POSITION PAPER

ESBG Position Paper on the Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937

ESBG (European Savings and Retail Banking Group)

Rue Marie-Thérèse, 11 - B-1000 Brussels

ESBG Transparency Register ID 8765978796-80

ESBG

General comments

We believe that the Corporate Sustainability Due Diligence Directive (CSDDD) is far too ambitious with regards to the role that financial entities would play and the fact that the current environment is not adequate for driving an initiative that would hamper economic and financial recovery, as it would imply huge implementation and monitoring costs, together with uncertain legal consequences. Therefore, we request further clarification on the role that financial entities would play on these matters.

Additionally, we would like to propose some adjustments that would be necessary for making this regulatory initiative feasible.

Our common goal is to tackle environmental issues and human rights abuses. Therefore, it is essential to harness the strengths of the private sector. This requires creating a workable regulation and avoiding measures that restrict competition and innovation.

The responsibility for compliance with environmental standards, social standards as well as human rights is an essential task for Member States. In addition to the central responsibility of Member States, companies can provide support within their own sphere of influence. However, Member States must create legal certainty and appropriate framework conditions for companies. **Any regulation must therefore be proportionate and feasible.**

We are committed to sustainable, responsible and future-oriented business and, in this sense, we recognise the European Commission's goal of creating a coherent legal framework.

Yet, we advocate for a practical and realistic approach with a sense of proportion:
- No excessive administrative burdens.
- No measures that restrict competition and innovation.
- Restriction to the area of direct effects.
- No unforeseeable liability risks.
- Coordination of the various initiatives.

Scope of application

As is already anticipated, the scope of the EU proposal is broader than existing regulations, such as the German Supply Chain Act, which is already relevant for the industry.

We assume that the purpose of excluding SMEs from the value chain of regulated financial undertakings is a general exclusion. However, the same wording is not used for what is in the scope of a regulated financial undertaking's value chain (loans, credits, and other financial services) and the services excluded for SMEs (SMEs receiving loan, credit, financing, insurance or reinsurance). It needs to be ensured that the same wording is used in the Directive. While the general exemption for SMEs is a step in the right direction, all SMEs will be severely affected by the trickle-down effect, as many of them are in the supply chain of large companies. SMEs need to be effectively supported, whether or not they fall within the scope of a binding framework.

Whether the envisaged accompanying measures can actually provide a remedy here must be questioned. A concretisation of these measures is desirable.

The application of the EU framework to companies from third countries operating in the EU is welcomed in principle, in the sense of maintaining a level playing field. It should be noted that this is only a minimum harmonisation. For example, further-reaching national legislation can be enacted, which can lead to a fragmentation of the legal situation and unequal conditions of competition. It should not leave room for national legislation that goes beyond the EU framework.

Following existing national regulations, such as the German and French supply chain laws, which define a scope of application of more than 1000 employees, we want to stress that the future Directive must not apply to companies with less than 1000 employees.

<u>Proportionate Due Diligence</u>

There is no limitation of due diligence to the companies' own operations. This goes far beyond the direct sphere of influence of the companies.

The design as an "obligation of means", for example as process requirements rather than performance requirements, is in principle a sensible approach, but the complexity of companies' supply chains must be taken into account.

Mandatory due diligence can realistically only be carried out in the area of direct impacts, for example in companies' own operations.

The same also goes for the inclusion of the client's subsidiaries. They should solely be included in the value chain in the case that the subsidiaries are receiving the financial services directly, meaning that they are also expressly mentioned in the contract.

Lastly, for regulated financial services, the mandatory due diligence provisions should be limited to clients that are not regulated financial services themselves. The wide range, large number and complexity of business relationships within the financial sector would make it disproportionately burdensome to apply the Directive, for example, in the interbank market and in securities clearing and settlement. The value added would also be limited, as regulated financial undertakings are, by definition, already subject to harmonized regulation and supervision, including those for ESG risks.

<u>Avoidance of (unforeseeable) liability risks</u>

Duties of care can and should be discussed independently of damages. The existing liability regimes of the Member States already provide sufficient and appropriate rules for the civil liability of companies.

It is important to develop the legal concept of "safe harbour": Businesses should not be held liable for damage in their supply chain if they did not directly cause it. The right to the presumption of innocence is one of the fundamental human rights upon which the European Union is based, and it should be kept a priority over any other objective. Legal requirements should not inadvertently lead to situations where companies are held liable because they have taken reasonable due diligence measures.

The provisions for enforcing claims must be consistent with the international legal framework.

Creating legal certainty and a level playing field for all companies

Europe has long been a leader in responsible business. Mandatory due diligence requirements must be harmonised with international frameworks (example given: OECD Guidelines, UN Guiding Principles on Business and Human Rights). This also applies to numerous industry initiatives that have proven effective in practice. Instruments such as standard codes of conduct or contractual model clauses should be carefully examined with regard to legal certainty. Businesses must be able to rely on the legal sufficiency of compliance with certain instruments under this Directive.

Coherence at EU level

There is also a risk of over- and double-regulation. The EU is currently working on several parallel projects related to sustainable corporate governance (example given: Sustainable Finance, Taxonomy, Corporate Sustainability Reporting Directive, Deforestation Directive and Conflict Minerals Regulation). All these projects need to be coordinated and aligned in terms of content and timing in order to avoid duplication.

Specific comments

Recital 10 (page 30)

Recital 10 (page 30) indicates that the CSDDD should be coherent and consistent with the Capital Requirements Directive (CRD). We believe that an inclusion of an Article that further elaborates on this consistency would be positive. It would also be positive to get clarification on what responsibility the parent company of a consolidated situation has in relation to this Directive. If a subsidiary breaches the requirements in this Directive, should it be the turnover of the subsidiary or the parent company that is used for the calculation of the fine? Always using the turnover of the parent company creates an unproportionate burden for parent companies, especially those for large groups.

Recital 19

There is also a need for a clear delineation of scope between the Sustainable Finance Disclosure Regulation (SFDR) and CSDDD requirements for identifying and preventing or reducing adverse impacts. Actions in terms of principal adverse impacts of investment decisions in investee companies should be governed exclusively by SFDR, whereas the CSDDD framework should pertain to business relationships in a company's operations. Investment activities on behalf of the clients like portfolio management would fall under SFDR. Such delineation would cause no compromise for the level of protection given the comparable scope of application for financial market participants under both frameworks (application to large financial undertakings with more than 500 employees and focus on direct clients/investee company in question). We request supplementing recital (19) of the draft Directive on application to regulated financial undertakings by a sentence clarifying that adverse impacts arising from investment decisions in investee companies are to be dealt with under SFDR rules and consequently, are not subject to CSDDD requirements.

Context of the proposal

Within the context of the proposal, the CSDDD acknowledges the achievements of large companies in the field of sustainability when it states that "*Mostly large companies have been increasingly deploying due diligence processes as it can provide them with a competitive advantage. This also responds to the increasing market pressure on companies to act sustainably as it helps them avoid unwanted reputational risks vis-à-vis consumers and investors.*"

However, the aforementioned argument is followed by a non sequitur: "*these processes are based on voluntary standards and do not result in legal certainty for neither companies nor victims in case harm occurs … Certain EU companies have been associated with adverse human rights and environmental impacts, including in their value chains*."

It is broadly known that financial entities mainly base their businesses on their reputation, which would be undoubtedly harmed by any adverse impacts on human rights or on environmental issues that could be caused by their activities. Moreover, many financial entities are listed companies and, consequently, they are already subject to above-average supervisory requirements in terms of governance. Furthermore, many listed financial entities have recently and voluntarily adhered to best practice governance initiatives designed and/or supported by public authorities, such as the Spanish "Código de buen gobierno de las sociedades cotizadas". Finally, the financial sector is one of the most regulated industries. Therefore, we propose that no new legal obligations arise on the topics covered by the CSDDD, but instead that its concerns are dealt with by an **EU voluntary common framework of best practices in corporate sustainability due diligence**, which would foster competition among EU players in order to implement the highest possible standards on this area.

Legal basis section of the CSDDD

In the legal basis, it is claimed that this proposal regulates not only sustainability due diligence obligations of companies, but also **corporate directors' duties**. Under a non-mandatory approach to this topic, we see no reason to establish new obligations for corporate directors and/or management bodies, as **they already**

take into account long-term sustainability goals in their decisions. Moreover, corporate directors **cannot be held accountable for concepts** of an undetermined nature that are **not completely under their control**.

Context section of the CSDDD

Although the context section of the CSDDD states that "*Union legislation on corporate due diligence would advance respect for human rights and environmental protection, create a **level playing field** for companies within the Union and avoid fragmentation resulting from Member States acting on their own*"; **Article 20** sets out that "***Member States shall lay down the rules on sanctions** applicable to infringements of national provisions adopted pursuant to this Directive.*" And **Article 22** sets out the requirement for **Member States** to **lay down rules governing the civil liability of the company** for damages arising due to its failure to comply with the due diligence obligations under specific conditions.

To start with, an enforcement through **a combination of sanctions and civil liability would significantly increase the financial entities' costs**, as it would be necessary to implement a Know Your Customer procedure on sustainability, analogous to the one which is already in place for Anti-Money Laundering and Counter Terrorism Financing.

Moreover, if **Member States** would lay down the **rules on sanctions and civil liability**, that would be **opposed to the level-playing field** goal and **legal arbitrage** could be pursued by companies that are not aligned with the EU sustainability goals, looking for weaker national legislations.

Limitation of due diligence

Concerning the established business relationship defined in Article 3 (f), further clarification is required as to which aspects are to be taken into account for determining the intensity and duration of the established business relationship. An "established" relationship is one that does not represent a negligible or merely ancillary part of the value chain. In addition, with reference to the above-mentioned Article, it is unclear which requirements must be met in order to determine whether a business relationship is "negligible or merely ancillary". Concrete criteria are needed here.

Concerning the implementation of the due diligence requirements for activities in the credit institutions own business operations and those of its suppliers, we call for a restriction to those activities that are directly related to the provision or use of the financial service. We differentiate here between so-called "specific" and "non-specific" activities. Specific activities are all activities that have a specific connection to the provision of services by the banks. Only then do the due diligence obligations extend to these activities. These are, for example, bank IT, outsourcing partners or sales partners. Non-specific activities are not covered, without which the provision of services would still be possible. These are, for example, facility management, security services or office equipment suppliers.

Article 3. Definitions.

Article 3 (g) – value chain:
ESBG supports the Commission's general approach of limiting the obligations of financial undertakings with regard to the provision of their services to their direct clients.

However, according to the definition set out in Article 3 (g), the "value chain" with regard to the provision of financial services includes not only the activities of the direct client, but also those of the other companies belonging to the same group whose activities are linked to the contract in question. This could result in a duty to verify beyond the direct client. Since direct information and conduct obligations can only be agreed upon with the client in the direct contractual relationship, it is either very difficult or impossible to agree on an additional information and conduct obligation (at the expense of third parties). The information and conduct obligations should be limited to the direct client.

With regard to Article 3 (g), there is also a need for a clear definition of what exactly is meant by the terms "loan" and "credit", as these are not used synonymously in the wording of the Directive.

Furthermore, we advocate clarifying the term "other financial services" in the wording of the Directive. According to a concrete interpretation, it would be feared that the entire banking product portfolio of a credit institution could fall within the scope of a future law. The scope of the business relationships to be included in the risk analysis would thus be very high. In view of the relevance of bank loans and their function in the value chain, we suggest limiting the due diligence requirements to certain services such as lending and credit-related products.

The proposed Directive indicates that the definition of supply chain for banks excludes SMEs as well as households and individuals respectively, so we believe that the assessment of risks for these customer groups would not be necessary. However, the exclusion of households and natural persons from the supply chain of banks is only mentioned in recital 19 and not in the definition of the term (Art. 3 (g)). Here, a clarification is needed in the wording of the Directive that households and natural persons as well as SMEs are excluded from the supply chain of banks.

Therefore, we would suggest the following amendment to Article 3(g):
'*Article 3*

Definitions

For the purpose of this Directive, the following definitions shall apply:

…

(g)… As regards companies within the meaning of point (a)(iv), 'value chain' with respect to the provision of these specific services shall only include the activities of the clients receiving such loan, credit, insurance or reinsurance. The value chain of such regulated financial undertakings does not cover SMEs, households and natural persons receiving loan, credit, insurance or reinsurance of such entities.

With regard to financial services to companies that are not SMEs, it should be possible to define appropriate thresholds by financial services companies.

Article 3 (h) - Independent third-party verification:
Article 3 (h) defines the term "independent third-party verification." Independent third-party verification - as well as the use of appropriate industry initiatives - may be an appropriate measure to verify compliance with contractual agreements to avoid or remedy adverse impacts. We welcome the fact that the draft Directive does not provide for more extensive audit requirements of external third parties for compliance with due diligence obligations.

Article 3 (o) - director:
It is unclear what is meant by "director", especially considering the different corporate governance structures in different countries. It is crucial that this definition is clarified to ensure harmonized allocation of roles and responsibilities. As Article 26 requires directors to report to the board of directors, it creates even more confusion on who is to report to who.

Article 4 (1) a). Due Diligence.

We propose the following wording: "~~Integrating due diligence into their policies~~ **Adopting a due diligence policy** in accordance with Article 5".

Article 5 (1). Integrating due diligence into companies' policies.

We suggest renaming the following: "~~Integrating due diligence into companies' policies~~ **Companies' due diligence policy**. 1. MS shall ensure that companies ~~integrate due diligence into all their corporate policies and~~ have a due diligence policy".

Article 6. Identifying actual and potential adverse impacts.

Article 6 (3). Identifying adverse impacts by credit institutions

Article 6(3) of the draft EU Directive states that financial institutions are subject to obligations **only before providing** the financial service. In principle, this is to be welcomed, as checks after disbursement of credits or loans are usually not enforceable. However, in the event of a breach of certain provisions by the customer, Articles 7 (5) and (6) or 8 (7) specify business interruptions with the customer (unless there are significant reasons not to do so), which would imply checks over the entire term of the contract. It should be clearly stated here that a one-time check before granting credit is sufficient. In addition, the question arises as to what impact these regulations have with regard to liability issues and any penalties (see Articles 20 and 22).

It should also be noted that a re-identification of actual or potential adverse effects with respect to a customer in the event of a rollover, novation or similar action is not required, provided that existing contractual relationships are continued.

In addition, an explicit grandfathering provision should be introduced so that only new exposures of credit institutions are subject to the review obligations.

Article 6 (4). Appropriate resources

Companies should be entitled to use appropriate resources to identify actual and potential adverse impacts, including independent reports and information gathered through the complaints procedure. There is a need to further define "adequate resources" here. Are these provided by the EU or the Member States?
We propose that the following sentence is removed from the Directive "Companies shall, where relevant, also carry out consultations with potentially affected groups including workers and other relevant stakeholders to gather information on actual or potential adverse impacts." This requirement is too far-reaching, while also creates unpredictability. There are unclarities about how far a company is required to perform its due diligence and also whether it is even possible for a company to perform such due diligence (e.g., due to confidentiality agreements for employees).

Furthermore, reading Article 6 together with Article 20 on sanctions, it creates the possibility for companies to end up being punished for a lack of identifying "potential" human rights or environmental adverse impacts (hence punished for a potential violation that has never occurred). The word "potential" should be deleted from the proposal, since it creates disproportionate legal uncertainty.

Articles 7 and 8. Dealing with potential adverse impacts.

We welcome Article 7 (at least the exemption part for financial services contracts).

Article 7(6): By way of derogation from paragraph 5, point (b), when companies referred to in Article 3, point (a)(iv), provide credit, loan or other financial services, they **shall not be required to terminate the credit, loan or other financial service contract** when this can be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided.

However, with regard to this Articles 7(6) and also 8(7) of the proposed Directive, we see the need for a clear definition of what ***reasonable expectation to cause substantial prejudice*** (*"…. when this can be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided."*) means.

The Commission states that the aim of introducing this law is not to terminate the business relationship in the event of non-compliance with standards along the supply chain, but rather to support the company in implementing environmental and human rights standards. Articles 7 and 8 of the draft Directive refer to this in particular.

Accordingly, companies are required to insist on compliance with the "Codes of Conduct" to be drawn up by each company by means of corresponding contractual obligations. Banks have numerous different customers who also fall under the scope of the Directive and accordingly have their own "Codes of Conduct" contractually assured. This means a comprehensive control of all "Codes of Conduct" of the companies with which a corresponding established business relationship exists. A uniform standard (e.g. RTS) for the preparation of a Code of Conduct, which must be specified by the EU Commission, is absolutely necessary here.

The requirement to seek contractual assurance from a direct partner that it will ensure compliance with the code of conduct, is unclear and possibly also not even feasible (Article 7(2)(b) and Article 8(3)(c)). If the requirement refers to the direct partner needing to comply with the other company's code of conduct, this will entail that a company needs to comply with several different codes of conduct and also keep track of any changes to the counterparties' code of conduct. This is not feasible, and also creates a high legal risk for the company. It should be sufficient that the company contractually requires that the direct partner has its own code of conduct and that it is held to the same standard as the company's own code of conduct.

If the measures listed in Articles 7 and 8 to avoid and end the adverse effects are not successful, the business relationship must be terminated. However, it is not sufficiently clear from the wording whether a business relationship is to be terminated in its entirety or whether the termination relates to the business relationship that gives rise to adverse effects. We demand clarification here that the necessary termination of a business relationship refers to the activity through which the adverse effects result.

Article 7(3) and Article 8(4) respectively refer to the possibility of entering into a contract with an indirect business partner in order to achieve compliance with a code of conduct or a prevention plan. It is unclear to what extent concluding a contract with indirect service providers is presentable and reasonable.

Article 7 and 8. Dealing with adverse impacts – support for SME.

Articles 7(2)(d) and 8(3)(e) respectively provide for targeted and proportionate support measures for SMEs in the context of established business relationships. It is unclear whether support measures are also to be taken for corresponding customers of financial services companies.

Article 9. Complaints procedure.

This Article sets out the obligation for Member States to ensure that companies provide for the **possibility to submit complaints to the company** in case of legitimate concerns regarding those potential or actual adverse impacts, including in the company's value chain.

In our opinion and at least for financial entities, there is no need to regulate a specific complaint mechanism on topics related to the CSDDD, as our customers already have several channels to contact us available. We additionally do not see any grounds to widen the potentially interested parties, as there would probably be an unbalance between the implementation and administrative costs of the new complaint mechanism on one side and the potential benefits of their legitimacy on the other.

Article 10. Monitoring.

We ask for more clarification on how the periodic assessments have to be carried out and what exactly has to be part of them. We want to underline that the monitoring obligation laid down in Article 10 should not lead to a circumvention of the exemption for companies referred to in Article 3, point (a)(iv) stated in Article 6(3). Regulated financial undertakings providing loan, credit or other financial services shall carry out identification of actual and potential adverse human rights impacts and adverse environmental impacts only before providing that service.

Article 12. Model contractual clauses.

This Article states that in order to provide support to companies to facilitate their compliance with the CSDDD, the Commission shall adopt guidance about voluntary **model contract clauses**.

We believe that this would be a good initiative and that it would be fully compatible with our proposed best practices approach. Nevertheless, it would be essential that:

- The model contract clauses are provided as part of the proposal/voluntary code instead of being developed at a subsequent stage, as any change in financial contracts is always costly to implement.
- Financial entities could be deemed to be compliant by using and/or adapting those contract clauses in their established business relationships.

Article 13. Guidelines.

The Commission may provide guidelines to support companies and member states in implementing their "due diligence" obligations. We consider it urgently necessary that the specifics of the banking industry are also taken into account in the development of corresponding guidelines, in particular the existing banking supervisory requirements regarding ESG risks and the fact that direct information and conduct obligations for banks can only be agreed upon in the direct contractual relationship with clients and, accordingly, the due diligence obligations are only to be applied to the direct client. In addition, the guidelines should be issued as soon as possible and before the Directive enters into force.

Article 14. Accompanying measures.

With regard to the envisaged "accompanying measures", the explanations remain vague as to exactly which information and support services are to be provided on the websites, platforms and portals that the Member States maintain pursuant to Article 14 (1). We believe that further specification of the information to be published is desirable.

Article 15 (3). Combating climate change.

We suggest eliminating this Article as we understand it as being redundant with respect to the already existing link between directors' variable remuneration and the companies' long-term interests and sustainability.

For instance, Article 33 of the Spanish Law 10/2014 on the regulation, supervision and solvency of credit institutions states that:
Article 33. General remuneration policy principles.
1. Remuneration policy for the staff categories referred to in Article 32(1) shall be determined in keeping with the following general principles:
...
b) It shall be consistent with the corporate strategy, objectives, values and long-term interests of the institution and shall include measures to avoid conflicts of interests.
...
e) A clear distinction shall be drawn between the criteria for setting:
...
2.- variable remuneration, which should reflect not only a sustainable and risk-adjusted performance but also a performance in excess of that required to meet the job description as part of the terms of employment

Article 17 (5). Supervisory Authorities

In order to harmonize the regulation on supervisory authorities, we suggest the following wording: "MS ~~may~~ **shall** designate the authorities for the supervision of regulated financial undertakings also as supervisory authorities for the purposes of this Directive."

Article 19. Substantiated concerns

This Article establishes the requirement for **Member States** to ensure that **any natural or legal person that has reasons to believe**, on the basis of objective circumstances, **that a company does not appropriately comply with the provisions of the CSDDD, is entitled to submit substantiated concerns to the supervisory authorities**.

From our point of view, this would be a disproportionate provision, as any person with a conflict of interest against the financial entity would be entitled to submit concerns, causing an unjustified increase in the administrative burden both for supervisory authorities and for financial entities. Consequently, we propose that this this provision is eliminated alongside all related references.

Article 20 (3). Sanctions
The Directive does not define the limits related to the companies' turnover in relation to pecuniary sanctions on an EU-level. This creates a risk that different limits are set in different countries, which would go against the purpose of this Directive as it would not create harmonization within EU.

As this Directive provides both for sanctions and civil liability, it needs to be ensured that a company is not penalized twice for the same action. Consequently, we propose to eliminate Articles 20 and 22.

Article 26 (1). Setting up and overseeing due diligence

We suggest the following wording: "MS shall ensure that directors of companies (...) are responsible for putting in place and overseeing the due diligence actions referred to in Article 4 and in particular the due diligence policy referred to in Article 5, with due consideration **where relevant** for relevant input from stakeholders and civil society organizations. ~~The directors shall report to the board of directors in that respect.~~"

Article 30. Transposition

This Article provides **different implementation periods** for large companies on one side and those with lower turnover and employees that are active in high impact sectors.

We suggest a simultaneous adoption by both segments, as financial entities would need to collect data from high impact customers.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 17 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 900 banks, which together employ 650,000 people driven to innovate at 50,000 outlets. ESBG members have total assets of € 5.7 trillion, provide € 1 trillion in corporate loans, including to SMEs, and serve 163 million Europeans seeking retail banking services. ESBG members commit to further unleash the promise of sustainable, responsible 21st century banking.

Our transparency ID is 8765978796-80.

European Savings and Retail Banking Group – aisbl
Rue Marie-Thérèse, 11 ▪ B-1000 Brussels ▪ Tel: +32 2 211 11 11 ▪ Fax : +32 2 211 11 99
Info@wsbi-esbg.org ▪ www.wsbi-esbg.org

Published by ESBG. May 2022.