Corporate Sustainability Due Diligence

AFME's recommendations on the CS3D proposal in the context of the trilogues

July 2023

AFME and its members wish to contribute to the interinstitutional negotiations on the Corporate Sustainability Due Diligence Directive proposal (the "Directive"). Since the inception of this initiative, AFME has been supportive of the Directive's objectives of enhancing due diligence on human rights and environmental impacts, and contributed to its development by highlighting the specificities of how the Directive would apply to financial institutions.[1]

Upholding these objectives, the aim of this further contribution remains to ensure that the Directive can become an effective tool for financial institutions to carry out due diligence, identify material risks, engage with their clients, and promote best practices across the investment value chain. To do so, it is necessary to ensure that the proposal takes a proportionate, risk based and workable approach and that it provides a clear, practical and legally certain framework.[2]

We urge the co-legislators to focus on addressing, conclusively, the serious outstanding issues that financial institutions would face with the implementation of the Directive and the limits these cause to achieving the objectives of the initiative. The key challenges arise from the proposed scope of the value chain for financial institutions and the granularity of due diligence requirements. These challenges are compounded by the implications of the strict civil liability regime proposed in the Directive, and may harm the competitiveness of EU companies and limit the role of banks in providing finance to support the transition.

A workable and effective compromise would be based on addressing the following priorities:

- Value chain (Art. 3g): limiting due diligence requirements to upstream direct business relationships would address the significant challenges with applying the due diligence requirements to financial institutions' downstream value chain. To the extent that financial institutions' downstream value chain is included, it should be limited to the activities of large corporate clients directly receiving loan or credit services in the EU. It is crucial to ensure a harmonised approach to this definition within the Single Market.
- Risk-based due diligence (Art. 5, 6): while entity-level due diligence policies shall be updated periodically, the identification of adverse impacts shall only be conducted prior to client onboarding and specifically for the provision of subsequent loans. Identification can't be conducted effectively for other types of transactions e.g. before every individual payment or trade is executed, nor can banks ensure continuous monitoring of potential adverse impacts across all counterparties.
- Preventing and mitigating adverse impacts (Art. 7, 8): financial institutions shall not be required to terminate the provision of financial services. The Directive should avoid the use of ambiguous or unclear wording that may lead to different interpretations.
- Civil liability (Art. 22): civil liability should be clearly limited to circumstances where "intentionally or through gross negligence" a breach occurs that causes or directly contributes to the adverse impact, and where there is a direct causality link between the companies' operations and the damage.
- Combating climate change – transition plans (Art. 15): the Directive shall ensure consistency and coherence with CSRD and existing EU and international initiatives, without additional requirements.
- Directors' duties (Art. 25): the Directive should not seek to regulate directors' duties or directors' remuneration, as Member States have different frameworks in place.

[1] Corporate Sustainability Due Diligence: AFME position Paper (July 2022)
[2] Corporate Sustainability Due Diligence: An effective approach for financial institutions (January 2023)

Scope of the value chain and due diligence

The definition of 'value chain' for financial institutions still fails to take into account the distinguishing features of financial institutions' downstream value chains, which can be made up of many thousands of companies and counterparties, operating across different sectors and jurisdictions, as recipients of a broad range of products and services which are not always necessarily traceable and where the indirect links with companies' impacts on the environment and human rights are more or less relevant.

We recommend instead to adopt a proportionate, risk-based approach. Applying the due diligence requirements only to upstream business relationships would be aligned with existing, robust due diligence expectations for financial institutions, and mitigate the legal and implementation risks faced by financial institutions, whose clients would already be captured directly by the Directive. Requirements and definitions should nevertheless be harmonised across Member States to ensure a consistent application of the Directive throughout the EU and to ensure a level playing field.

To the extent that financial institutions' downstream value chain is included, the scope of the requirements should be focused on the provision of financing where the inclusion of the services within the legislation is expected to have the greatest impact on safeguarding human rights and the environment. It follows that, for financial institutions, due diligence obligations on their downstream value chain should not cover a scope going beyond the activities of large corporate clients directly receiving loan or credit services and it should be clear in any event that it does not extend to other services including trading and investment activities, derivatives, guarantees, custody, clearing and payment services for which banks cannot carry out an identification of adverse impacts, nor can they ensure continuous monitoring of potential adverse impact across all counterparties as recipients of these services. The identification of adverse impacts shall only be conducted prior to client onboarding and updated for the provision of subsequent loans.

In addition, with respect to guarantees, it is worth noting that the beneficiary of these instruments is not a bank's client but rather its client's business counterpart with whom the banks do not have any direct relationship. Thus, it would not appear appropriate and proportionate to extend a bank's responsibility to those third parties with whom the bank does not have a business relationship.

Due diligence policies, as suggested by co-legislators, shall be risk-based and prioritise the most urgent threats to human rights or the environment, with policies proportionate and commensurate to the likelihood and severity of adverse impacts. The provisions allowing for a prioritisation of material risks shall also be emphasised and reflected in the requirements for the identification of potential adverse impacts as well as in the civil liability regime established by the proposal.

At the same time, the frequency of further reviews of companies' due diligence policies should be revised. For financial institutions, a requirement to continuously review the due diligence policy exacerbates the already significant burdens and would not be consistent with existing practices and reporting cycles. In addition, due to the role these play in financial markets, the termination of business relationships involving the provision of financial services could also destabilise markets and hamper companies' access to essential services. The termination of a business relationship shuts down the channels for financial institutions to engage with their counterparties to promote more responsible business models and support their transition efforts. This should be avoided with a revised definition of value chain for financial institutions and with a full derogation to the provisions obliging companies to terminate relationships in case of breaches. Further, financial undertakings should not be legally required to provide financial support for SMEs or other business relationships as this must remain a business decision within their own responsibility taking into account, inter alia, their own risk assessment and regulatory requirements (such as own funds).

Internationally active companies face additional challenges due to being subject to different jurisdictional requirements and the proposal's coverage of business with no nexus to the EU and no means to bring about an impact, positive or negative, to EU markets, while harming the international competitiveness of EU companies competing with regional competitors outside the EU. Such extraterritorial application raises proportionality concerns and is also likely to give rise to enforcement challenges. To address this while maintaining a level playing field between companies headquartered in the EU and those headquartered outside the EU, we propose that the due diligence requirements should apply only to the value chains of products sold in the EU and services provided in the EU.

Civil liability

The combination of the civil liability provisions, the scope of the value chain definition, and the corresponding due diligence requirement is the cause for major concerns for financial institutions. Significant concerns arise where potential liability of financial institutions could occur as a result of adverse environmental or social impacts caused by corporate clients or trading counterparties around the world.

If firms will have to assess the risk of potential liability for the actions of the companies they finance, trading counterparties and their subsidiaries, they are likely to avoid dealing with those where the risk is harder to assess or manage. An unintended effect of these provisions would be to make financial institutions captured by these requirements less competitive compared with large regional banks not captured by the same requirements. The loss of business to regional competitors will be accompanied with a loss of oversight over potential breaches of human rights or environmental damages.

Civil liability should thus be clearly limited to circumstances where "intentionally or through gross negligence" a breach occurs that causes or directly contributes to the adverse impact, and where there is a direct causality link between the companies' operations and the damage, in line with the OECD guidelines. Financial undertakings should not be linked to an adverse impact in their value chain without causing or contributing to it as this would neither be realistically controllable nor appropriate. Any civil liability should not have a presumption in favour of the claimant.

Transition plans

Other provisions in the Directive shall be revised to ensure coherence with existing initiatives and compatibility with Member States law. Notably, it is essential to consider that significant work is already underway on transition plans for the financial services sector, and any obligations for combating climate change shall be compatible with other requirements, in the EU and internationally, for example in the context of the upcoming CSRD and upcoming transition plan requirements in other jurisdictions.

Moreover, linking the very long-term objective of a transition plan to the shorter period applicable to directors' remuneration would be hardly achievable. This would mean establishing yearly climatic sub-objectives to be linked with directors' yearly variable remuneration. To date, the European legislative framework does not allow such a precise level of sensitivity for the formulation of these short-term climate objectives.

Directors' duties

The proposal also introduces very broadly worded changes to directors' duties which would give rise to liability and potential litigation risk, as well as significant uncertainty as to how these directors would be able to meet these duties in practice. Articles 25 and 26 interfere with national provisions regarding directors' duty of care, potentially undermining directors' duty to act in the best interest of the company. The provision would bring great legal uncertainty for EU companies and should therefore be deleted from the text.

AFME's previous contributions elaborate on the rationale for these recommendations in greater detail. In particular, our recommendations for effective approach for financial institutions build upon evidence to highlight the key challenges arising from the inclusion of different types of financial services within the scope of the Directive. While negotiations proceed, we will continue to identify potential sources of legal uncertainty and develop targeted recommendations for co-legislators. We hope that due consideration is given to these points in the co-legislators' deliberations and would be very happy to discuss these points further.

Contacts

Oliver Moullin, Managing Director, Sustainable Finance and General Counsel
Oliver.Moullin@afme.eu

Giorgio Botta, Manager, Sustainable Finance
Giorgio.Botta@afme.eu

Carolina Cazzarolli, Manager, Advocacy
Carolina.Cazzarolli@afme.eu

About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.[3]

[3] AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is registered on the EU Transparency Register, registration number 65110063986-76.