

Policy Paper on Corporate Sustainability Due Diligence for the Financial Sector

The EU financial sector holds financial assets totalling over 30 trillion Euros,ⁱ which is double the GDP of the EU-27 in 2021. Investment funds account for the largest share, with 22.9 trillion euros.ⁱⁱ Besides its indisputable impact on economic activities, the financial sector is directly or indirectly involved in numerous human rights violations and environmental degradation (HR&E adverse impacts). Voluntary due diligence practices are not effective in preventing these adverse impacts.

Under the current negotiations for an EU Directive on Corporate Sustainability Due Diligence (CSDDD) several voices, including the European Commission, the Council of the EU, conservative and certain liberal wings at the European Parliament, as well as the financial sector's lobby, are calling for the exclusion of the financial sector from certain mandatory measures. There is even discussion about excluding investment funds all together or leaving it up to member states to decide whether to include the financial sector. In our opinion, such a preferential treatment of the financial sector is not legally justified considering the enabling role that it plays in value chains leading to HR&E adverse impacts in several cases. We therefore strongly believe that the forthcoming CSDDD should be applied to the entire financial sector, including investments, and without exceptions, to prevent these adverse impacts and to ensure accountability. In this policy paper, Facing Finance, Südwind and FIAN outline through examples in Guinea, Brazil and Cambodia why the CSDDD should apply to the financial sector, and the specific requirements that must be guaranteed to ensure its effective application.

The financial sector needs human rights and environmental due diligence obligations

1. Consistency with global standards: Existing due diligence instruments like the UN Guiding Principles on Business and Human Rights (UNGPs)ⁱⁱⁱ and the OECD Guidelines for Multinational Enterprises^{iv} explicitly include the financial sector. Both recognize the high impact that financial undertakings have on economic activities, as well as the conditions in which they occur, including HR&E adverse impacts. The OECD Guidelines even define the financial sector as a high impact sector with specific risks. Excluding the financial sector from the CSDDD regulation or weakening its due diligence requirements would result in legal inconsistencies.

2. Existing voluntary measures are insufficient: As stated in the Explanatory Memorandum of the EU Commission's Proposal, voluntary due diligence practices from the business sector have proven to be insufficient to prevent, mitigate and end human rights and environmental negative impacts. This is also the case in the financial sector. Most banks in Europe claim to respect human rights by endorsing the UN Global Compact, but according to the BankTrack's Global Human Rights Benchmark, banks on average only apply 36% of the UNGPs. Furthermore, when it comes to implementing concrete mitigating practices, only 18 % of 152 actual human rights adverse impacts were backed by specific measures taken.^v

FIAN casework demonstrates that the absence of clear mandatory due diligence obligations does not prevent EU financial undertakings from financing companies involved in HR&E adverse impacts:

- In 2016, the Compagnie des Bauxites de Guinée (CBG) obtained loans totalling US\$823 million from international lenders, including ING-DiBa, BNP Paribas, Société Générale and Crédit Agricole. CBG used this financing to expand its bauxite mine near the town of Sangaredi (Guinea) resulting in adverse human rights and environmental impacts. The agricultural lands of local communities were dredged, their forests were cleared, and the water resources were destroyed and polluted. One local community was forcibly displaced without adequate compensation, leaving the population without access to water and land for subsistence.^{vi}

- The German pension fund for medical doctors, Ärzteversorgung Westfalen-Lippe (ÄVWL) and the second Swedish buffer fund, Andra AP-fonden (AP2), invested more than one billion US Dollars in two farmland funds, namely TIAA CREF Global Agriculture Fund (TCGA) I and II, established by TIAA (Teachers Insurance and Annuity Association). Both funds are managed by the U.S.-based Westchester Group Investment Management, which acquires land through various firms and leases it out to farm operators for monoculture production, mainly soybeans. For this purpose, Westchester has acquired land in the Brazilian region Matopiba (States of **MA**ranhão, **TO**cantins, **PI**auí, **BA**hía), in the northeast of the country, which is part of the Cerrado, the second largest ecosystem in Brazil after the Amazon, with a significant indigenous and traditional population. According to FIAN's research, these land acquisitions have resulted in illegal appropriations, as declared by Brazilian authorities in 2019, and have led to the displacement of many indigenous and traditional communities. Additionally, deforestation and contamination of water and soil have led to food insecurity among the population. Through their investments, ÄVWL and AP2 are directly linked to these HR&E adverse impacts.^{vii}
- Institutional investors such as development banks from Germany, Sweden, and Austria, as well as fund managers on behalf of small investors, including Triodos Investment Management (Netherlands), Impact Asset Management GmbH (Austria) and Invest in Vision GmbH (Germany), have invested several million Euros in microfinance institutions in Cambodia through microfinance funds. According to FIAN's research, these investments have led to systematic human rights violations against the most vulnerable population in Cambodia, a country where the microfinance sector has been over-saturated for years. Many of the borrowers are over-indebted or at risk of over-indebtedness due to microcredits, considering that the average size of these "micro" loans is US\$4,280 compared to the annual disposable income per capita, which is only around US\$1,150. As a result, many borrowers have lost their lands as land titles are often used as collateral for credit, leading to forced land sales. Many households reduce their food consumption, which is already scarce, and family members are forced to migrate to cities or even abroad. In some cases, children are taken from school to help repay the loans.^{viii}

The financial sector shall be comprehensively included in the CSDDD

1. Same level playing field in the EU: The aim of the CSDDD is to establish harmonized rules for all companies operating in EU Member States. However, the European Council's General Approach (Art. 2(8)) undermines this aim by granting Member States the option to exclude business partners of financial undertakings that receive financial services. If Member States decide not to include those businesses, severe human rights violations, like those documented by FIAN in Guinea, would continue to be enabled by EU financial institutions, despite the high environmental and social risks pointed out by an impact assessment prior to the conclusion of the loan agreement with CBG. To prevent such cases, we strongly advocate for the mandatory inclusion of the financial sector within the scope of the CSDDD, as proposed by the European Commission and the JURI-Report. With an effective CSDDD in place, banks would be obligated to decline the loan or adequately compensate affected communities.

2. The financial sector shall be considered as a high-risk sector: Given its crucial enabling function, the financial sector must be classified as a high-impact sector in line with the OECD Guidelines and Amendment 57 of the JURI-Report. However, the EU Commission and Council explicitly ignore this recommendation (Recital 22) "due to" the "specificities" of the financial sector. Nevertheless, we firmly believe that a risk-based approach, as proposed by the JURI-Report (Amendment 94), will enable financial undertakings to prioritize potential or actual adverse impacts based on their severity and likelihood, addressing the most significant ones first.^{ix}

3. All pension institutions shall be included: As stated in the Commission's Proposal and in the JURI-Report, pension institutions that operate pension schemes considered to be social security schemes must also fall within the scope of the CSDDD, in the same line as institutions for occupational retirement provision (Art. 3, point (a) (iv)). As shown by FIAN casework, the German and Swedish pension institutions ÄVWL and AP2 were involved in human rights violations in Brazil through their investments in the U.S.-based farmland funds TCGA I and II. These were used to acquire huge tracks of land, some of them illegally, in the Brazilian ecoregion Cerrado. The land acquisitions contributed to land grabbing, deforestation, contamination of water and fields, and food insecurity, among other adverse HR&E impacts. By including pension institutions operating pension schemes considered to be social security schemes, ÄVWL and AP2 will be obliged to assess and mitigate HR&E adverse impacts, thereby preventing illegal acquisitions and further human rights violations more effectively.

4. The CSDDD shall apply to all financial services, including investment services through investment funds: The Council's General Approach suggests the exclusion of alternative investment funds (AIFs) and undertakings for collective investment in transferable securities (UCITs) from the scope of the CSDDD (Art. 2.7), in contrast to the Commission's and the JURI Committee's position (Art. 3, point (a) (iv)). This overlooks their influence, as AIFs and UCITs had a net asset value of 21,9 trillion Euros by the end of 2021 in Europe,^x over two thirds of all European financial assets. According to FIANs casework, institutional investors and European fund managers have invested almost two hundred million Euros in Cambodia's microfinance sector through investments funds, contributing to the over-indebtedness, food scarcity and land loss of disadvantaged populations. With their inclusion into the scope of the CSDDD, it will be mandatory for managers of EU-based AIFs and UCITs to conduct due diligence measures in their investments to prevent and minimize actual or potential HR&E adverse impacts.

5. Scope criteria shall be harmonized in line with the Corporate Sustainability Reporting Directive (CSRD): The criteria to determine the scope of the CSDDD established by the Commission's Proposal and the Council's Approach, namely the figures for net worldwide turnover and the number of employees, are not sufficient for the financial sector, considering the impacts of its activities. Many financial undertakings manage billions of Euros but often have fewer than the threshold of 500 employees proposed by both EU Institutions. One example is ÄVWL, which with only 130 employees managed around 14 billion Euros in 2021. In our opinion, incorporating balance sheet total (20 million Euro) along with the number of employees (250) and the net turnover (40 million Euro) into the scope criteria, in line with the CSRD, will be much more accurate in capturing the size and influence of financial undertakings. According to the CSRD, a company exceeding the threshold value of at least two of the criteria will fall within the scope of application.^{xi} Importantly, this alignment would create consistency between different regulations on sustainability matters.

6. Inclusion of the entire value chain: We strongly believe that the CSDDD shall cover the entire value chain, as stated by the JURI Report in its Amendment 74, including all upstream and downstream activities, operations and entities, with no exceptions for financial undertakings. The limitations established by both the Commission and the Council are contradictory to the objective of the Directive. The Commission's definition of value chain (Article 3 (g)) limits the application of due diligence obligations only to the activities of clients receiving financial services and their subsidiaries, excluding SMEs. With this restriction, in FIAN's Matopiba case, the Directive would only be applicable to the activities of ÄVWL's and AP2's contract partners and not to the firms buying land on their behalf and agricultural operators, whose activities eventually led to HR&E adverse impacts. According to the Council's General Approach, the Matopiba case would not be covered at all because it omits the activities of entities receiving investment services from its definition of "chain of activities".

7. Due diligence is an ongoing process: According to the UNGPs and OECD Guidelines, HR&E due diligence is an ongoing process. Sustainable-finance related regulations such as SFDR, the Taxonomy

Regulation and the CSRD also consider due diligence obligations as an ongoing process. Nevertheless, the Commission's Proposal and the Council's Approach contradict them as they require financial undertakings to conduct due diligence only before providing a financial service (Art. 6 (3)). According to FIAN's casework, human rights and environmental risks are not static and are subject to change due to factors such as business operations or context. Thus, the land acquisition through TCGA I and II were declared illegal by Brazilian authorities years after ÄVWL and AP2's investments. Without mandatory HR&E risks assessments on an ongoing basis, major adverse impacts may go unidentified and unresolved.

8. Acknowledgment of different degrees of involvement, responsibility, and civil liability: In our opinion, considering the different degrees of involvement of companies in HR&E adverse impacts, namely causality, contribution, and direct linkage, is the right approach to determine related due diligence obligations to prevent, mitigate or bring to an end those impacts. This is in line with the UNGPs and the OECD Guidelines and is addressed in the JURI-Report accordingly. This differentiation is particularly relevant for financial undertakings, since they do not operate in the real economy and in most cases, they do not cause HR&E adverse impacts directly but may be directly linked or contribute to them.^{xii} Thus, the use or increase of a financial undertaking's leverage to prevent or mitigate adverse impacts in cases of direct linkage or contribution, as proposed in the JURI-Report (Amendments 115 and 136) is a necessary measure to tackle those impacts. As FIANS Sangaredi case shows, EU-based financial undertakings have contributed to the displacement of local communities by financing CBG for the expansion of its bauxite-mine. In the Matopiba case, the investments of ÄVWL and AP2 in the farm-land funds TCGA I and II were directly linked to human rights violations of indigenous and traditional communities in Brazil. Without the acknowledgment of contribution and direct linkage, cases like Sangaredi and Matopiba will not be covered by the CSDDD. This approach will be very relevant regarding the civil liability of financial undertakings in cases of damages due to the failure to comply with their obligations to prevent, mitigate and put an end to adverse HR&E impacts, especially as the Council (Article 22) and the ECON Committee (Amendment 141) exclude direct linkage from civil liability.

ⁱ As of December 2022, see https://www.ecb.europa.eu/stats/macroeconomic_and_sectoral/sector_accounts/html/index.en.html.

ⁱⁱ See Factbook 2022, p. 12, published by European Fund and Asset Management Association (EFAMA). URL: <https://www.efama.org/data-research/research/fact-book>

ⁱⁱⁱ See <https://www.business-humanrights.org/en/big-issues/un-guiding-principles-on-business-human-rights/>.

^{iv} See <https://mneguidelines.oecd.org/guidelines/>.

^v See BankTrack Global Human Rights Benchmark 2022. URL: https://www.banktrack.org/download/global_human_rights_benchmark_2022/global_human_rights_benchmark_2022_2.pdf.

^{vi} For further information on this case, please visit: <https://www.fian.de/was-wir-machen/fallarbeit/sangaredi-guinea/>.

^{vii} For further information on this case, please visit: https://www.fian.org/files/files/The_Human_and_Environmental_Cost_of_Land_Business-The_case_of_MATOPIBA_240818.pdf, https://www.grain.org/system/attachments/sources/000/006/304/original/Land_grabbing_in_Brazil_EN_04.pdf and <https://www.fian.de/was-wir-machen/fallarbeit/matopiba-brasilien/>

^{viii} For further information on this case, please visit: <https://www.fian.de/wp-content/uploads/2022/02/FIAN-Ueberschuldungsstudie-Studie-17.02.pdf> and https://www.uni-due.de/imperia/md/content/inef/bliss_2022_micro_finance_in_cambodia_ave30b.pdf

^{ix} Helpful Guidance for institutional investors, corporate lending and securities underwriting and project and asset finance transaction is provided by OECD: <https://mneguidelines.oecd.org/rbc-financial-sector.htm>.

^x See EFAMA Factbook 2022, p. 12.

^{xi} See Art. 3 (4) in Directive 2013/34/EU, amended by Directive 2022/2464/EU.

^{xii} OHCHR Response to Request from BankTrack for Advice Regarding the Application of the UN Guiding Principles on Business and Human Rights in the Context of the Banking Sector <https://www.ohchr.org/sites/default/files/Documents/Issues/Business/InterpretationGuidingPrinciples.pdf>