Corporate Sustainability Due Diligence

An effective approach for financial institutions

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AFME, ISDA, FIA and EPIF (the "Associations") highlight the importance of ensuring that the proposed EU Corporate Sustainability Due Diligence Directive ("CSDDD" or the "Directive") takes a proportionate, risk-based and workable approach and provides a clear, practical and legally certain framework[1].

As has been highlighted by associations representing businesses[2] and in the discussions in the Council and the European Parliament, all companies (including financial institutions) will face significant challenges with applying the proposed due diligence obligations to their downstream value chains.

This paper highlights the serious challenges faced by financial institutions if the obligations are applied beyond their upstream supply chain to their relationships with corporate clients or trading counterparties in their downstream value chain. We have significant concerns with proposals to extend the scope of downstream financial services that would be included in the scope of the Directive.

To the extent that the co-legislators decide that the scope of the Directive should include downstream business relationships, it would be essential to take account of the distinguishing features of financial institutions' downstream value chains, and ensure a risk-based and proportionate approach. As we outline in detail below, financial institutions cannot effectively influence the behaviour of their corporate clients and trading counterparties through the provision of financial services such as trading, derivatives, custody, clearing and payments. The inclusion of these services in the scope of the value chain thus will creates undue burdens and obstacles in financial markets, without any contribution to the objectives of the Directive.

We strongly propose that any inclusion of downstream business relationships 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 receiving loan or credit services and it should be clear in any event that it does not extend to other services including (but not limited to) trading and investment activities, derivatives, custody, clearing or payment services.

[1] See AFME's broader position paper for further details.
[2] See for example the Joint Business Statement on the due diligence proposal

The value chain of financial institutions

We support the inclusion of financial institutions' upstream supply chain within the scope of the due diligence obligation alongside all other sectors, subject to our broader recommendations including to clarify the due diligence and civil liability framework.[3] While this will give rise to implementation challenges, we support the importance of addressing adverse impacts on human rights and the environment in companies' upstream supply chains. We also support a consistent application of the requirements throughout the EU to ensure a level playing field.

The nature of financial institutions' downstream business relationships

To the extent that the co-legislators decide to include downstream business relationships within the scope of the due diligence obligation, it is essential to take account of the distinguishing features of financial institutions' downstream value chains and ensure a risk-based and proportionate approach.

The downstream value chain of financial institutions 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 where the indirect links with companies' impacts on the environment and human rights are more or less relevant.

It is essential to consider the nature of the different financial services and clients or counterparties to understand the legal and operational challenges in applying due diligence obligations and identify where financial institutions are best able to support the objectives of the legislation.

An overly broad approach which is not risk-based nor focused on where financial institutions are able to best support the policy objectives would risk creating unworkable, disproportionate and ineffective legislation. It could also adversely impact companies' access to financial services, increase costs and potentially disrupt markets where it is not possible to comply with the requirements. An example is provided in the Annex which shows an illustration of challenges arising from complex value chains.

The need to consider the different types of financial services

Financial institutions provide many services, including services which are essential for the infrastructure of the financial system but where there is little to no ability to impact real economy activity.

Corporate lending is the primary type of financial services where banks are most likely to have the opportunity to carry out due diligence and work with their clients to address potential adverse impacts on the environment and human rights. In a loan relationship, a bank is extending financing which may be used to finance a particular investment or for general corporate purposes. In such business relationships, banks have a relationship with the borrower with ongoing information provision. However, as discussed below, there are also significant challenges with applying the proposed due diligence and civil liability provisions to lending which need to be carefully considered.

Corporate lending is only one type of financial services. Yet the Commission proposal refers broadly to "other financial services" which would include many other services such as trading securities, derivatives, payments, custody, settlement and clearing. Many types of financial services such as these are of a different nature to directly financing a business. They are unlikely to cause or contribute to adverse impacts on human rights or the environment.

The box on the following page describes a selection of financial services and highlights some key challenges with the inclusion of these different types of financial services within the scope of the Directive.

[3] See AFME's broader position paper for further details.

Financing activities: *when financing companies, banks could be indirectly contributing to companies' activities and this is why they are already making significant efforts in assessing and mitigating potential or actual environmental and social adverse impacts of their dedicated financing (e.g., project finance) and of their main large corporate clients across multiple sectors and jurisdictions, based on the information available or provided by their clients. However, the impact of potentially attaching civil liability needs to be carefully considered as discussed further below. If financial institutions have to assess the risk of potential liability for the actions of companies they are financing and their subsidiaries, they are likely to avoid dealing with companies where the risk is harder to verify.*

Trading and investment activities*: trading and investment activities can serve various purposes and are unlikely to directly cause or contribute to any adverse impacts in the client's or trading counterparty's value chain. It would be impractical for due diligence to be required for each transaction as these frequently have to be executed in a short space of time, including on trading venues, for example, or bilateral platforms. While due diligence is carried out when onboarding the client, including an assessment of potential adverse impacts based upon the information available or provided by their clients, the provision of trading activities occurs at multiple stages and on an ongoing basis throughout the duration of a contractual relationship with a client and numerous transactions may take place which technically form separate contracts. Application of due diligence for each transaction would therefore be unworkable. Additionally, as explained below, the impact of potentially attaching civil liability needs to be carefully considered. In situations where this risk is not manageable, such as lack of reliable sustainability-related information from the counterparties, financial institutions would be forced to stop the trading relationships with their counterparties. This may result in unintended negative consequences in terms of financial market stability and economic actors' ability to access hedging and other services. As discussed below, concerns would also arise regarding potential disruption to financial collateral, set-off and netting arrangements and impact on security arrangements.*

Derivatives activities: *the purpose of derivatives markets as a fundamental hedging tool in finance means that having a requirement to terminate relationships would be destabilising for the market itself. If derivatives counterparties have to stop doing new business with counterparties, this will limit their ability to engage in normal risk mitigation activities that are critical for their ability to manage their derivatives exposures (and in some cases are required by EU legislation – e.g., European Market Infrastructure Regulation). In order to manage risks in derivatives markets, counterparties sometimes have to enter into new transactions (e.g., portfolio compression), or aggregate existing transactions (e.g. "netting"). Having the possibility of those transactions needing to be terminated could undermine the central purpose of derivatives transactions as a risk reduction tool.*

Custody services: *custody services involve the safekeeping and servicing of client assets post trade - custody service providers do not have influence or control over how client assets are invested. These services are therefore unlikely to cause or contribute to any adverse impacts. Nevertheless, it is a service which is essential in the maintenance of a robust and reliable financial system, and many investors are required by regulation to use custodians. Clients of custodians may include corporates but for the majority part they comprise asset managers and other financial institutions, meaning that, as well as having no control over how client assets are invested, the custodian is also often another step removed from an impact which might occur as a result of corporate activity in the real economy.*

Clearing services*: Clearing services reconcile purchases and sales of various options, futures, or securities, and include the direct transfer of funds from one financial institution to another. Clearing is essential to mitigate counterparty credit risks that can potentially affect financial stability. For that reason, clearing has been mandated by the G20 after the financial crisis. Since then, clearing has been critical in delivering safe and transparent markets. However, the impact clearing banks or clearing houses can have on the protection of human rights and the environment along a given supply chain is limited: First, clearing is in many cases mandatory under EU law (European Markets Infrastructure Regulation). In order to ensure a proper risk management, clearing service providers do not have a choice other than to unconditionally perform their services. Second, as clearing occurs at the back end of a trade, clearing members in many cases do not include corporates. The potential impact of clearing banks or clearing houses on the underlying corporate activity in the real economy thus remains very remote.*

Payment services: *these include transfers, card payments and bank remittances. These services involve very frequent, short-term and numerous transactions and implementing a process of due diligence for each operation would result in an overly burdensome activity for financial institutions, not balanced by specific advantages for the purpose of this Directive, due to the short period of time between one operation and the next.*

For all of the above types of services, there are likely to be legal and practical challenges in conducting the due diligence obligations under the CSDDD. The nature of the service needs to be carefully considered, taking account that for many types of financial services there is a low likelihood that provision of the service actively causes or contributes to an adverse impact. We therefore strongly recommend that the scope of the due diligence, to the extent that it applies to downstream activities, is focused on lending to large corporates and does not extend to other types of financial services, consistent with a risk-based approach.

Scope of clients in the downstream part of the value chain

To the extent that the co-legislators decide to extend requirements to include downstream financial services, as provided in the Commission's proposal, it is important to limit the scope of clients of financial institutions subject to the CSDDD obligations. It is essential that the scope of the downstream value chain extends only to direct clients of financial institutions and does not extend to entities with whom the financial institution has no contractual relationship. It would not be practical or effective to seek to expand the scope beyond this as there would be very limited scope for financial institutions to address impacts on entities with which they do not have a direct business relationship.

It is also essential to clearly exclude SMEs and individuals from the scope of the value chain as provided in the Commission's proposal. The inclusion of small companies and retail activities would be overly burdensome given the number of clients and would also result in additional burdens on SMEs and consumers. Moreover, information about the negative impact on human rights and the environment would currently not be available, partially or totally, for these client segments and they would not be adequately resourced to provide the necessary information.

Challenges arising from the extraterritorial scope of application

It is important to ensure that the requirements take a proportionate, risk-based and workable approach for EU firms with international businesses and non-EU firms with EU businesses. The Commission's proposed scope would cover not only large international EU financial institutions at consolidated level but also non-EU financial institutions with cross-border business and/or branches in the EU, requiring both EU and non-EU international financial institutions to comply with the EU CSDDD requirements throughout their global businesses. These global businesses are subject to different jurisdictional requirements and the CSDDD proposal would cover business with no nexus to the EU and no means to bring about an impact, positive or negative, to EU markets. Value chains for the provision of the services would be entirely contained outside of EU borders, such as the provision of loans by a non-EU bank to a non-EU company or a Chinese company selling goods or services to a customer in China. Such extraterritorial application raises concerns around proportionality 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.

When competing for financing business in non-EU regions (particularly emerging markets), EU firms and non-EU headquartered firms with an EU footprint above the revenue threshold will be subject to requirements that would be likely to render them uncompetitive compared with large regional banks not captured by the same requirements. If measures are not coordinated internationally, banks operating in the EU could be rendered less competitive outside the EU against local/regional competitors which are not subject to CSDDD obligations, resulting in financial market fragmentation and an un-level playing field for firms active in the EU. Similar considerations and concerns are likely to apply to companies in other economic sectors.

Civil liability: implications for financial services

Concerns also 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. The impact of this needs to be very carefully evaluated. If firms 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 harder to manage.

The potential increased liability for damages could also have an impact on regulated financial institutions' regulatory capital requirements. Financial institutions would be required to account for any contingent liabilities (including potential litigation / damages claims) where the likelihood of the liability crystallising is more than merely remote. Any liabilities that appear on the balance sheet would then attract capital charges. This is one factor that financial institutions will take into account when deciding whether they are willing to serve a corporate client or trade with a counterparty and what the cost to the firm of serving that client or trading with that counterparty would be. Even if financial institutions are not required to terminate relationships with particular corporate clients or trading counterparties under the CSDDD, if the cost of providing financial services to those clients or trading with those counterparties is disproportionate, the they are likely to terminate the relationship in any event, potentially leading to difficulties for companies and investors in accessing financial services.

While the proposal states that financial compensation should be "proportionate to the significance and scale of the adverse impact and to the contribution of the company's conduct to the adverse impact", which is helpful, this does not address issues around controlling liability that typically exist under most legal systems in connection with contractual / non-contractual liability (e.g., limits on liability, the types of damages or loss that a person can claim, the ability to exclude liability for certain issues, rules against double jeopardy or double claiming).

In addition, it is important to ensure that civil liability is clearly limited to circumstances where the breach 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.

Impact of forced termination of financial services

The potential impact of any requirement for financial institutions to terminate contracts also requires careful consideration. In addition to the potential impact on the company receiving the service and the financial institution, there could be disruption to financial collateral, set-off and netting arrangements and security arrangements.

Disruption of financial collateral, set off and netting sets: requiring financial institutions to terminate relationships with counterparties or to cease entering into new contracts with existing counterparties could also result in disruption to key rights and protections such as financial collateral arrangements, set off arrangements and netting arrangements, particularly in a situation where counterparties have to terminate or novate certain contracts but not others, or where they are unable to manage their exposures actively by entering into new contracts or amending existing ones.

Impact on security arrangements: if counterparties are required to terminate relationships or cease new dealing, this may also have an impact on security arrangements, potentially resulting in counterparties being left without security or with ineffective security (including where they have no ability to exercise rights under existing security arrangements). This may be the case where counterparties need to enter into new security arrangements or where exercising rights under a security arrangement may be considered to involve new dealing with a counterparty.

Where financial institutions have the most impact: a risk-based approach

To the extent that the co-legislators decide to incorporate downstream client relationships, it is essential to take account of the distinguishing features of financial institutions' downstream value chains, and ensure a risk-based and proportionate approach, focused on the provision of financing where the inclusion of the services within the Directive is expected to have the greatest impact on safeguarding human rights and the environment.

It follows that, for financial institutions s, any sustainability due diligence obligations on their downstream value chain should not cover a scope going beyond the activities of large corporate clients receiving loan or credit services and it should be clear in any event that they do not extend to other services such as trading and investment activities, derivatives, custody, clearing or payment services.

Finally, we note proposals from some MEPs to designate the financial services sector as a "high risk sector". We do not understand the rationale for this. Financial services is a highly regulated sector. Specification of high-risk sectors should be based on evidence, and we have not seen evidence to suggest that financial services sector poses a particularly high risk to human rights and/or the environment compared to other sectors.

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.

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 for stable, competitive, sustainable European financial markets that support economic growth and benefit society. www.afme.eu

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on www.isda.org.

About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. Our membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers. Our mission: To support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. Information about FIA and its activities is available on www.fia.org

About EPIF

EPIF, founded in 2011, represents the interests of the non-bank payment sector at the European level. We currently have over 190 authorised payment institutions and other non-bank payment providers as our members offering services in every part of Europe. EPIF seeks to represent the voice of the Payment Institutions industry and the non-bank payment sector with EU institutions, policy-makers and stakeholders. We aim to play a constructive role in shaping and developing market conditions for payments in a modern and constantly evolving environment. www.paymentinstitutions.eu

Annex 1

This example illustrates the complexity of assessing and addressing adverse impacts in complex value chains.

Complex value chains: Carrying out due diligence, according to the Directive, on the impacts of plastic pollution along the value chain provides an example of the challenges related to data availability and the allocation of responsibilities. The flowchart illustrates the case of a plastic value chain where a bank provides financing to a packaging company, in turn supplied by a chemical and petroleum company for the production of plastic. 'Alpha Packaging Company', recipient of finance from the bank, uses the plastic to provide packaging services to 'Charlie Technology Company' and 'Delta Food Company'. 'Charlie Technology Company' and 'Delta Food Company' make use of the packaging to provide a service to the consumer (Echo, Foxtrot and Golf). Two out of the three consumers (Echo and Foxtrot) dispose of the plastic packaging through their respective countries' waste system, whilst the third consumer (Golf) disposes of the plastic packing in the ocean.

Concerns arise when considering whether Alpha Packaging Company should be held responsible for upstream GHG emissions and waste (Bravo Chemical Company and Petroleum Company). Equally, should Alpha Packaging Company be held responsible for waste downstream, both in respect of Golf Consumer and policy constraints preventing recycling for Echo and Foxtrot consumer? If so, is it the bank's responsibility to map the client's entire supply chain for reporting purposes or should the bank focus on the client's direct impacts from its activities?

In order to accurately measure the impact of plastic pollution on the entire value chain, the relevant data needs to be available on the use of plastic. Considering this alongside the absence of policy framework and/or technical capacity to address plastic waste, it becomes increasingly difficult to identify the party responsible for plastic pollution.