its products and services, its business relationships and its supply chain;

(iii) any **actions taken**, and the result of such actions, **to prevent, mitigate or remediate actual or potential adverse impacts**;

e) a description of the principal risks to the undertaking related to sustainability matters, including the undertaking's principal dependencies on such matters, and how the undertaking manages those risks.

Undertakings shall report the process carried out to identify this information.

C. [HOW] Specific reporting requirements for FIs:

EFRAG is developing the draft sector-agnostic standards which FIs under the CSRD will have to report on, such as the **ESRS E4 on Biodiversity and ecosystems** which will be highly relevant for understanding the impact of FIs on biodiversity and deforestation. EFRAG will also develop a draft standard with specific disclosure requirements for the financial sectors (insurances, capital market, credit institutions) in the year 2024 to 2025, which will then be (potentially amended and) adopted by the European Commission.

D. [WHEN] Date of application of the CSRD for FIs:

The CSRD will become applicable in three stages:

From 1 January 2024: for the companies (and thus FIs) already subject to the obligations of the NFRD (large undertakings with more than 500 employees) (reporting in 2025 for the financial year 2024)

From 1 January 2025: for large companies and FIs not subject to the NFDR (reporting in 2026 for the financial year 2025)

From 1 January 2026: for listed SMEs, small and non-complex credit institutions and captive insurance undertakings (reporting in 2027 for the financial year 2026).

EU Taxonomy Regulation

What is it? The EU Taxonomy for sustainable activities[33] lies at the heart of the EU's sustainable finance agenda. It is a classification framework that sets out criteria for an economic activity to be considered (and thus defined at the EU-level) as sustainable. It contains a catalogue of economic activities that make (i) a substantial contribution (SC) to one of the six environmental objectives,[34] (ii) Do No Significant Harm (DNSH) to the other five environmental objectives and (iii) meet minimum and explicitly listed social safeguards. The Taxonomy aims to "*create security for investors, protect private investors from greenwashing, help companies to become more climate-friendly, mitigate market fragmentation and help shift investments where they are most needed*"[35]. Since the EU Taxonomy is linked to disclosure regulations that oblige entities (including FIs) to disclose sustainability information, it is expected and intended to greatly increase transparency for investors.[36]

How does it address deforestation? Deforestation can be addressed in the EU Taxonomy by means of adding a "causing no deforestation" pre-requisite criteria for fulfilling:

1) The SC criteria for biodiversity and ecosystem protection
2) The DNSH criteria for biodiversity and ecosystem protection
3) The DNSH criteria for climate change mitigation

As those criteria, first drafted by the EU Platform on Sustainable Finance, are now being reviewed and transformed (into a delegated act by the European Commission), it remains uncertain to what degree deforestation will be explicitly addressed/included in the final version of the criteria.

What stage is it at? The Taxonomy Regulation entered into force in July 2020. A first delegated act[37] outlining the activities which substantially contribute to climate change adaptation and mitigation was published in December 2021 and is applicable since January 2022. The delegated act for the other four environmental objectives (water, circular economy, pollution, as well as biodiversity & ecosystems) is expected at the earliest by the end of 2022. The EU Platform on Sustainable Finance, an expert group appointed by the European Commission to draft the criteria which define economic activities as sustainable, published its recommendations[38] of criteria for most remaining activities in March 2022.

Table 4: Inclusion of FIs in the Taxonomy Regulation

A. [WHO] Which kind of FIs are in scope:

A Delegated Act supplementing Article 8 of the Taxonomy Regulation (= the Disclosure Delegated Act) specifies the scope of FIs, i.e., undertakings subject to disclosure requirements under the CSRD and classifying as credit institutions, asset managers, investment firms or insurance and reinsurance undertakings.

B. [WHAT] What are the proposed obligations for FIs:

Briefly, FIs are required to disclose the **proportion of their financial activities that are Taxonomy-eligible** and, later on, **Taxonomy-aligned** (exact timeline below). This information should be disclosed by means of including a non-financial statement in their management report as requested by the CSRD, which needs to be published annually for the preceding financial year.

To ensure coherence and comparability of reporting between all undertakings (financial and non-financial), it is hinted that disclosure on Taxonomy-eligibility of assets and activities of FIs be based on information disclosed by their investees and counterparties regarding the Taxonomy-eligibility of their own activities, which is based on their turnover and capital expenditure. For taxonomy-alignment, however, the Disclosure Delegated Act says that "Revenue, capital expenditure and operating expenses are irrelevant when assessing the environmental sustainability of financial activities, including lending, investment and insurance" and that these KPIs are thus not suitable for demonstrating the Taxonomy-alignment of FIs' activities.

C. [HOW] Specific reporting requirements for FIs:

Article 8 of the Taxonomy Regulation obliges FIs to report how and to what extent their economic activities can be considered environmentally sustainable. The details of what information needs to be included are stipulated for the different types of financial FIs[39].

Currently the technical screening criteria, as drafted by the EU Platform on Sustainable Finance, are defined separately for every single activity without a defined common ground, and the generic DNSH criteria on Biodiversity and Ecosystems (objective 6) in the Delegated Act (supplementing Regulation (EU) 2020/852) **do not include deforestation, nor supply chain impacts.**

The current drafts for individual high-forest impact sectors that can make a substantial contribution to Objective 6; namely: 'animal production', 'crop production', and 'manufacturing of food products and beverages', do safeguard against deforestation in general. However, there are still loopholes[v]. For example, the **sourcing requirements** for animal feeds are weak while these feeds are highly linked to deforestation-risk commodities. **Verification procedures** on minimum sourcing requirements are not yet fully defined and (due to parallel developments of the two files) lack **coherence** with the proposal for the Deforestation-Free-Product-Proposal. Furthermore, deforestation in supply chains of other activities with a potential risk to forests, amongst others through high-forest risk commodities in their supply chains (such as Furniture, Wearing Apparel, and Civil Engineering) is only partially addressed, but not systematically safeguarded.

It is still uncertain whether and how the Commission is going to reflect on these loopholes in its Delegated Act for the 4 remaining environmental objectives.

D. [WHEN] Date of application of the Regulation for FIs:

From 1 January 2022 until 31 December 2023, FIs need to disclose the proportion of their total assets which is considered Taxonomy non-eligible and Taxonomy-eligible (activities that fall under the scope of the EU Taxonomy, under the Climate Delegated Act). They are not required to assess and disclose Taxonomy-alignment of those assets.

From 1 January 2024 onwards, FIs need to comply with full reporting requirements and disclose the share of Taxonomy-aligned assets for activities related to climate change mitigation and adaptation objectives. The annual report covers the previous financial year. Therefore, in the first reporting period in January 2024 FIs will need to report on the year 2023.

From 1 January 2026 onwards, credit institutions shall include the Taxonomy-alignment of their trading books and fees[40].

Sustainable Finance Disclosure Regulation (SFDR)

What is it? The SFDR[41] aims to bring higher transparency to sustainability-related disclosures in the financial services sector. This regulation requires **entity-level** (organisational) disclosures and financial **product-level** disclosures for all EU FIs and financial advisors. Covered entities should publish their policies on the integration of sustainability risks and impacts (the "double materiality" concept) into their investment decision-making and how they integrate sustainability risks into the returns of the financial products they advise on for their customers to see. Additionally, the methodologies and evaluation of financial products advertised for sustainability aspects should be clearly disclosed to prevent 'greenwashing' of financial products.

How does it address deforestation? This regulation does not consider deforestation impacts as a primary objective. However, through some mandatory and other voluntary disclosures[vi] of the statement on the

[v] The results of our analysis of the Taxo4 report and our policy recommendations here: Climate & Company (2022), Key actions to safeguard against deforestation in the EU Taxonomy, link.

[vi] Only some PAIs are mandatory to be reported (Table 1 of Annex 1) and others are voluntary (Table 2 of Annex 1). FMPs have to choose one voluntary impact from this table and report on it. Further explanation is in Table 5 of this briefing.

consideration of principal adverse impacts (PAIs[42]) of investment decisions on sustainability factors (Annex 1 of the Delegated Regulation[43]), the SFDR will expose financial products which invest in companies with harmful land-use practices, whose operations negatively affect biodiversity-sensitive areas, or without a deforestation policy (specific examples in *Table 5*). If these products can no longer be classified under an environmental or ESG label due to enhanced regulation, this would be considered a win for eliminating greenwashing claims on European-sold financial products. Firms would get lower access for green financing, which is expected to encourage higher sustainability and less deforestation. In addition to that, funds classified as "sustainable" (under Article 8 or 9) need to disclose how they are in alignment with all six environmental objectives of the EU Taxonomy, thus including the biodiversity-related objective.

What stage is it at? This regulation first entered into force in March 2021 and is currently partially applicable. A Commission Delegated Regulation providing template statements and information for FMPs to follow in their disclosures was adopted in April 2022. The regulation will be evaluated by the EU Commission at the end of 2022, where adjustments and improvements will be made to further strengthen the regulation and its implementation in the future.

Table 5: Inclusion of FIs in the Sustainable Finance Disclosure Regulation (SFDR)

A. [WHO] Which kind of FIs are in scope:

The SFDR covers **financial market participants (FMPs) and financial advisors (FAs)** who make insurance-based investment products available, investment firms managing portfolios, institutions for occupational retirement provision, pension product manufacturers, alternative investment fund managers, pan-European personal pension product providers, venture capital fund managers, social entrepreneurship managers, UCITS management companies, and credit institutions managing portfolios. All FMPs and financial advisers must disclose their sustainability risks (Art. 3), but only FMPs with more than 500 employees are obliged to disclose their due diligence policies with regard to their PAIs (Art. 4). This regulation does not cover insurance intermediaries providing insurance advice or investment firms employing fewer than three people.[44]

B. [WHAT] What are the obligations for FIs:

From this regulation, FMPs are required to disclose **sustainability-related information** and explain how they **consider sustainability risks in their investment decision-making**. They need to be transparent about how the PAIs of environmental factors are considered in their financial products or decision-making. Under the "comply or explain mechanism", FMPs should explain with clear reasons why they do not consider degradation of the environment or social injustice caused by their investments if they do not comply. However, the option to "explain" is only possible for FMPs with less than 500 employees, all others need to "comply".

When "**complying**", FMPs must include on their website:

a) information about their policies to identify and prioritise PAIs and sustainability indicators;

b) a description of the PAIs and the related taken or, where relevant, planned actions;

c) a summary of the engagement policies, where applicable;

d) a reference to their compliance with responsible business conduct codes and internationally recognised standards for due diligence and reporting.

Financial entities covered under the SFDR also need to explain how they comply with the "do no significant harm" (DNSH) principle of the SFDR and the minimum safeguards of the Taxonomy Regulation. The difference here with the EU Taxonomy DNSH is that the latter applies to economic activity-level, while the DNSH criteria in the SFDR are assessed at entity-level. The identification of the environmental objective of the financial products will also use the Taxonomy Regulation definitions.

C. [HOW] Specific reporting requirements for FIs:

FMPs are required to disclose the following information about their financial products on their websites, in pre-contractual disclosures, in periodic reports and marketing communications:

Entity level: obligation for FMPs to disclose actual and potential adverse sustainability impacts of investment decisions (PAI statement), including a statement on due diligence policies (on website)

Product level: consideration of sustainability risks and expected impact on return, potential adverse impacts

Other product-level: different disclosure requirements depending on level of sustainability of financial product:

- *Dark green products*[45]: have sustainable investment as an objective and contribute substantially to one of the 6 environmental objectives from the EU Taxonomy
- *Light green products*[46]: promote environmental or social characteristics
- *All other products*: do not meet the criteria of dark or light green products, but may still integrate sustainability considerations to a certain extent.

Commission Delegated Regulation (EU) 2022/1288 supplementing Regulation (EU) 2019/2088 (SFDR)[47]:

Adverse sustainability indicators affecting forests and high-biodiversity areas that shall be (**mandatory**) included in the statement on PAIs of investment decisions:

- Activities negatively affecting biodiversity-sensitive areas

Additional climate and other environment-related indicators affecting forests and high-biodiversity areas that can be (**voluntarily**) included in the statement on PAIs of investment decisions[vii]:

- Land degradation, desertification, soil sealing
- Investments in companies without sustainable land/agriculture practices
- Natural species and protected areas
- Deforestation
- Land artificialisation

D. [WHEN]: Date of application of the Regulation for FIs:

In the Level 1 Requirements of the SFDR, FMPs with an average of 500 employees or more need to first disclose their PAI statements by 30 June 2023 for reporting on the calendar year of 2022 and continue every subsequent year thereafter. The determination of PAIs should happen at least four times a year and the average should be disclosed on an annual basis. The Regulatory Technical Standards encompassing Level 2 Requirements apply beginning 1 January 2023 as laid out in the Delegated Regulation. After this point, no in-scope FMPs can choose to “explain” instead of complying with sustainability-related disclosure obligations.

ADDITIONAL REGULATORY MEASURES FOR FINANCIAL INSTITUTIONS

Solvency II

What is it: The Solvency II Directive[48] is a risk-based legislation that sets standards for funding and governance in the EU insurance sector. The Directive specifically applies to insurance and reinsurance undertakings with their headquarters in the EU[49]. It aims to promote transparency and risk management, and to protect policyholders.[50] It is based on three pillars:

1. Pillar 1 on quantifiable risks and the calculation of capital requirements.
2. Pillar 2 on risk management and governance of insurance companies.
3. Pillar 3 on reporting requirements, with a focus on public disclosure of information and supervisory reporting.

Solvency II is in effect since 1 January 2016, but was amended in April 2021 by the Delegated Regulation (EU)2021/1256[51] as regards the integration of sustainability considerations in the governance of insurance and reinsurance undertakings. The Delegated Regulation appears to include a double materiality dimension[52], by adding the following:

[vii] at least 1 indicator must be reported from Table 2 of Annex I

- **Financial materiality**: when governing risks arising from investments, insurance and reinsurance undertakings shall take into account "**sustainability risks"**, defined as "*ESG event or condition that, if it occurs, could cause an actual or a potential negative impact* ***on*** *the value of the investment or on the value of the liability*"[53]
- **Impact materiality**: when governing risks arising from investments, insurance and reinsurance undertakings shall take into account the potential long-term impact **of** their investment strategy and decisions on "**sustainability factors**"[54], defined as "*environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters*"[55].

How does it address deforestation? Deforestation is not explicitly mentioned as a sustainability risk.

Reporting/due diligence obligations for FIs: The requirements for applying the Solvency II framework are outlined in the Solvency II Delegated Regulation (EU)2019/981[56]. The disclosure obligations for FIs include producing two reports under pillar 3:

a) Public disclosure: FIs need to make public an annual Solvency and Financial Condition Report (SFCR). The amending Regulation[57] integrated sustainability risk in the prudent persons principle. Under Article 295 2(c) in the SFCR, FIs need to disclose information regarding their risk exposure, including an explanation of "how assets have been invested in accordance with the prudent person principle"[58].

b) Regular reporting: A Regular Supervisory Report (RSR) needs to be submitted to a regulator on an annual basis. This report follows the same structure as the SFCR[viii] and includes "*a summary which shall in particular highlight any material changes that have occurred in the undertaking's business and performance, system of governance, risk profile, valuation for solvency purposes and capital management over the reporting period, and provide a concise explanation of the causes and effects of such changes*". Sustainability risks and impacts needs to be reported on in the risk section, as it includes the prudent person principle.

What stage is it at? Solvency II is in effect since 1 January 2016, and the sustainability requirements are enforceable since 2 August 2022.[ix] It is currently under review.

Markets in Financial Instruments Directive II (MiFID II)

What is it? MiFID II[59] aims at making financial markets in the EU more transparent and to reinforce the protection of investors. Investors are provided with increased information on products and services offered or recommended to them. MiFID II also provides guidelines for financial advisors to integrate information on the sustainability performances of corporates and financial products and reflect into their financial advice the preferences of their clients in terms of sustainability performance. In sum, it should provide granular information on sustainability aspects to allow client-product compatibility.

Reporting/due diligence obligations for FIs: The Delegated Directive (EU) 2017/593[60], amended by Delegated Directive (EU) 2021/1269[61] on the *integration of sustainability factors into the product governance obligations*, requires investment firms to consider sustainability factors, as defined in the SFDR, in the product approval process of each financial instrument. The Directive stipulates that the investment firm shall identify any group(s) of clients with whose needs, characteristics and objectives the financial instrument is not compatible. The Delegated Regulation (EU) 2017/565[62], amended by the Delegated Regulation (EU) 2021/1253[63] on the *integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms*, aims to prevent green-washing and mis-selling of financial instruments that are falsely recommended as environmentally sustainable.

The sustainability preferences of a (potential) client mean their choice as to whether and if so, to what extent, one or more of the following financial instruments shall be integrated in their investment:

1. Financial instrument for which the client determines a minimum proportion shall be invested in environmentally sustainable investments as defined by the EU Taxonomy.

[viii] as explained in Annex XX of the Delegated Regulation
[ix] https://www.finchandbeak.com/1710/double-materiality-built-around-the-new.htm

2. Financial instrument for which the client determines that a minimum proportion shall be invested in sustainable investment (environmental or social contribution) as defined under the SFDR's Article 8 & 9.
3. Financial instrument that considers principal adverse impact (PAI) on sustainability factors as defined under the SFDR, where qualitative or quantitative elements proving this consideration are determined by the client.

How does it address deforestation? This Directive only "addresses" deforestation indirectly, by requiring investment firms to address their *clients' and potential clients' preference* in terms of sustainable performance of their investment. If the (potential) client shows preference for deforestation-free financial instruments (for example by indicating that at least 70% of its investment should be aligned with the EU Taxonomy), the investment firm will have to take this preference into account before proposing financial instruments.

What stage is it at? MiFID was drafted in 2004 and has been in force across the EU since 2007. It was replaced by MiFID II, adopted in 2014, which had to be transposed into national law by 2 July 2017 and is applicable since 3 January 2018. It was supplemented in April 2021 by a Delegated Directive[64] and a Delegated Regulation[65].

EU Banking Package – Capital Requirements Directive (CRD) and Regulation (CRR)

What is it? The 'EU Banking Package' consists of the Capital Requirements Directive[66] (CRD) (Directive 2013/36/EU) and the accompanying Capital Requirements Regulation[67] (CRR)[68]. The Package has been in force since 2014, and the Commission adopted a review of the rules in October 2021[69]. The stated purpose of this review was to reform the banking rules and better align them with Europe's Green Deal, Climate Law and COVID-19 recovery plans, making banks more resilient to financial shocks[70]. It also finalised the implementation of the Basel III reform. The reform included:

- A legislative proposal[71] to amend the Capital Requirements Regulation
- A legislative proposal[72] to amend the Capital Requirements Directive

How does it address deforestation? The reformed Banking Package does **not** follow a double materiality approach. It focuses on ESG risks **for** FIs (*climate related risks as a source of financial risk)* but does not consider the risks that result **from** a bank's operations (e.g., on deforestation).

The CRR reform provides uniform definitions for ESG risk and environmental risk in order to improve the measurement and management of risks.[73] The environmental risk definition[74] covers negative financial impacts on the institution, counterparts and invested assets arising from impacts of environmental factors, including factors related to the six objectives of the taxonomy. **Deforestation is not explicitly mentioned as an environmental risk**. However, given that risks arising from biodiversity loss and ecosystem degradation are covered by objective 6 of the taxonomy, deforestation is arguably implicitly included as a risk to FIs.

It is also noteworthy that the Council's general approach[75] on the CRD stresses the need for the short-, medium-, and long-term monitoring of ESG risks, which is more specific than the "*monitoring of risks over an appropriate set of time horizons*", as proposed by the Commission.

Reporting/due diligence obligations for FIs: Credit institutions and investment firms need to publicly disclose how they comply with the requirements. Article 430 of the CRR reform requires institutions to include information on exposures to ESG risks (this includes physical risks[76] and transition risks[77] for the respective institution) in the supervisory reporting which is submitted to the competent authorities on an annual basis.

The CRD reform explains how FIs should identify and manage these ESG risks:[78]

1. Article 76: The management bodies of FIs need to develop **concrete plans** to address the current and future financial risks arising from an institution's misalignment with ESG-related objectives. These plans are meant to monitor and address the risks arising **for** the banks. The European Banking Authority (EBA) still needs to issue guidance to specify the content of the plans.
2. Article 87a: Institutions need to put robust strategies, policies, processes, and systems in place to measure, manage and monitor ESG risks across short, medium, and long term (10+ years) time horizons.[79] This includes conducting climate stress tests.

What stage is it at? The review of the files was adopted by the European Commission in October 2021. The ordinary legislative procedure is underway and CRR and CRD amendments are likely to enter into force and become legally binding EU law in 2023 at the earliest.[80] Banks will likely need to implement the rules from 1 January 2025 onwards.[81]

INTERLINKAGES AND SYNERGIES BETWEEN KEY REGULATORY MEASURES

SUMMARY OF STATE OF PLAY OF DISCLOSURE OBLIGATIONS RELATED TO DEFORESTATION-RISKS AND IMPACTS FOR FINANCIAL INSTITUTIONS

The EU sustainable finance strategy aims to shift private capital toward financing the Green Deal. A central pillar of this is the emerging framework on sustainability disclosure, which is intended to help FIs and supervisors to better understand and manage sustainability risks and impacts related to their investments and assets under management; and to increase the transparency about financial products' and institutions' environmental footprint.

Applicability of Taxonomy disclosure requirements

Companies and FIs under the scope of the CSRD will need to report the extent to which their assets are aligned with the definition of environmentally sustainability under the Taxonomy Regulation. Companies' information will feed into different frameworks for FIs:

1. the FIs' reporting requirement under Article 8 of the Taxonomy Regulation and its Delegated Act
2. the information required under the SFDR showing the share of Taxonomy-aligned assets[82]
3. the requirement of the MiFID II to match clients' sustainability preferences with the performance of their financial products (if clients' preferences require a certain share of alignment with the Taxonomy)

Linkage between CSRD and SFDR

The Commission also aims to increase coherence within the EU sustainable finance toolbox by trying to ensure that, under the CSRD, companies report the information that FIs subject to the SFDR need. It remains unclear whether duplication of requirements between the FIs falling both under the scope of the CSRD and the SFDR will take place, but a clear differentiation is that the SFDR requires both entity and product-level disclosure, while the CSRD focuses on the entity-level. Another distinction is that, in the SFDR, FIs will disclose product-level information differentiating between the different types of products. Moreover, as impact on deforestation remains one of the voluntary standards of the SFDR, the CSRD has the potential to oblige FIs to be more transparent about their double materiality risks and impact on deforestation particularly, through the Biodiversity Standard E4. In an effort to reduce complexities and allow FIs under the SFDR to efficiently use the disclosed information of companies under the CSRD, the Commission aims for its reporting standards to include indicators that correspond to the indicators contained in the SFDR. The exact extent to which this is the case will be assessable once the Commission adopts its Delegated Act on the ESRS.

Linkage between the CSDDD and CSRD

As of the Commission proposal for the CSDDD, FIs falling under both the scope of the CSDDD and the CSRD will have to demonstrate compliance with sustainability due diligence obligations through the disclosure requirements of the CSRD. Thus, an implicit linkage between the CSRD and the CSDDD is the usability of the information disclosed by corporates under the CSRD for FIs having to comply with the CSDDD. In fact, the CSRD will make a lot of FIs' investee companies' sustainability impact information publicly available, which can thus in turn be used by FIs to assess risks and comply with their (potential) sustainability due diligence obligations under the CSDDD.

Very limited coverage of FIs in upcoming sustainability due diligence rules

Some of the regulatory measures discussed here include deforestation as a (potential) adverse impact in principle. However, none of the regulatory measures include comprehensive environmental due diligence requirements for FIs. For example, the SFDR does not mandate due diligence obligations for FIs – FIs are merely required to include, on their websites, a "due diligence statement" explaining how they consider PAI of investment decision on sustainability factors. Whether sustainability due diligence has indeed been carried out is not assessed under the SFDR. Similarly, the CSRD requests FIs within its scope to make public the due diligence process implemented regarding sustainability matters but does not directly obligate FIs to exercise sustainability due diligence. Therefore, disclosure regarding deforestation risks caused by, contributed to, or directly linked to an FI's operations are in principle captured by these regulatory files. However, they do not include any obligation of *conduct* to mitigate risks and bring to an end adverse impacts caused or contributed to.

Furthermore, it is important to differentiate between the types of obligations included in the CSDDD legislative proposal as opposed to the Banking Package (CRD and CRR) and Solvency II. The CSDDD proposal focuses on sustainability due diligence measures to mitigate and bring to an end the potential and actual adverse impacts of companies *on human rights or the environment*. In contrast, the CRD focuses on the management of sustainability and ESG risks with an impact *on an FI* covered under this file. The plans to be developed by FIs to address the current and future financial risks from their misalignment with ESG-related objectives are meant to monitor and address the risks arising for the banks, and not, as the transition plans in the CSDDD proposal, actual and potential adverse impacts arising from a company's operations. In other words, the plans foreseen in the CRD follow the logic of financial materiality, and not that of sustainability due diligence as does the CSDDD. Solvency II, in turn, requires the entities to manage and report on sustainability risks and impact based on a double materiality assessment, but without full-fledged sustainability due diligence duties. It also only applies to insurance and reinsurance companies.

Obligations and exceptions

While the CSDDD legislative proposal aims at establishing comprehensive sustainability due diligence duties for companies of a certain size, it introduces a number of exceptions for FIs that make it highly unclear to what extent the obligations would work in practice to identify, prevent and potentially bring to an end adverse impacts, such as deforestation. The CSDDD legislative proposal foresees deforestation-centred human rights obligations and addresses deforestation through a rather vague reference to the Convention on Biological Diversity. These exceptions include a duty to conduct due diligence only *before* a contract is concluded, only with regards to direct contractual partners and only where these are not SMEs. Furthermore, unlike all other types of companies, FIs, as of the Commission proposal, are not required to terminate a business relationship even in cases of ongoing grave human rights violations or mass deforestation if this termination can be expected to cause "substantial prejudice" to the business partner. The Council of the EU is proposing to make these already rather fragmented obligations for FIs purely voluntary.

The EUDR does not include duties for FIs. The European Parliament proposed such duties, requiring FIs headquartered or operating in the Union that provide financial services to customers whose economic activities are linked to forest-risk commodities, to collect information about their customers' activities, the commodities they place on the EU market, the geolocation of all plots of land where the commodities have been produced and their policies put in place to ensure that no deforestation, forest degradation and forest conversion is taking place through their activities. The Parliament's position would have further demanded from FI a risk assessment and the provision of mitigation measures to reduce the risk that their customers do not comply with the Regulation. FIs would have been required to submit a due diligence statement.

CONCLUSION

There is, as of yet, no thorough sustainability due diligence requirements for FIs in the EU regulatory framework, particularly regarding deforestation. While deforestation as a (potential) adverse impact would, as of now, in principle be covered by some of the regulatory measures addressed here, none of them includes comprehensive environmental due diligence requirements for FIs. This could change if the financial sector is included in the review of the Regulation on Deforestation-free Products. The CSDDD Commission proposal does not ensure that FIs will have comprehensive due diligence obligations with regard to deforestation, as so far causing deforestation is only explicitly considered as an infringement of human rights but not in its own right as a key driver of adverse environmental impact and risk. The other regulatory measures do not impose any direct sustainability due diligence obligations on FIs. The legislation targeting disclosure and transparency only require FIs to disclose whether and how they conduct due diligence prior to undertaking financial activities.

Ambitious mandatory disclosures greatly facilitate companies' due diligence exercise. 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. The ESRS, linked to the CSRD, will serve as reporting standards for companies falling under the scope of both CSRD and CSDDD. 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 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. The implementation of the CSDDD as well as the EUDR would be significantly facilitated by solid and mandatory value chain disclosure.

For the disclosure regulatory measures to be useful, the specific reporting requirements will need to enter into force as soon as possible (and realistically feasible). The current timeline of the CSRD indicates that the companies falling under the scope of the NFRD will have to publish their first report in 2025 for their activities of 2024, and the rest of the companies of the CSRD to publish their first report in 2026 for the year 2025. From the perspective of an entity falling under the scope of the CSDDD and the Regulation on Deforestation-free Products, it will be important not to further postpone any of these reporting requirements, while incentivizing and supporting companies in publishing their ESG disclosures as soon as possible.

Guidance from the Commission would help FIs to comply with their disclosure and due diligence requirements. While the ESRS are still being drafted by EFRAG as a basis for the corresponding Delegated Acts (to be drafted by the European Commission), it will be important to clarify how disclosure requirements under the CSRD and the SFDR are related to each other. While the two pieces of legislation have different objectives and hence differ in their reporting requirements, it would be important to outline the complementarities, while making overlapping reporting requirements as easy as possible. Clear guidance from the Commission on which kind of FIs need to report which kind of information under which format and by when would highly benefit the implementation of those different regulatory measures. In a similar fashion, the EUDR highlights that guidance by the Commission could help prevent any undue administrative burden that could emerge for companies falling under the scope of both this Regulation and the CSDDD[83].

PUBLICATION DETAILS

FUNDED BY

The Gordon and Betty Moore Foundation, more information on the project page.

CREATED BY

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Version: 4.0, March 2023

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[26] Official Journal of the European Union (2014), Directive 2014/95/EU of the European Parliament and of the Council of October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, link
[27] EFRAG (2022), Exposure Draft: ESRS E4 Biodiversity and ecosystems, link
[28] European Parliament (2022), Press release: new social and environmental reporting rules for large companies, link
[29] European Parliament (2022), Legislative Train Schedule of the Corporate Sustainability Reporting Directive (CSRD), link
[30] The European Financial Reporting Advisory Group (EFRAG) (2022), Home, link
[31] as defined in Article 4(1), point (1), of Regulation (EU) No 575/2013.
[32] within the meaning of Article 2(1) of Council Directive 91/674/EEC.
[33] Official Journal of the European Union (2020), Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment, link.
[34] 1) Climate change mitigation, 2) Climate change adaptation, 3) Water, 4) Circular economy, 5) Pollution prevention and control, 6) Protection of biodiversity and ecosystems. For 1 and 2, the first batch of criteria is already published in the form of a delegated act (link). For the "non-climate" environmental objectives 3-6, draft criteria are already published and were part of a public consultation (link).
[35] European Commission (2022), EU Taxonomy for sustainable activities, link
[36] Draft criteria for environmental objectives 3-6, including biodiversity (i.e., the "protection and restoration of biodiversity and ecosystems"), were released for consultation in August 2021. (link)

[37] Official Journal of the European Union (2021), Commission Delegated Regulation (EU) 2021/2139, link
[38] Platform on Sustainable Finance, Part A: Methodological report ; Part B – Annex : Technical Screening Criteria.
[39] - Article 3 requires asset managers to disclose key performance indicators (explained in Annex III) in a tabular form for which a template is provided in Annex IV of the regulation.
- Article 4 requires credit institutions to disclose key performance indicators (explained in Annex V) in a tabular form, for which a template is provided in Annex VI.
- Article 5 requires investment firms to disclose key performance indicators (explained in Annexes VII and XI) in a tabular form, for which a template is provided in Annex VIII.
- Article 6 requires insurance and reinsurance undertakings to disclose key performance indicators (explained in Annexes IX and XI), for which a template is provided in Annex X.
[40] According to points 1.2.3 and 1.2.4 of Annex V of the Delegated Act for Article 8 of the Taxonomy Regulation.
[41] Official Journal of the European Union (2019), Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, link.
[42] According to the Maples AIMA Guide to the EU SFDR (link), principal adverse impacts are "intended to capture the impact of investment decisions and advice that result in negative effects on sustainability factors, for example, the negative effect of an underlying investee company on sustainability factors."
[43] European Commission (2022), Delegated Regulation (EU) 2022/1288, link
[44] Article 17 of the SFDR
[45] Article 9 of the SFDR
[46] Article 8 of the SFDR
[47] European Commission (2022), Commission Delegated Regulation (EU) 2022/1288, link
[48] Official Journal of the European Union (2009), Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), link.
[49] European Commission (2022), Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast), link
[50] Finch and Beak (2022), Double Materiality built around the new Solvency II Directive, link
[51] Official Journal of the European Union (2021), Commission Delegated Regulation (EU) 2021/1256 amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings, link.
[52] Finch and Beak (2022), Double Materiality built around the new Solvency II Directive, link
[53] Section 6 – Article 275a on Investments (link): Integration of sustainability risks in the prudent person principle
[54] Ibid "*For the purpose of paragraph 1, insurance and reinsurance undertakings shall take into account the potential long-term impact of their investment strategy and decisions on sustainability factors and, where relevant, that strategy and those decisions of an insurance undertaking shall reflect the sustainability preferences of its customers taken into account in the product approval process referred to in Article 4 of Commission Delegated Regulation (EU) 2017/2358 (*).*"
[55] Article 2, point (24), of Regulation (EU) 2019/2088 of the European Parliament and of the Council (SFDR), link.
[56] Official Journal of the European Union (2019), Commission Delegated Regulation (EU) 2019/981 amending Delegated Regulation (EU) 2015/35 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), link.
[57] Official Journal of the European Union (2021), Commission Delegated Regulation (EU) 2021/1256 amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings, link.
[58] Official Journal of the European Union (2015), Commission Delegated Regulation (EU) 2015/35, link
[59] Official Journal of the European Union (2014), Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast), link.
[60] Official Journal of the European Union (2017), Commission Delegated Directive (EU) 2017/593 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits, link.
[61] Official Journal of the European Union (2021), Commission Delegated Directive (EU) 2021/1269 amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations, link.
[62] Official Journal of the European Union (2017), Commission Delegated Regulation (EU) 2017/565 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, link.
[63] Official Journal of the European Union (2021), Commission Delegated Regulation (EU) 2021/1253 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, link.
[64] Official Journal of the European Union (2021), Commission Delegated Directive (EU) 2021/1269 amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations, link.

[65] Official Journal of the European Union (2021), Commission Delegated Regulation (EU) 2021/1253 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, link.
[66] Official Journal of the European Union (2013), Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, link.
[67] Official Journal of the European Union (2013), Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, link.
[68] European Commission (2021), Press release: Banking Package 2021: new EU rules to strengthen banks' resilience and better prepare for the future, link
[69] Ibid.
[70] Ibid.
[71] European Commission (2021), Proposal for a Regulation amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, link.
[72] European Commission (2021), Proposal for a Directive amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU, link.
[73] Linklaters Sustainable Futures (2021), EU Banking Package 2021: Commission publishes proposals to integrate ESG risks in the EU prudential framework, link
[74] 'environmental risk' means the risk of losses arising from any negative financial impact on the institution stemming from the current or prospective impacts of environmental factors on the institution's counterparties or invested assets, including factors related to the transition towards the following environmental objectives: (a) climate change mitigation ; (b) climate change adaptation; (c) the sustainable use and protection of water and marine resources; (d) the transition to a circular economy; (e) pollution prevention and control; (f) the protection and restoration of biodiversity and ecosystems; Environmental risk includes both physical risk and transition risk.
[75] Council of the European Union (2022), General approach to the implementation of Basel III - Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU (CRD), link.
[76] 'physical risk', as part of the overall environmental risk, means the risk of losses arising from any negative financial impact on the institution stemming from the current or prospective impacts of the physical effects of environmental factors on the institution's counterparties or invested assets
[77] 'transition risk', as part of the overall environmental risk, means the risk of losses arising from any negative financial impact on the institution stemming from the current or prospective impacts of the transition of business activities and sectors to an environmentally sustainable economy on the institution's counterparties or invested assets;
[78] Linklaters Sustainable Futures (2021), EU Banking Package 2021: Commission publishes proposals to integrate ESG risks in the EU prudential framework, link
[79] European Commission (2021)
[80] Linklaters Sustainable Futures (2021), EU Banking Package 2021: Commission publishes proposals to integrate ESG risks in the EU prudential framework, link
[81] Ibid.
[82] European Commission (2022), FAQs: How should financial and non-financial undertakings report Taxonomy-eligible economic activities and assets in accordance with the Taxonomy Regulation Article 8 Disclosures Delegated Act?, link
[83] European Parliament (2022), Amendments adopted by the European Parliament on 13 September 2022 on the proposal for a regulation of the European Parliament and of the Council on making available on the Union market as well as export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010 (COM(2021)0706 – C9-0430/2021 – 2021/0366(COD)), link