

Strengthening due diligence requirements for financial institutions in the Corporate Sustainability Due Diligence Directive (CSDDD)

This paper focusses on the role of the financial sector in effective human rights and environmental due diligence and provides advice on how to fully integrate financial institutions within the scope and obligations of the proposed Corporate Sustainable Due Diligence directive.

'Where finance goes today, the world goes tomorrow' - why the financial sector needs to be fully included in the CSDDD proposal

Financial institutions have an enormous impact on people and the planet. Investment decisions funnel trillions of euros towards companies operating in global value chains - impacting industry developments for decades to come. Although the sector is starting to acknowledge that ESG-Risks and especially climate related risks are material and need to be considered in investment decisions, the vast majority of financial actors still turn a blind eye on human right violations committed by their corporate clients and investee companies. Case studies have shown again and again the role of financial institutions in financing companies and projects that have caused human rights violations and environmental damage¹.

Although financial institutions usually don't commit environmental or human rights violations themselves, they *facilitate* business activities, by providing financial services, that might cause human rights or environmental violations. Consequently, the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises make clear that human rights due diligence obligations also apply to the financial sector. Financial institutions, just as any other business regardless of their size, sector, operational context, ownership, and structure need to set up processes to identify and assess human rights and environmental right risks, take appropriate action to prevent or mitigate adverse impacts, track the effectiveness of those actions, and regularly report.

It is, therefore, of utmost importance that the Corporate Sustainability Due Diligence proposal extend responsibilities for an effective mandatory human rights and environmental due diligence framework and explicitly include financial institutions that operate, or offer a product or service, within the EU. It is key that the European Parliament and the Council improve the current proposal and fully integrate financial institutions into the legislation to meet the Commission's objective *'to foster sustainable and responsible corporate behaviour and to anchor human rights and environmental considerations in companies' operations and corporate governance'*.

What is missing in the current Commission's CSDDD proposal regarding the financial sector?

The Commission's proposal has the potential to significantly change the way European companies operate in global supply chains and overall, it has been welcomed by civil society organizations. However, in key issues it falls short of the recommendations of the UN and OECD Guidelines for business and human rights. Several organizations already shared their recommendations on how the proposal needs to be strengthened for it to be effective². This paper focuses specifically on the proposed framework for the financial sector, as the current proposal problematically limits the application of the due diligence provisions for financial institutions which deviates not only from the UN Guiding Principles but also from

¹ <https://fairfinanceguide.org/ff-international/case-studies/>

² https://corporatejustice.org/wp-content/uploads/2022/05/CSO_statement_CSDDD_EN.pdf and https://shiftproject.org/wp-content/uploads/2022/03/Shift_Analysis_EU_CSDDProposal_vMarch01.pdf

the OECD recommendations for institutional investors³. There are three problematic gaps in the current proposal:

- **Limitations in due diligence obligations:** First, the Commission proposal limits the scope of financial institutions' obligations to conduct due diligence. It states that these institutions must only conduct due diligence once, prior to providing their services, and there is no obligation to conduct any ongoing due diligence. This is problematic since limiting the application of due diligence goes against the ongoing and risk-based nature of the due diligence principle. While pre-contractual due diligence obligations might be sufficient for short-term financial services and transactions, for long term investment relationships it is key to regularly assess and monitor potential or actual adverse human rights impacts. This is already established market practice e.g., in project finance under Equator Principles terms or for ESG-funds which regularly monitor the companies they invest in.
- **Limitations in value chains:** Responsibilities for financial institutions are furthermore limited to direct large clients (i.e., excluding entities in these clients' own value chains and direct clients that are SMEs⁴). This is problematic because the responsibility for human rights and the environment is not a matter of company size and should rather be oriented towards the salience of the risks. The proposal on scope is also not in line with industry uptake, as for example the Investor Alliance for Human Rights state that: 'all businesses, including investors and other financial actors, have a responsibility to respect human rights and the environment. The process of continuously conducting robust human rights and environmental due diligence is a core requirement for businesses in fulfilling that responsibility⁵.
- **Limitations in mitigation measurements:** Unlike other multinational enterprises, financial institutions are also required not to terminate their relationship with a company where this termination could cause "substantial prejudice" to that company. While financial stability of an investee company should in most cases not be jeopardized, the current proposal leaves ample space for interpretation. Moreover, if a company's financial stability is at risk by having to comply with environmental and human rights standards, the ESG-risks of that business model should have been addressed at a much earlier stage.

How to strengthen the CSDDD proposal

- The OECD guidelines for institutional investors clearly state the importance of ongoing due diligence throughout the entire duration of an investment relationship (not just once during the pre-contractual phase). To make a meaningful positive impact, all financial institutions therefore must be held to the same ongoing due diligence obligations as other companies, particularly considering the long-term nature of investment, crediting and other financial sector activities.

³ <https://mneguidelines.oecd.org/RBC-for-Institutional-Investors.pdf> and [https://www.suedwind-institut.de/files/Suedwind/Publikationen/2021/Titel%20Publikationen%202021/2021-30%20Minimum%20Standard Human%20Rights_eng.pdf](https://www.suedwind-institut.de/files/Suedwind/Publikationen/2021/Titel%20Publikationen%202021/2021-30%20Minimum%20Standard%20Human%20Rights_eng.pdf)

⁴ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0034&from=EN>

⁵ <https://investorsforhumanrights.org/sites/default/files/attachments/2021-10/Investor%20Statement%20mHREDD%20FINAL%206%20October%202021.pdf>

- Regarding scope, it is important that due diligence requirements for financial institutions include their full business portfolio, rather than large corporate clients only. Furthermore, the definition of 'value chain' needs to be clarified with regards to the financial sector; it should include the full range of capital market activities, including secondary market transactions, since financial institutions also exercise leverage through the offering of those services. Financial institutions should also require robust due diligence processes of their portfolio companies, as this increases their impact and helps them mitigate their own investment risks. In addition, the financial sector should be included as a high impact sector, in line with the Commission's own rationale to select high-risk sectors based on existing sectoral OECD due diligence guidance.
- Due to the special nature of the business relationship of financial service companies, due diligence requirements for prevention and mitigation of potential adverse human rights impacts deviate from other companies and they vary according to the nature of the financial service. The CSDDD needs to define financial institutions due diligence obligations. E.g., for institutional investors whose main tool for exercising leverage is corporate engagement and shareholder advocacy, due diligence obligations need to be in line with the corresponding OECD recommendations. For project finance, the IFC performance standards and Equator Principles need to be made mandatory. By defining the due diligence requirements for prevention and mitigation, responsible divestment as a last step if other efforts failed also needs to be included. Thus, financial institutions must be required to suspend or stop providing a financial service to a company in the same way and under the same circumstances delineated for other companies in scope of the Directive. This should be aligned with the dynamic nature of the 'cause/contribute /directly linked framework', that define a company's connection to a negative impact and subsequent duty to provide a remedy, which could ultimately result in terminating a business relationship.
- Public financial institutions like the European Investment Bank and European Bank for Reconstruction and Development should also be bound by the same due diligence requirements as private financial companies, as they also have leverage over companies via their financial services. This is already rightfully mentioned in the European Parliament's resolution on corporate due diligence and corporate accountability⁶.
- Finally, legislation should establish mandatory and effective corporate due diligence processes covering all human rights violations, environmental damage, including climate, and corruption practices linked to the activities of financial institutions as business actors.

Next steps

We are putting forward the above proposed changes to ensure that the European Union implements a strong and effective legal framework that contributes to better outcomes for people and planet across globalized value chains. It is now crucial that the European Parliament and the Council improve the directive in line with these recommendations. We stand ready to offer support and guidance.

⁶ https://www.europarl.europa.eu/doceo/document/A-9-2021-0018_EN.html