Beyond sustainability reporting:

Why a standardised due diligence framework for the financial sector will improve the management of financial risks stemming from the EU's supply chains.

BY CLIMATE & COMPANY AND GERMANWATCH E.V.

Climate & Company is Germany's leading Sustainable Finance Think Tank. Be it for biodiversity protection and the restoration of ecosystems, tackling the climate crisis, or halting deforestation - with sound data evidence, solid regulatory analysis and strategic policy recommendations we help decision-makers in connecting the dots and bridging the gaps between finance, policy and the environment.

EXECUTIVE SUMMARY

- A primary role of **financial institutions (FIs)** is to facilitate investments for both corporations and households. They play a pivotal role in shaping the environmental sustainability of investments through their investment strategies and interactions with clients and investee companies.
- FIs also face increasing risks from financing clients or investing in assets with impacts on the environment and exposure to environmental risks, such as financing actors along deforestation-linked supply chains. These risks can add up to **systemic risks at market level**, thus representing stability risks for Member States' and the EU's economy.
- To achieve positive outcomes or better manage financial risks, financial institutions must broaden their traditional due diligence processes to include sustainability considerations.
- Yet, no harmonised sustainability due diligence framework across all EU Member States is available to support FIs in this endeavour.
- The **Corporate Sustainability Due Diligence Directive (CSDDD)** has the potential to fill this gap. However, the role of FIs in the current draft CSDDD is not sufficient to address the bulk of environmental impact that e.g. takes place in the supply chain.
- We have five recommendations to adjust the CSDDD to more effectively serve its purpose:
    - **Include all FIs in the scope of mandatory sustainability due diligence provisions in the CSDDD** and avoid distortion of competition and additional burden through divergent national legislation.
    - **Require FIs to consider in their engagement strategy the impacts that their clients/investees identified throughout their value chain**, hidden upstream, such as deforestation.
    - **Require regular identification of impacts,** as supply chains and environmental conditions change over time**.**
    - **Require divestment or disengagement as back-up strategies,** if actions are not taken by investees and clients.
    - **Provide specific guidelines for the financial sector** to recognize the specific structures and procedures of different types of FIs, clarify expectations and provide the necessary guidance.

WHAT IS THE PROBLEM?

Environmental destruction and protection are, ultimately, driven by specific investment decisions. Let's quickly consider the example of **forests** and **deforestation** to illustrate this point, but also recall the scope and urgency of the problem. Addressing deforestation is key to delivering the targets of globally agreed environmental commitments such as the Paris Agreement and the 2022 Kunming-Montreal Global Biodiversity Framework (GBF). Forests harbour most of the Earth's terrestrial biodiversity and provide numerous ecosystem services on which we depend. They are home to many Indigenous communities, where the traditional use of forests is an integral part of their culture and livelihoods. Forests are essential CO2 sinks, and their depletion reduces carbon absorption capacity and contributes to greenhouse gas emissions. Between 1990 and 2020, an estimated 420 million hectares of forest (more than 10% of total forest area) were lost through conversion to other land-uses[1], threatening numerous species. In most high-impact sectors, the bulk of environmental impact, such as deforestation, is taking place upstream, hidden in the supply chain (98% for the food and beverage sector[2]).

With the EU Green Deal as its new economic paradigm, EU and national policymakers are shaping the EU regulatory framework to address environmental impacts and dependencies. Two very important measures in this context are the **EU Deforestation-free Products Regulation (EUDR),** which entered into force in June 2023, and the **Corporate Sustainability Due Diligence Directive (CSDDD)**, currently under negotiation. Those regulatory measures have the potential, when implemented in close cooperation with the EU's partner countries, to transform the production of raw materials, commodities and intermediate goods in our supply chains to minimise deforestation and other significant environmental and social impacts.



Figure 1: How financial institutions are financing deforestation (Sources: Forests & Finance (2022), link ; Forest500 (2023), link)

What role does the financial sector play in all of this?

Financial institutions (FIs) indirectly support deforestation by providing financing to companies in sectors such as beef and soy production. Additionally, they have an indirect influence by offering financial support to wholesale and retail operators whose supply chains involve high-risk commodities associated with deforestation. **Figure 1** shows some striking numbers. These numbers are not only alarming for those concerned with human prosperity and survival. They are also deeply disconcerting for everyone who cares about the stability of financial markets and the profitability of financial institutions.

The **role of the financial sector** needs to be clarified urgently: the EUDR does not (yet) include FIs in its scope[3] and it is still unclear whether and how the CSDDD will require FIs to exercise sustainability due diligence throughout their value chains and for all their clients/investees.

[1] FAO (2022), The state of the world's forests, link.
[2] UN Principles for Responsible Investment (2017), link.
[3] Subject to an impact assessment on the role of FIs and the potential need for additional requirements in EU legislation as part of the second review process of the EUDR in Spring 2025.

WHY FINANCIAL INSTITUTIONS ARE KEY FOR THE EU GREEN DEAL

FIs face **financial risks** from (1) their investees' and clients' dependency on nature and their exposure to climate change impacts, and (2) their impact on environmental and social issues (**Figure 2**).

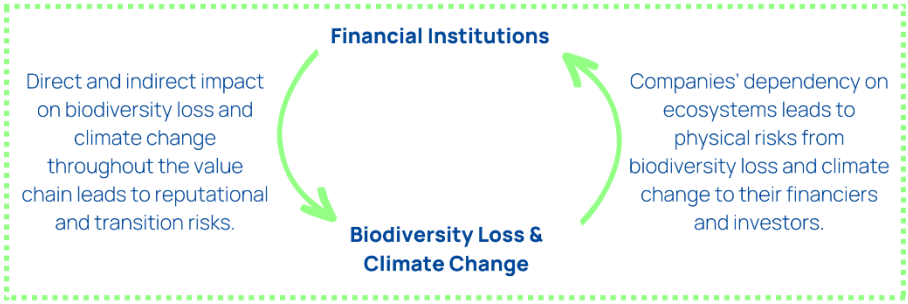


Figure 2: Financial risks from dependencies and impacts on the environment

As forests continue to disappear, so does the availability of ecosystem services on which many economic activities depend. This *dependency* leads to major **physical risks** from climate change and biodiversity loss, resulting in risks for the FIs financing them.[4]

The *impact* that investee companies have on environmental and social factors exposes the FIs to important **transition** or **regulatory** and **reputational risks.**[5] The transition to more sustainable practices and policies increases the likelihood of stranded assets, default probability on loans, and write-off of investments in companies with production processes that negatively impact biodiversity.[6] Those risks can lead to further serious **market**, **credit**, and **liquidity risks** for FIs.

As it currently stands, FIs are still largely exposed to economic activities that cause environmental harm.[7] The EU aims to transition to a climate-neutral economy[8], and delivering the EU Green Deal will require "**shifting trillions [of EUR]**". While both public and private resources are needed, the majority will need to be supplied by the private sector. For this, FIs play a key role in providing the right incentives for companies to address their impacts, either through their **financing and investment decisions** and/or by **engaging** with clients and investees about their ESG performance along their entire supply chain. For SMEs in particular, the engagement by banks can go and should be stenghtened in going beyond expressing concerns to taking a more active, supportive role vis-à-vis the SME, helping it in tackling transition challenges.

WHY FINANCIAL INSTITUTIONS SHOULD BE INCLUDED IN THE CSDDD

There are three issues which could be resolved by mandatory value chain due diligence for all FIs in the CSDDD:

1) **FIs and their investees/clients need a level-playing field across EU Member States.** The General Approach to the CSDDD adopted by the Council of the EU[9] would lead to divergent obligations for FIs in each Member State. This would increase the burden for FIs active in different countries. Additionally, divergent obligations would distort competition within the EU. Investee companies and clients would also suffer from a plethora of incoherent and unharmonized disclosure and due diligence requirements

[4] European Central Bank (2021), Climate-related risk and financial stability, link. McKinsey Global Institute (2020), Climate risk and response: Physical hazards and socioeconomic impacts, link. European Central Bank (2020) - Climate change and the macro economy, link.

[5] NGFS (2021), NGFS Occasional Paper – Biodiversity and financial stability: exploring the case for action, link. DNB & PBL (2020), Indebted to nature: Exploring biodiversity risks for the Dutch financial sector, p.12, link.

[6] DNB & PBL (2020), Indebted to nature: Exploring biodiversity risks for the Dutch financial sector, p.12, link.

[7] Rainforest Action Network (RAN), BankTrack, Indigenous Environmental Network (IEN), Oil Change International (OCI), Reclaim Finance, Sierra Club, and urgewald (2022), Banking on Climate chaos – fossil fuel finance report 2022, link.

[8] European Commission (2018), Communication: A Clean Planet for all A European strategic long-term vision for a prosperous, modern, competitive and climate neutral economy, link.

[9] Council of the European Union (2022), General Approach to the CSDDD, adopted 1st December 2022, link.The Council wants to leave it up to each Member State to decide whether to include financial institutions in the scope of the national transposition of the CSDDD.

from their investors and banks across the EU. SMEs in particular often lack the resources and expertise to navigate through varying sustainability-related demands from their banks and investors. They need a harmonized set of due diligence requirements from FIs, to provide them with clarity and consistency and reduce their administrative burden.

2) **Lack of policy coherence increases the burden, uncertainties, and liability risks for FIs**. Excluding FIs from the CSDDD also leads to considerable legal uncertainties for them. FIs are implicitly already required to comply with certain sustainability due diligence duties through, for example, deforestation-related standards and indicators in the CSRD and SFDR. However, these provisions lack clear guidance and specificity on what is expected of them and how to deal with identified risks from and impacts on, for example, deforestation. This increases their liability risks. Guidance on how to exercise sustainability due diligence would be facilitated if obligations for the financial sector across the EU were prescribed in law. Considering the specific structures of FIs and their distinctive position along the value chains, attention should be placed on making those requirements feasible, such as by specifying their role in checking the soundness and solidness of due diligence statements made available by their clients and investees. This is particularly important for small- and medium-sized FIs, who have more limited capacities and resources but also play a major role in advancing sustainable investments and supply chains.

3) **Voluntary actions have not been enough.** Despite several commitments from FIs to eliminate deforestation in their portfolios[10], the needed large-scale and timely shifts of financial flows to deliver the EU Green Deal will only happen with *regulation*. Due to information asymmetries, high search costs, and non-disclosure of value chain relationships and sustainability risks and impacts in the supply chain, FIs have lacked incentives and capacities to consider environmental impact as financially material. To date, FIs have introduced very little in the way of deforestation and other environmental impact mitigation measures, partly due to a lack of guidance and data.[11] This could be rectified by introducing value chain diligence obligations for FIs in legislation such as the CSDDD.

OUR RECOMMENDATIONS

Mandatory due diligence for the financial sector across the EU regarding sustainability impacts throughout their value chain, such as deforestation will help close important gaps and avoid unintended loopholes within EU legislation. However, the **current proposals[12] of the CSDDD do not effectively include FIs to prevent deforestation** (and other environmental and social issues) **throughout value chains**.

We have five recommendations to improve the inclusion of FIs in the CSDDD, which we encourage FIs to consider and endorse:

1) **Include all FIs in the scope of mandatory sustainability due diligence provisions in the CSDDD**. While the European Commission and European Parliament have agreed in their proposal that FIs should be part of the scope of the CSDDD, the proposal by the EU Council to leave it up to Member States to decide whether to include FIs in their national transposition is a very risky approach, as explained above. FIs need harmonized due diligence requirements across the EU, to be provided by the CSDDD. This means that institutional investors and asset managers should also be included in the scope of the Directive.

2) **Require FIs to consider in their engagement strategy the impacts that their clients/investees identified throughout their value chain**. Impacts such as deforestation are usually hidden upstream in the value chain of clients and investees. Limiting FIs' due diligence requirements to only the activities of their direct clients and investee companies (i.e. more likely downstream companies) means that the bulk of environmental impact is not considered or addressed. FIs should consider the results of their clients and investees' value chain due diligence, assess the soundness and quality of their clients and

[10] Most popular: Financial sector commitment letter on eliminating commodity-driven deforestation, link.
[11] Trase insights (2023), New guidance helps financial institutions grapple with deforestation due diligence, link.
[12] By EU Commission, EU Parliament and EU Council

investees' impact assessment and check that their clients/investees have adequate impact mitigation measures in place throughout their value chain. The inclusion of SMEs and their value chains is particularly valuable to mitigate environmental impact, and to provide FIs an adequate overview of the risks and impacts that *all* their clients and investees are associated with.

3) **Require regular identification of impacts**. A limitation to only pre-contractual identification of impact for FIs is incoherent with the concept of **dynamic materiality** (= what is considered material can change over time due to numerous factors), as well as the core purpose of sustainability due diligence. In this context, the Directive should specify the points in time during a contract or the provision of financial services when due diligence must be performed, as per the European Parliament report. This would help avoid further uncertainties.
4) **Require divestment or disengagement as back-up strategy if actions are not taken by investees and clients**. FIs' leverage with regard to mitigating adverse impacts is severely weakened if there is no credible threat of terminating a business relationship or selling assets ("divesting") if needed. Engagement and divestment are complementary strategies. The EU Commission proposed to exempt FIs from divesting or disengaging with a company if it is expected to cause substantial prejudice to the company. This is a vague provision, counter-productive to the objective of mitigating impact and could lead to more liability risks for FIs.
5) **Define specific guidelines for the financial sector**. Defining the specific steps that the different types of FIs should take to properly exercise sustainability due diligence would clarify expectations and provide the additional guidance needed. The OECD Guidelines already consider the different structures of FIs by distinguishing between institutional investors and banks. The European Commission could do the same through specific guidelines for different types of FIs. These should recognise the increased complexity of conducting due diligence from their position within the value chain, the difference in client relationships and the differences in their established due diligence systems compared to non-financial corporates.

HOW WE CAN SUPPORT YOU

Our team at Climate & Company and its partner organisations want to hear from you! We would be very happy to go into detail about and discuss with you the content of this brief and any comments/questions you might have. We invite you to have a look at the full analysis on our website.

We also want to learn more about the challenges that you face, and how those could be addressed in EU legislation. Climate & Company would like to formulate specific sustainability due diligence guidelines for the financial sector and your support here would be highly valuable.

Contact: Louise Simon - louise@climcom.org

Climate & Company is also working on the data solutions. We are implementing a pilot study with a pension fund to demonstrate the feasibility of mapping deforestation-related risks with existing data and available tools. We would be happy to present you our current findings during a workshop or similar closed-door event.

Contact: Malte Hessenius – malte@climcom.org

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