Joint Policy Briefing Paper by FIAN and Südwind

Don’t let the financial sector off the hook!
Call for a comprehensive inclusion of the financial sector into CSDDD

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This Policy Briefing Paper deals with human rights and environmental due diligence obligations of financial companies. It reviews the requirements already established for this purpose by the OECD Guidelines for Multinational Enterprises on Responsible Business Conduct (OECD Guidelines) and contained in the UN Guiding Principles on Business and Human Rights (UNGPs). Correspondingly, the strengths and weaknesses of the proposals for the text of the Corporate Sustainability Due Diligence Directive (CSDDD) of the EU Commission (Commission), the EU Council (Council) and the EU Parliament (Parliament) are assessed comparatively. In order to ensure that the final text of the forthcoming CSDDD will be as closely aligned with the standards of the UNGPs and OECD Guidelines as possible, this policy paper specifically highlights the proposed provisions and paragraphs that decision makers should advocate to retain in the trilogue negotiations.

Why the financial sector should be included in a comprehensive manner
Recent studies reveal how financial institutions enable human rights abuses and environmental degradation through financial services. A joint policy paper published by FIAN Germany, SÜDWIND Institute and Facing Finance in April 2023 highlights the financial sector’s contribution to human rights abuses on three occasions. Firstly, investments in land funds made by pension institutions are linked to illegal land grabbing in Brazil. Secondly, loans given out by a consortium of European banks to a bauxite mining company enabled the destruction of local people’s livelihoods in Guinea. Thirdly, the investments of several microfinance investment funds made in microfinance institutions have led to over-indebtedness in Cambodia.1 According to the Dirty Profits Report 9 by Facing Finance (2022), 14 German banks and insurance companies have a financing and investment volume totaling around 46.6 billion Euros in companies in the mining, agriculture, arms, and energy sectors, which are involved in human rights abuses and environmental destruction.2 Voluntary statements of intent and commitments to global standards, such as those contained in the UN Global Compact, are proving to be ineffective in these and many other instances.3 According to BankTrack’s Global Human Rights Benchmark (2022), a majority of 50 leading banks worldwide have not implemented voluntary human rights and environmental due diligence obligations in any meaningful manner.4 A due diligence regulation that encompasses these financial institutions in its scope could limit the severity of human rights abuses and environmental damage and, at best, prevent them from happening in the first place.

OECD: no exemptions for financial companies in line with global standards
According to the Organisation for Economic Co-operation and Development (OECD), it is crucial that domestic due diligence regulations such as the CSDD are fully coherent with global standards. This was emphasized by the representatives of the OECD member states and 13 other countries in a joint declaration on responsible corporate governance in the global economy in February 2023.5 In particular,

1 This briefing was originally published in German: https://www.fian.de/wp-content/uploads/2023/07/FIAN_SUeDWIND_Policy_Briefing_Paper_Finanz_CSDDD_deutsch_20230728.pdf
4 BankTrack has listed numerous problematic projects in its Dodgy Deals Databank: https://www.banktrack.org/dodgydeals
5 https://www.banktrack.org/download/global_human_rights_benchmark_2022
these standards include those contained in the OECD Guidelines\textsuperscript{7} and the UNGPs.\textsuperscript{8} In a separate paragraph on the financial sector, the country representatives emphasize the need to establish and promote these standards and their relevance for the credibility and effectiveness of a sustainable financial system.

Both, the OECD Guidelines as well as the UNGPs, recognize the differences between the financial sector and any other ‘regular’ sector of the economy. However, this does not imply a weakening of their standards, but an application that considers the particularities of the specific business relationships and practices in the financial sector. To this end, the OECD and the UN OHCHR have developed numerous financial sector-related resources to clarify how the OECD Guidelines and the UNGPs should be interpreted and implemented.\textsuperscript{9} From them, the following six requirements, among others, can be derived for the legal inclusion of the financial sector in the CSDDD in order to ensure its alignment with global standards:

1. **Human rights and environmental due diligence obligations for financial companies due to their direct linkage to negative impacts:** According to the UNGPs, human rights and environmental due diligence obligations do not only apply when causing or contributing to potential or actual negative effects ("cause" or "contribution"). Regarding financial companies, which are rarely directly causing or contributing to human rights violations, the UN OHCHR clarifies that these stakeholders are usually "directly linked" to them.\textsuperscript{10} This refers to a "[s]ituation […] where a bank has provided finance to a client and the client, in the context of using this finance, acts in such a way that it causes (or is at risk of causing) an adverse impact." Importantly, "the link needs to be between the financial product or service provided by the bank and the adverse impact itself."\textsuperscript{11} The OECD Handbook for Institutional Investors "recognises that enterprises may not be able to address themselves adverse impacts caused or contributed to by another entity, but nonetheless should seek to influence or encourage that entity to prevent or mitigate the adverse impacts".\textsuperscript{12}

2. **Continuum between direct linkage and contribution, and differentiated due diligence obligations:** The specific due diligence obligations that apply to financial companies are determined by the extent of their involvement in an actual or potential adverse impact. As just indicated, the OECD's financial sector-specific guidance provides for financial companies to use their leverage (see next point) in the case of direct linkage. If financial companies fail to use their leverage, if the negative impact was foreseeable, or if they create incentives for a business partner to cause an adverse impact (e.g., by imposing a condition to save costs),\textsuperscript{13} a situation of direct linkage to a human rights violation can turn into a substantial contribution.\textsuperscript{14} In such a case, in addition to using their influence, they are required to "contribute to the remedy of actual impacts". Where there is a potential adverse effect, they are required to cease or prevent contributing to it.\textsuperscript{15}

3. **Investors fall within the scope even without direct contractual relations:** The very existence of various guidelines targeting investors underscores that the OECD Guidelines and UNGPs apply not only to banks but also to institutional investors and asset managers, even in the case of minority shareholdings.\textsuperscript{16} A counter-argument often put forth is that without a direct

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\textsuperscript{7} OECD-Guidelines: \url{https://mneguidelines.oecd.org/due-diligence-guidance-for-responsible-business-conduct.htm}


\textsuperscript{10} Cf. UN OHCHR 2013: Advice regarding the UNGPs and the financial sector; UN OHCHR 2017: Advice regarding the application of the UNGPs in the context of the banking sector.

\textsuperscript{11} Ibid. p. 6.

\textsuperscript{12} P. 12 in OECD 2017: Responsible Business Conduct for Institutional Investors.

\textsuperscript{13} Cf. p. 43-46 in OECD 2019: Due Diligence for Responsible Corporate Lending and Securities Underwriting. For investors see p. 34f. in OECD 2017.

\textsuperscript{14} Cf. p. 6f. in UN OHCHR 2017.

\textsuperscript{15} p. 42 in OECD 2019 and for investors p. 35 in OECD 2017.

\textsuperscript{16} OECD 2017: Responsible Business Conduct for Institutional Investors; UN OHCHR 2013: Clarification on the applicability of the UNGPs to minority shareholdings of institutional investors.
credit or insurance relationship no business relationship would exist in the classic sense, and thus no possibilities for exerting influence. However, detailed recommendations for capital owners or investment managers in the role of shareholders, exerting influence (“leverage”), e.g. by exercising voting and information rights, by making speeches at annual general meetings, by coordinating action with other shareholders, etc. override this argument.

4. Inclusion of the entire value chain: As the UN OHCHR’s Interpretative Guide to the UNGPs clarifies, the business relationships of companies, including financial companies, encompass all entities in the value chain, including "indirect business relationships in its value chain, beyond the first tier, and minority as well as majority shareholding positions in joint ventures". In September 2022, the UN OHCHR emphasized that this value chain concept also includes the downstream value chain, which is relevant for the financial sector. This aspect should be reflected in the CSDDD.

5. Ongoing assessments of human rights and environmental risks: According to the OECD's financial sector guidance, financial institutions should assess actual and potential adverse impacts associated with their financing at three stages: 1) prior to entering into the financing relationship; 2) during periodic reviews at pre-determined times; and 3) on an ad hoc basis as warranted based on effective early warning systems such as complaint mechanisms and communication channels for affected stakeholders and their representatives. This applies not only to banks, but also to investors. In light of the often large amount of different relationships, to avoid an overburdening of companies, financial companies should prioritize their business relationships in a first rough screening according to the probability and severity of negative impacts. The prioritized business relationships should then be scrutinized more closely in a second detailed screening, while also taking into account various sources of information including NGO reports and stakeholder statements.

6. Prevention, mitigation and cessation of actual and potential adverse human rights and environmental negative impacts: The guidance on the implementation of the OECD Guidelines by financial companies emphasizes the importance to prevent, mitigate and cease both, actual and potential adverse impacts.

So far, various financial companies as well as church and civil society associations have called for the financial sector to be included into CSDDD in line with the OECD Guidelines and the UNGPs. These include the Association of Dutch Banks (Nederlandse Vereniging van Banken), the global investor network PRI or a coalition of Catholic associations including the EU Bishops’ Conference (COMECE).

The EU Commission’s proposal, the EU Council’s General Approach and European Parliament position: significant deviations from global standards

In February 2022, the Commission published its proposal for a CSDD-Directive, on November 30, 2022, the Council presented its General Approach to this directive, and most recently, on June 01,
2023, the European Parliament adopted its position.\(^{28}\) Although the three proposals all aim to translate the voluntary non-binding standards contained in the UNGPs and OECD Guidelines into law, the degree to which they intend to do so varies, as OECD Watch demonstrates in a detailed analysis.\(^{29}\) The Parliament's position is most ambitious in this respect.

Concerning the financial sector, however, all proposals display considerable divergences (which according to insiders can be attributed in large part to the considerable lobbying efforts of the financial sector\(^{30}\)). This is shown in the table below, which compares the three proposals regarding their alignment with the OECD Guidelines and the UNGPs.

**Table 1: Implementation of the financial sector-specific claims of the OECD Guidelines and UNGP in the EU proposals for the CSDDD (red border around the strongest regulation in each case)**

<table>
<thead>
<tr>
<th>Claim</th>
<th>UNGP and OECD Guidelines</th>
<th>EU Commission</th>
<th>EU Council</th>
<th>EU Parliament</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Inclusion of financial sector</td>
<td>Yes</td>
<td>No differentiated due diligence obligations according to degree of involvement</td>
<td>Differentiation of degrees of involvement in the preliminary remarks (Recital 25), but no due diligence obligations in this respect</td>
<td>Differentiated due diligence obligations according to the degree of involvement in negative impacts (causal, contribution, direct linkage) (Art. 3, para. 1, points a-c, Art. 7, para. 1a; Art. 8, para. 2a). For financial companies, a relation of direct linkage to negative impacts is presumed (Art. 7, para. 1a, Art. 8, para. 2b). This ignores that a situation of direct linkage can turn into a contribution. It also de facto excludes them from civil liability which is limited to causing and contributing to an adverse impact (Art. 22, para. 1).</td>
</tr>
<tr>
<td>2. Fluid understanding of degree of involvement in negative impacts and related differentiated due diligence obligations</td>
<td>Investment funds, fund managers and pension funds, including pension institutions operating social security schemes (Art. 3, Item (vi))</td>
<td>Optional for Member States; Application for pension institutions considered as social security schemes (Art. 1.6)</td>
<td>No due diligence requirements for companies in which investments are made through investment funds (Art. 1.7)</td>
<td>But: Inclusion of investors through separate definitions of institutional investors and asset managers (Art. 3, para. 1, Item a(iv)). Focus on direct contractual relationships in the value chain definition for financial undertakings (Art. 3, Item g).</td>
</tr>
<tr>
<td>3. Inclusion of investors, including pension institutions operating pension schemes which are considered to be social security schemes</td>
<td>But implicit exclusion by focusing on direct contractual relationships with business partners in the value chain definition for financial undertakings (Art. 3, Item g)</td>
<td></td>
<td>Exclusion of pension Institutions operating social security schemes (Art. 3, para. 1, Item a(vi)). Focus on direct contractual relationships in the value chain definition for financial undertakings (Art. 3, Item g).</td>
<td></td>
</tr>
<tr>
<td>4. Entire value chain of financial companies</td>
<td>Limited to direct large clients and subsidiaries, business relationships with SMEs and those of an indirect nature in the lower value chain are excluded (Art. 3, point (ii)).</td>
<td>Limited to direct large clients and subsidiaries using credit or insurance services. Companies receiving investments, business relationships with SMEs and those of an indirect nature in the lower value chain are excluded (Art. 3, point (iii)).</td>
<td>Limited to direct large clients and subsidiaries. Business relationships with SMEs and those of an indirect nature in the lower value chain are excluded (Art. 3, point (ii)).</td>
<td>Prioritized risk assessments according to severity and probability of occurrence (Art. 8, Para. 2) prior to the provision of financial services and on an ad-hoc basis in the event of complaints pursuant to Art. 9 (Art. 8, para. 3).</td>
</tr>
<tr>
<td>5. Ongoing risk assessments: before conclusion of a contract or investment decision, at regular intervals and on an ad hoc basis</td>
<td>Risk assessments only prior to the provision of the financial service (Art. 6, para. 3)</td>
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</tr>
<tr>
<td>6. Due diligence obligations equally for potential and actual negative</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Basically yes. For institutional investors and asset managers limited to actual negative impacts (Art. 8a).</td>
</tr>
</tbody>
</table>

**Point 1:** Following the Council's approach, the inclusion of the financial sector is not mandatory and is left to the discretion of EU member states.

**Point 2:** The proposal of the EU Commission and the EU Council's approach do not differentiate between cause, contribution or direct linkage as different degrees of companies' involvement in negative impacts. Moreover, these two proposals do not prescribe any specific due diligence obligations related to the extent of their involvement. Conversely, the position of the EU Parliament aligns with the UNGPs and the OECD Guidelines in addressing different degrees of involvement. However, in deviation from this, the Parliament's position presumes a situation of direct linkage for financial companies (Art. 7, para. 1b, Art. 8, para. 2b) and therefore ignores the possibility that a direct linkage can turn into a contribution. As a result, financial companies would de facto be excluded from civil liability, which is intended to apply only when companies cause or contribute to adverse impacts.

**Points 3 and 6:** Not all financial products and services fall under the scope of application. The Council's approach excludes investments in investment funds, while the Commission does this implicitly through

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a specific value chain definition solely applicable to financial undertakings. It only covers “clients” that are linked to financial companies through “the contract in question” (Art. 3, point g). As direct contractual relationships do not exist in the case of investments, this definition could be interpreted as not applying to investments. The same provision can also be found in the Parliament's draft. But this position does include investors along with corresponding definitions and special due diligence obligations (Art. 8a). However, it requires investors to conduct human rights due diligence only in connection to actual negative impacts but not potential negative impacts. Concerning the types of investors, the Council leaves it up to member states to decide on the inclusion of pension institutions operating pension schemes which are considered to be social security schemes, while the Parliament's position excludes them altogether. In contrast, all drafts include institutions for occupational retirement provision.

**Point 4:** All three drafts deviate considerably from the requirements contained in the UNGPs and the OECD Guidelines in point 4 (value chain) by limiting due diligence obligations of financial companies to their direct large clients and subsidiaries.

**Point 5:** According to the Commission's draft and the approach of the Council, financial companies are only required to carry out human rights and environmental risk assessments before providing a financial service, which is a clear deviation from the OECD Guidelines and the UNGPs. The position of the Parliament, however, prescribes a prioritized risk assessment before follow-up financing is renewed and on an ad hoc basis when information is received through the complaint procedure as established in Article 9. None of the drafts provide for periodic risk assessment.

**Trilogue: Adopt the strongest proposal**
Since 8 June 2023, the EU Commission, the EU Council and the EU Parliament have been negotiating their positions in a trilogue towards reconciling a final text. At this stage of the negotiations, it seems unlikely that the final text of the directive will go beyond the current proposals and become even more closely aligned with the UNGPs and the OECD Guidelines. We call on the negotiating stakeholders to retain the proposals on the financial sector that are the most closely aligned with the UNGPs and OECD Guidelines. They include the following (outlined in red in the table):

1. **Mandatory inclusion of the financial sector**
The goal of the EU CSDDD is to create harmonized rules for all companies operating in EU member states. However, the EU Council's approach undermines this objective by allowing member states to exempt financial companies from due diligence requirements in regard to business partners receiving their financial services. If member states decide to exclude these companies, serious human rights abuses would continue to be enabled by EU financial companies. Moreover, there is a risk that this would create legal fragmentation of national obligations for the financial sector. This would squander the opportunity to use regulation to strengthen Europe as a sustainable finance location and create legal uncertainty about upcoming obligations. To prevent this, we strongly advocate for the mandatory inclusion of the financial sector within the scope of the CSDDD.

2. **Differentiated due diligence obligations and changeable degrees of involvement**
The position of the EU parliament on differentiated due diligence obligations according to the degree of involvement in negative impacts should be retained. It recognises the unique nature of financial companies’ business activities by requiring companies that are directly linked to adverse impacts to use or increase their leverage with responsible business partners to prevent or mitigate those adverse impacts. However, in line with the UNGPs and the OECD Guidelines, changeable degrees of involvement should also be taken into account. It recognizes that a direct linkage could shift to a contribution to a negative impact. However, according to the EU Parliament's position, financial companies are defined as having only a direct linkage to adverse impacts. This approach overlooks that a financial company, e.g. if it fails to use its leverage to prevent or mitigate the adverse impact, could eventually be seen as being in a situation of contribution. This passus should therefore not be retained.

3. **Due diligence obligations for investors**
The Council proposes to exclude investment funds from the scope of the CSDDD and thereby fails to recognize the impact of these financial products. At the end of 2022, these funds had a
net asset value of 19.1 trillion euros\(^{31}\) in Europe, more than two-thirds of total European financial assets.\(^{32}\) Fund investments consistently flow into projects related to human rights abuses. For example, according to FIAN’s research, institutional investors and European fund managers have invested nearly two hundred million euros in the Cambodian microfinance sector through investment funds, thereby contributing to over-indebtedness, food shortages, and land loss for disadvantaged populations.\(^{33}\) A recent ShareAction’s survey of the 77 largest asset managers finds that few asset managers in fact exclude investments in companies that violate human rights.\(^{34}\) Greenwashing on a big scale in supposedly sustainable investment funds\(^{35}\) shows that the EU Sustainable Finance Regulation (SFDR) is not sufficient in this regard.\(^{36}\) Including investment funds in the scope of the CSDDD and defining specific due diligence obligations as set out in the EU Parliament position (Art. 8a), would require institutional investors and asset managers to induce their investee companies to at least end and minimize actual negative impacts. Providing for an analogous Article 7a would be desirable, defining investor obligations to prevent and mitigate potential negative impacts, as is the case for all other companies. The risk-based approach proposed by the Parliament makes it possible for investors to prioritize and address the severest and most likely adverse impacts first, thus rendering the due diligence obligations feasible in terms of implementation.

4. **Harmonization of the scope criteria with the Corporate Sustainability Reporting Directive (CSRD)**

Going beyond the current proposals, it would be useful for the thresholds put forth in the Parliament’s position regarding company size and turnover to be brought into full alignment with the criteria for the scope of the CSRD. The objective of the CSRD is similar to that of the CSDDD but focuses on reporting requirements.\(^{37}\) Further harmonization would make it possible to ensure that investors who move enormous sums of money, but often have only a few employees, would be covered by the two criteria of turnover >40 million euros and total assets >20 million euros.

5. **Inclusion of pension institutions that are considered social security schemes**

In line with the Commission’s proposal, pension institutions operating pension schemes which are considered to be social security schemes must also fall within the scope of the CSDDD, as do all proposals for occupational pension institutions. As institutional investors of statutory pension contributions, they move enormous sums of money sometimes with significant adverse impacts. As shown by FIAN’s casework, the second Swedish buffer fund Andra AP-fonden (AP2) was involved in human rights violations in Brazil by way of their investments of more than one billion euros in the U.S-based farmland funds TCGA I and II. These funds were used to acquire huge tracks of land, some of them illegally, in the Brazilian ecoregion Cerrado. These land acquisitions contributed to causing land grabbing, deforestation, pollution of water and arable land, and food insecurity, among other adverse impacts.\(^{38}\) By including pension institutions operating pension schemes considered to be social security schemes into the scope of CSDDD, AP2 would be required to assess and mitigate the negative impacts, thereby more effectively preventing illegal land acquisitions and further human rights abuses.

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\(^{33}\) [https://www.fian.de/wp-content/uploads/2022/02/FIAN-Ueberschuldungsstudie-Studie-17.02.pdf](https://www.fian.de/wp-content/uploads/2022/02/FIAN-Ueberschuldungsstudie-Studie-17.02.pdf)


\(^{36}\) For a comparison of sustainable finance regulation with, among others, CSDDD, see the joint briefing paper by Germanwatch and climate & company. URL: [https://www.germanwatch.org/en/87749](https://www.germanwatch.org/en/87749)

\(^{37}\) The CSRD applies to companies that meet two of the following three criteria: Employees >250, Sales >40 million euros, Balance sheet total >20 million euros. Cf. Art. 3 (4) in Directive 2013/34/EU, amended by Directive 2022/2464/EU.

6. Ongoing risk assessment
According to the UNGPs and the OECD Guidelines, risks for potential or actual negative impacts should be assessed on an ongoing basis, which is also a requirement according to the Sustainable Finance Disclosure Regulation (SFRD) and the CSRD. Both the Commission’s proposal and the Council’s approach, which only require risk assessment for financial companies prior to the provision of a financial service, fall short of providing for this requirement. However, human rights and environmental risks are not static and can change due to a multitude of foreseen and unforeseen circumstances. For example, some land acquisitions by TCGA I and II were declared illegal by Brazilian authorities years later. Therefore, the EU Parliament’s position on risk assessment should be integrated into the final text of the forthcoming CSDDD. Conducting risk assessments before financing is extended or on an ad hoc basis, e.g., in response to complaints received from affected parties, could facilitate identifying and addressing negative impacts that occur at a later stage.

7. (Not) an utopian demand: Due diligence obligations for the entire value chain
All three positions deviate significantly from the UNGPs and OECD Guidelines with a financial sector-specific value chain definition limited to direct large clients. As the example of AP investments in U.S.-based farmland funds shows, financial value chains are often nested. It is not always the direct business partner of a financial company, in this case the manager of the farmland funds, that directly causes or contributes to the negative human rights and environmental impacts. Rather, it is the companies that purchase land on behalf of the funds and farms that manage the land they receive for use through leases. In her report for the EU Parliamentary Legal Affairs Committee, rapporteur Lara Wolters deleted the financial sector-related exemption and proposed a comprehensive value chain definition that would cover the activities of all entities in the entire value chain, in line with the definition of the UN OHCHR Interpretative Guide (see above). Such a value chain definition would put the onus on the Swedish AP2 to exert its influence also over its indirect business partners to terminate and minimize the negative impacts, or, if that is not possible, to withdraw the investment. It is highly desirable that such a value chain definition will be integrated into the final text of the forthcoming CSDDD.

39 Cf. amendment 74 in the report of the EU Parliamentary Committee on Legal Affairs of 07.11.2022.
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