# Due diligence: the risk-based approach and the financial sector

The recent adoption of the Corporate Sustainability Due Diligence Directive will lead to the adoption by large companies of a due diligence system. The basis for its design is an analysis of the risks that business activities may have a negative impact on the environment and human rights. The financial sector has been taking these issues into account for years.

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Over two years ago the Commission submitted to the European Parliament and the Council the proposal for a Directive on corporate sustainability due diligence (also known as CS3D). On 24 May, the final text was adopted, which is a departure from the Commission's original proposal.

The directive is consistent with all the action plans that the Commission has been approving in recent years to protect the environment and human rights. In this vein, it imposes on large companies a series of due diligence obligations to avoid adverse effects or impacts on the environment and human rights resulting from the activity of the company itself, that of its subsidiaries, and that of the companies that form part of its chain of activities. The activity chain includes the activities of upstream companies, i.e. those involved in the process prior to production of the good or provision of the service (the design of the good or service, procurement, supply, manufacture, transport and storage of raw materials), as well as the activities of downstream companies, which refer to the distribution, transport and storage of the product (services are excluded).

The differences between the initial text and the one finally adopted have been extensively discussed. We dwell here on two issues that have perhaps been less discussed so far: *a*) the *risk-based approach* and *b*) how the Directive will affect the financial sector.

*a*) The approved text incorporates a due diligence obligation based on a risk-based approach. This involves identifying which activities of the company and its chain of activities may entail higher risks of negative impact on the environment and human rights. The risks thus identified help the company to design more effective policies and corresponding measures to prevent, mitigate and eliminate negative impacts. If, for example, a company uses in its production process mostly raw materials whose extraction damages the environment, this is a risk factor to consider when designing policies and measures to protect the environment.

**Due diligence is integrated into risk management systems**

Companies must therefore integrate due diligence not only in their policies but also in their risk management systems. This approach is a relevant shift that prioritises combating the most risky adverse impacts. Furthermore, the fact that companies carry out ongoing risk analysis means that the ultimate objectives of CS3D are much more deeply embedded in their organisation and culture.

*b*) The *financial sector* - generally banks, insurers, asset managers and financial advisors - will also have to apply the Directive (provided they exceed the stated asset and turnover thresholds). However, when designing their due diligence, they should consider their activity, that of their subsidiaries and that of upstream companies, but not that of downstream (distribution, storage and transport) companies. For practical purposes, this means that the financial sector will not take into account its clients' activities.

This change in the approved text has not been without criticism, but it is consistent with the role that financial institutions have played since 2018 in terms of sustainability (transparency obligations), as well as with the abovementioned risk-based approach.

Since the European Commission published the Action Plan for a green and cleaner economy in March 2018, outlining the strategy for the financial system to support the EU agenda, a set of rules has been adopted to help the financial sector channel savings into investments and activities that take into account environmental, social and governance factors. The aim of this legal framework has been to create a coherent flow of sustainability information along the entire financial value chain.

One of the most important of these rules is Directive 2022/2464 as regards corporate sustainability reporting (better known by its acronym CSRD). This directive will be applied by, among other undertakings, banks and insurance companies that are considered large according to the thresholds set out in the CSRD itself (which are, incidentally, much lower than the thresholds set out in CS3D). Banks and insurers have been preparing their annual non-financial reporting statement since 2017 and already report on the due diligence procedures they have adopted in relation to environmental and human rights issues. From this year onwards, the CSRD strengthens the due diligence obligations. In this respect, the European Sustainability Reporting Standards (ESRS), which regulate how the new sustainability report is to be prepared, define in detail concepts such as due diligence or the value chain.

The CSRD is not the only piece of legislation that has imposed environmental and human rights obligations on the financial sector. Other regulations such as Regulation 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR) have also done so.

For its part, the risk-based approach is inherent to the financial sector. Risk management systems are mandatory, and the various European pieces of legislation that regulate the activity of financial institutions have also obliged them in recent years to integrate sustainability risk into their risk management systems.

The fact that the financial sector is already informed about the environment and human rights, and that these issues have been integrated into its risk management system, together with the need for standards to be established and not to introduce overlaps, is consistent with the approach that the CS3D has given to the financial sector, without forgetting that the Directive itself provides for a review within two years.