BANCA D'ITALIA
EUROSISTEMA

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by Audinga Baltrunaite, Romualdo Canini, Francesca Chiarelli, Enrica Consigliere, Piera Coppotelli, Federico Fornasari, Tommaso Loizzo, Sauro Mocetti, Chiara Muraca, Raffaele Parrella, Federico Schimperna and Enrico Sette

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THE CORPORATE SUSTAINABILITY DUE DILIGENCE DIRECTIVE (CSDDD): AN ANALYSIS OF THE POTENTIAL ECONOMIC AND LEGAL IMPACTS

by Audinga Baltrunaite*, Romualdo Canini*, Francesca Chiarelli*, Enrica Consigliere*, Piera Coppotelli*, Federico Fornasari*, Tommaso Loizzo*, Sauro Mocetti*, Chiara Muraca*, Raffaele Parrella*, Federico Schimperna* and Enrico Sette*

Abstract

On 24 April 2024, following lengthy political and technical negotiations, the European Parliament adopted the Corporate Sustainability Due Diligence Directive (CSDDD), which requires the largest European financial and non-financial companies to comply with due diligence obligations to ensure that their operations and those carried out along their chain of activities do not violate the human and environmental rights enshrined in international treaties. This paper makes several contributions. First, it provides an in-depth analysis of the obligations of companies subject to the CSDDD and of private and public enforcement mechanisms. Second, it provides an estimate of the number and the economic importance of Italian firms subject to the Directive, as well as a study of its scope of application, should it be extended to financial services. Finally, it presents a preliminary assessment of the effectiveness of the Directive in preventing violations of human and environmental rights treaties and its overall economic effects, although its actual impact will depend on how it will be made operational by EU Commission and national authorities.

JEL Classification: G21, G23, K20, M10.

Keywords: CSDDD, due diligence, sustainability, transition, banks, companies.

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* Bank of Italy.

Executive summary

On 24 April 2024, following lengthy negotiations, the European Parliament adopted the final text of the Corporate Sustainability Due Diligence Directive (CSDDD), which was published in the Official Journal of the EU in July 2024. The CSDDD is very innovative and potentially very relevant for companies, which will be required to take concrete steps to prevent, mitigate or minimize the impacts on human rights and the environment that may arise from their operations and chains of activities.

This paper provides comprehensive information on the main obligations introduced by the Directive, an evaluation of its scope for financial and non-financial companies, and a general assessment of the potential impact of the framework. The paper aims to raise awareness among external stakeholders of the importance of the new discipline and the need to prepare in good time for its full implementation.

Below is a summary of the main findings:

a) Main obligations of the CSDDD

Companies falling within the scope of the CSDDD will have to:

- integrate due diligence on human rights and potential environmental harm into their internal processes and policies in order to identify, prevent, minimize and, if necessary, stop and neutralize any negative impacts on human rights and the environment resulting from their own operations and chains of activities;
- require their business partners to contractually ensure compliance with the companies' own codes of conduct and, if necessary, suspend or, in the most serious cases, terminate business relations with business partners that are unable to prevent a potential negative impact on the environment and on human rights;
- adopt a plan to ensure that their business models and strategies are compatible with the transition to a sustainable economy and with keeping global warming below the 1.5ºC threshold, in line with the Paris Agreement.

Failure to comply with the obligations of the CSDDD will expose companies – including banks and financial intermediaries – to liability for any damage caused.

The text of the CSDDD improves access to justice by expanding the legal standing of trade unions and civil society organizations and establishes a minimum period of five years within which injured parties can bring a civil liability action. It also requires Member States to designate one or more supervisory authorities to monitor compliance with the national legislation transposing the obligations it sets out.

b) ***Scope of application***

The CSDDD applies to companies that had more than 1,000 employees on average and a net worldwide turnover of more than €450,000,000 in the last two financial years, and to all other companies in their upstream and downstream chain of activities. The rules apply to both financial and non-financial corporations. Based on our estimate, the number of banks and other financial intermediaries directly covered by the CSDDD in Italy would include 12 significant institutions, 8 less significant institutions, and 2 non-bank intermediaries, while the number of non-financial corporations would be close to 650.

Contrary to what was set out in the texts circulated during the negotiations, the final version of the Directive does not include in the chain of activities of banks and other financial intermediaries the entities to which banking, financial and insurance services are provided. However, it has a review clause on financial services that requires the Commission to submit a report to the Parliament and the Council containing an impact analysis and a legislative proposal on the need to extend the due diligence

obligations of financial intermediaries to entities to which financial services are provided. The report is to be prepared no later than two years after the entry into force of the CSDDD.

In light of this review clause, an initial estimate was made of the breadth of the chain of activities for Italian banks and financial intermediaries. Specifically, if the chain of activities were extended to include large companies that obtained credit from them, significant Italian banks would have to consider an average of more than 3,700 borrowing counterparties for due diligence purposes, while less significant Italian banks would have to consider an average of about 800.

c) ***The potential impact of the Directive***

Unlike other EU legislations that aim to promote sustainability through disclosure, the CSDDD directly imposes conduct obligations on companies to ensure compliance with human and environmental rights enshrined in international conventions. However, the actual economic impact of the new piece of legislation and its effectiveness in preventing practices contrary to these conventions are not easy to assess *ex ante*, as they depend to a large extent on how due diligence will actually be carried out, the definition of the chain of activities, and the way in which supervisory authorities will operate.

Under the CSDDD, companies will have to bear the costs of carrying out due diligence and of setting up the organizational structure to perform this activity. These costs cannot be estimated on the basis of the data currently available.

Notwithstanding the costs of compliance, the CSDDD is likely to have positive economic effects by increasing the product, labour, and financial market attractiveness of compliant companies falling within its scope and by encouraging operational improvements. To this end, however, it is crucial that the due diligence obligations and the chains of activities are defined as accurately as possible by the European Commission’s guidelines in order to ensure a level playing field and avoid unintended effects such as strategic relocation of economic activities.

1. Introduction[1]

Sustainable development is a core principle of the Treaty on European Union and a priority objective of EU policies. The EU and its Member States have employed a variety of tools – such as economic incentives (including tax incentives) and direct and indirect market regulation – to ensure that private companies contribute effectively to the EU's sustainability agenda.

Achieving sustainability goals requires investment in technology upgrading, innovation in production processes, and appropriate management safeguards. Since the second half of the last decade, the European institutions have issued several pieces of legislation aimed at aligning the strategies of financial and non-financial companies with a sustainable development model. These include the Sustainable Finance Disclosure Regulation (SFDR), the Corporate Sustainability Reporting Directive (CSRD) – which replaced and extended the scope of the Non-Financial Reporting Directive (NFRD) – and the Taxonomy Regulation. These initiatives are mainly based on imposing disclosure requirements on the impact of companies' activities.

In addition to these disclosure requirements, in February 2022 the European Commission adopted a proposal for a Directive on corporate sustainability due diligence obligations (*Corporate Sustainability Due Diligence Directive* – hereafter CSDDD). The aim of this Directive is to incentivize responsible business conduct by requiring large EU companies and non-EU companies with significant operations in the EU to verify that their own operations, those of their subsidiaries, and those carried out along their chain of activities do not harm human rights or the environment.[2] The adoption of a binding sustainability due diligence framework has long been advocated by the EU Parliament, as well as by non-governmental organizations and academia,[3] with the ultimate aim of aligning the EU framework with international best practices on responsible business conduct, in particular the UN's Guiding Principles on Business and Human Rights, the OECD Due Diligence Guidance for Responsible Business Conduct and the OECD Guidelines for Multinational Enterprises.

In December 2023, the Council and the European Parliament reached political agreement on the most controversial aspects of the Directive during the trilogue.[4] However, the text resulting from this agreement was not approved by the Council. The European Parliament adopted an amended text of the Directive on 24 April 2024 and, as the last step in the legislative process, the Council formally adopted the Directive on 24 May 2024. The Directive was published in the Official Journal of the EU on 5 July 2024.

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[1] The authors would like to thank P. Angelini, A. Argentesi, F. Cannata, G. Cannistrà, A. Di Cesare, M. Francese, V. Lionetti, B. Mastroianni, V. Riccardi, L. Ridi, A. Schifino, E. Venturi. The views expressed are those of the authors and do not imply any responsibility on the part of Banca d'Italia.

[2] Article 1 of the CSDDD states: 'This Directive lays down rules on: (a) obligations for companies regarding actual and potential human rights adverse impacts and environmental adverse impacts, with respect to their own operations, the operations of their subsidiaries, and the operations carried out by their business partners in the chains of activities of those companies; (b) liability for violations of the obligations as referred to in point (a); and (c) the obligation for companies to adopt and put into effect a transition plan for climate change mitigation which aims to ensure, through best efforts, compatibility of the business model and of the strategy of the company with the transition to a sustainable economy and with the limiting of global warming to 1,5 °C in line with the Paris Agreement'.

[3] See A-C. Mittwoch, P. Welte, M. Birkholz, 'On the Necessary Adoption of the CSDDD by the EU Council', Oxford Business Law Blog, February 2024.

[4] See European Council, 'Corporate sustainability due diligence: Council and Parliament strike deal to protect environment and human rights', press release, 14 December 2023.

Member States will have 2 years from the Directive's entry into force to transpose it into national law, after which the CSDDD will be phased in as follows:

- from 2027, it will apply to companies with more than 5,000 employees on average and a net worldwide turnover of more than €1,500,000,000 in the two previous financial years;
- from 2028, it will apply to companies with more than 3,000 employees on average and a net worldwide turnover of more than €900,000,000 in the two previous financial years;
- from 2029, it will apply to companies with more than 1,000 employees on average and a net worldwide turnover of more than €450,000,000 in the two previous financial years.

Contrary to the Commission's initial proposal,[5] the final text of the CSDDD stipulates that the chain of activities of financial undertakings subject to the obligations of the Directive does not include the entities to which the financial services are provided. However, a review clause requires the European Commission to carry out an impact assessment within two years of the entry into force of the CSDDD and, if appropriate, to prepare a legislative proposal on the possible extension of the chain of activities of financial intermediaries so as to also include the entities to which they provide financial services.[6]

The purpose of this paper is to provide an overview of the new Directive and to raise awareness of its economic, legal and supervisory implications among all potential stakeholders. The paper is divided into the following sections: the main content of the CSDDD on the new due diligence obligations, the resulting civil liability, the designation of the supervisory authorities, and the Directive's interaction with other EU laws (Section 2); the application to the Italian productive system, including both financial and non-financial companies, with a what-if analysis of the impact of extending the chain of activities of financial intermediaries (Section 3); and an analysis of the potential effects of the Directive (Section 4).

[5] See Proposal for a Directive on corporate sustainability due diligence and annex, European Commission, 23 February 2022.

[6] Article 36(1) of the CSDDD states: 'The Commission shall submit a report to the European Parliament and to the Council on the necessity of laying down additional sustainability due diligence requirements tailored to regulated financial undertakings with respect to the provision of financial services and investment activities, and the options for such due diligence requirements as well as their impacts, in line with the objectives of this Directive'.

2. Overview of the provisions of the CSDDD: scope of application and main obligations

The CSDDD was formally adopted by the European Parliament on 24 April 2024, after lengthy political and technical negotiations between the co-legislators, which started in February 2022 when the EU Commission published its legislative proposal. Some of the most sensitive provisions included in the Commission's proposal (e.g. on directors' duty of care or on variable remuneration based on environmental performance) were eventually carved-out by the final version of the Directive, which therefore reflects the compromises reached on several, albeit crucial, aspects of the new legislation, the main contents of which are summarized in the following subsections.

Scope of application

The identification of the firms (and activities) to be included in the scope of the CSDDD was one of the most debated issues during the legislative process.[7] To overcome the resistance of some Member States, the original thresholds set out in the Commission's proposal were significantly revised in order to narrow the Directive's scope.[8]

According to the final draft (Article 2), a **company established in the EU** shall be subject to the new requirements if it meets one of the following conditions:

a) it has more than 1,000 employees[9] on average and a net worldwide turnover of more than €450,000,000 in the last two financial years;

b) it does not reach the thresholds in point (a), but it is the ultimate parent company of a group that reached those thresholds in the last two financial years.

With respect to **non-EU companies**, the Directive does not provide for an employee threshold, but includes those companies that:

a) had a net turnover in the EU of more than €450,000,000 in the last two financial years; or

b) did not reach the threshold as referred to in point (a) but are the ultimate parent companies of groups that on a consolidated basis reached that threshold in the last two financial years.

The same provision establishes the rules to determine which Member State is competent to regulate the matters covered by the Directive: for EU companies, it is the Member State in which the company has its registered office, while for non-EU companies, the competent Member State is the one in which the company has a branch or – if the company has no branch in any Member State or has branches located

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[7] See Parliamentary question | Answer for question E-000281/24 | E-000281/2024(ASW), European Parliament, 14 March 2024

[8] The Commission proposal included EU companies with 500 employees and a net worldwide turnover of more than €150,000,000 and non-EU companies with a net turnover in the EU of more than €150,000,000. Moreover, lower thresholds were set for 'high-risk sectors'.

[9] According to recital 27, the term 'employee' includes temporary agency workers, posted workers and other workers in non-standard forms of employment provided that they meet the criteria established by the Court of Justice of the European Union (CJEU). '. To this respect, the CJEU leading case in the field of free movement of workers (Lawrie-Blum decision) states that the essential feature of an employment relationship "is that, for a certain period of time, a person performs services for and under the direction of another person in return for which remuneration is received". See Court of Justice, C-66/85 Lawrie-Blum, paragraph 17.

in different Member States – the Member State in which that company generates the highest net turnover in the EU.

Moreover, specific rules and thresholds are provided for holding companies and companies (both EU and non-EU) that entered into franchising and licensing agreements with independent third-party companies in return for royalties.[10]

Finally, the Directive explicitly excludes alternative investment funds (AIFs) and undertakings for collective investment in transferable securities (UCITS) from its scope of application.

As mentioned above, the definition of the Directive's scope has long been debated, as evidenced by the review clause set out in Article 36, which requires the Commission to periodically assess the effectiveness of some of the compromise solutions adopted in the final text, particularly with regard to the scope of the Directive.

With respect to the activities that fall within the scope, Article 1 specifies that the obligations thereby stated concern the actual and potential human rights violations and adverse environmental impacts caused by:

a) companies' own operations;

b) the operations of their subsidiaries;

c) the operations carried out along companies' **chain of activities** by:

- their upstream business partners related to the production of goods or the provision of services (e.g., design, extraction, transport, storage and supply of raw materials, products or parts of the products); and
- their downstream business partners related to the distribution, transport and storage of products.[11]

As mentioned above, financial services were removed from the scope of the Directive in its final version; on the one hand, the definition of the downstream chain of activities does not cover the provision of financial services; on the other hand, this principle is explicitly laid down in Recital 26, which clarifies that for regulated financial undertakings the definition of the term 'chain of activities' only covers the operations carried out by their upstream business partners and does not include partners that receive their services or products.[12]

[10] Article 2(1)(c) and Article 2(2)(c) of the CSDDD state: 'The company entered into or is the ultimate parent company of a group that entered into franchising or licensing agreements in the Union in return for royalties with independent third-party companies, where those agreements ensure a common identity, a common business concept and the application of uniform business methods, and where those royalties amounted to more than €22,500,000 in the last financial year for which annual financial statements have been or should have been adopted, and provided that the company had or is the ultimate parent company of a group that had a net worldwide turnover of more than €80,000,000 in the last financial year for which annual financial statements have been or should have been adopted'.

[11] An entity with which the company has a commercial agreement (direct business partner) or performs business operations (indirect business partner) relating to the operations, products or services of the company or to which the company provides services. Moreover, Recital 26 clarifies that 'the definition of the term 'chain of activities' should not include the activities of a company's downstream business partners related to the services of the company'.

[12] See Section 3.

The due diligence process

With the aim of strengthening the contribution that large companies can make to environmental and social progress, the CSDDD introduces a set of due diligence obligations that should allow them to avoid (or address) adverse impacts on human rights[13] and the environment.[14]

As a general principle, the Directive requires companies to perform these obligations using a risk-based approach, which means that where it is not feasible to address all identified adverse impacts at once, companies should prioritize their actions according to the severity and likelihood of the identified impacts.[15] The severity of an adverse impact should be assessed taking account of its scale, scope, the irreversibility of its effects, and the number of the individuals potentially affected. A risk-based approach also implies that companies should tailor their measures to the specific risks, taking into account all relevant circumstances.

With regard to the content of the due diligence obligations, Article 5 of the Directive sets out a process based on a sequential approach designed to ensure that the actual or potential adverse effects of companies' activities are addressed in a timely manner. In particular, companies must take the following steps to fulfil their due diligence obligations:

1. **integrate due diligence into companies' relevant policies and risk management systems (Article 7):** companies must develop a due diligence policy containing a description of their due diligence approach, a code of conduct (to be followed by the company, its subsidiaries and its business partners) and a description of the process for implementing the due diligence policy (including the measures taken to verify compliance with the code of conduct);
2. **identify and assess actual or potential adverse impacts arising from their activities (Articles 8-9):** taking into account the relevant risk factors (e.g. at company level, or geographical and sector-specific risk factors), companies are required to map the areas of activities where adverse impacts are most likely to occur and be most severe and to carry out an in-depth assessment accordingly;
3. **take appropriate measures to prevent or, where prevention is not possible, to mitigate the potential adverse impacts that have been identified (or should have been identified) and to put an end the actual adverse impact (Articles 10-11):** the Directive identifies the possible measures that can be taken to prevent or mitigate and bring to an end the adverse impacts, depending on the specific circumstances (e.g. developing and implementing prevention plans, seeking contractual assurance from business partners, and making financial or non-financial investments or adjustments). As a last resort, in the case of adverse impacts that cannot be prevented, adequately mitigated or brought to an end, the Directive requires companies to refrain from entering into new relations, or extending existing ones, with the business partners in relation to whom the impact has occurred. According to the relevant national law, companies may also temporarily suspend or terminate business relationships (see Section 2.1);

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[13] The Directive adopts a comprehensive definition of human rights, including all five fundamental principles and rights at work as defined in the 1998 ILO Declaration on Fundamental Principles and Rights at Work. With regard to violations of these rights, the Directive refers to the international instruments listed in its Annex. In addition to this specific due diligence, the Directive (Recital 34) states that companies should also be responsible for using their influence to contribute to an adequate standard of living in chains of activities.

[14] With respect to adverse impacts on the environment, the Directive also refers to the prohibitions and obligations listed in the Annex. These prohibitions include the prohibition of causing measurable environmental degradation, such as harmful soil alteration, water or air pollution, harmful emissions, excessive water consumption, and land degradation.

[15] This principle is also stated in the OECD Guidelines for Multinational Enterprises.

4. **provide remediation for actual adverse impacts (Article 12):** companies must provide remediation for actual adverse impacts caused individually or jointly and, when the actual adverse impact is caused only by one of their business partners, they may provide voluntary remediation. The Directive also specifies that the company may use its influence to persuade the responsible business partner to provide remediation;
5. **carry out meaningful engagement with stakeholders (Article 13):** companies must consult with stakeholders at different stages of the due diligence process (e.g. when they identify, assess and prioritize adverse impacts and develop prevention and corrective action plans);
6. **establish and maintain a notification mechanism and a complaints procedure (Article 14):** companies should allow natural or legal persons, trade unions, and civil society organizations that have legitimate concerns (as detailed in the Directive) to submit complaints by establishing a fair, publicly available, accessible, predictable and transparent procedure. Moreover, the Directive requires companies to establish an accessible mechanism for the submission of notifications by persons and entities that have information or concerns about actual or potential adverse impacts caused by their activities;
7. **monitoring (Article 15):** companies must carry out periodic assessments (at least annually) of their own operations and measures, those of their subsidiaries and those of the business partners within their chain of activities, to evaluate their adequacy and effectiveness;
8. **public statement (Article 16):** companies that are not subject to the reporting requirements of the CSRD must publish on their website an annual statement on the activities carried out to comply with the CSDDD.

In order to assist companies or Member State authorities in fulfilling their due diligence obligations under Article 19, the EU Commission is required to issue general and sector-specific guidelines, which should include, among other things, information on how to conduct the due diligence process and references to best practices.

The transition plans

The Article 22 of CSDDD requires companies to adopt a transition plan for climate change mitigation that aims to ensure, to the best of their ability, that their business model and strategy are compatible with the transition to a sustainable economy and with keeping global warming below the 1.5 °C threshold, in line with the Paris Agreement. This plan must be updated annually with evidence of progress made. This obligation therefore does not concern sustainability in general but specifically covers the actions taken to mitigate climate change.

The Directive also establishes the specific information that must be included in the transition plan, such as time-bound climate change and emission reduction targets, a description of the identified decarbonization levers, the key actions planned, and an explanation of the investments made to support the implementation of these actions.

The obligation to adopt a transition plan does not apply to companies that already have a transition plan under the CSRD, or are already covered by the transition plan adopted by their parent company.

Transition plans have become one of the EU's key regulatory tools to ensure that companies factor in ESG risks in their risk management. The latest version of the Capital Requirements Directive (CRD VI) introduces a binding requirement for financial institutions to develop specific plans to address the financial risks arising from ESG factors in the short, medium and long term, including those arising from

the transition towards the relevant regulatory objectives of the European Union as set out in the Paris Agreement. [16] As reported in the draft EBA guidelines on the management of ESG risks, *'plans under non-prudential regulations, such as CSRD and CSDDD, focus on the compatibility of business models of undertakings with the 1.5-degree pathway and the objective of the EU to achieve net-zero greenhouse gas emissions by 2050 or on the due diligence policies, processes and activities conducted to identify and address actual or potential adverse impacts from institutions' activities. Plans under CRD on the other hand are focused on (prudential) risks; they constitute a new risk management tool through which institutions should understand, assess and manage the risks stemming from their activities and exposures in view of the process of adjustment towards the regulatory sustainability objectives of the jurisdictions they operate in, or broader transition trends towards a sustainable economy'*. [17]

For the transition plans under the CSDDD, the EU Commission is tasked with issuing guidelines on how companies should fulfil their obligations.

2.1. Preliminary considerations on suspension and termination obligations and on civil liability

As noted above, financial services are not included in the chain of activities of financial intermediaries under the CSDDD.[18] This exclusion is reflected both in the suspension and termination obligations and in the conditions for civil liability, with the effect of limiting their scope.

(i) *Suspension and termination obligations*

Article 10 of the Directive provides that in the event of potential adverse impacts (adverse environmental impact or adverse human rights impact), where other prevention and mitigation measures have failed,[19] companies are required to refrain from entering into new or extending existing relations with a business partner. As a last resort, and to the extent permitted by national law governing the company's contractual relationships, companies should:

a) temporarily suspend the business relationship with the business partner in question;

b) terminate the business relationship if the potential adverse impact is severe.[20]

A similar provision is made for actual adverse impacts (Article 11). Again, as a last resort, companies should temporarily suspend or terminate relations with their business partners in order to put an end to these impacts.[21]

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[16] According to Article 76(2) of CRD VI, financial institutions shall develop specific plans to monitor and address the financial risks stemming from ESG factors, including those arising from the process of adjustment and from transition trends in the context of the relevant Union and Member State regulatory objectives in relation to ESG factors, as well as, where relevant for internationally active institutions, third-country legal and regulatory objectives. Article 87a(5)(2) of CRD VI also states that, where relevant, the methodologies and assumptions sustaining the targets, the commitments and strategic decisions disclosed by institutions under the CSRD, or other relevant disclosure and due diligence frameworks, shall be consistent with the criteria, methodologies, assumptions, and targets used in the plans to be prepared in accordance with the CRD.

[17] See 'EBA Consultation paper on Draft Guidelines on the management of ESG risks', EBA, 18 January 2024.

[18] The chain of activities identifies the subject of the due diligence requirements of the Directive.

[19] See Article 10(2), (3) and (4), e.g. adoption and implementation of a prevention action plan; seeking contractual assurances from counterparties to comply with the company's code of conduct; making the necessary investments to adapt operational processes, etc.

[20] Article 10(6).

[21] Article 11(3), (4), (5) and (7).

Business relations can be temporarily suspended as long as there is a reasonable expectation that the negative impacts will be successfully prevented, ended or minimized.[22] Otherwise, companies are required to terminate the business relationship if the potential or actual adverse impact is severe.

In any event, companies must assess whether the adverse impact of suspending or terminating relations is manifestly more severe than the negative effects of not taking such action. In this case, they may refrain from suspending or terminating relations and shall report the reasons for their decision to the competent supervisory authority.

The definition of the arrangements to make these obligations operational is left to national implementation frameworks. Only after the transposing legislation has been adopted will it be possible to assess the relationship between these specific contractual instruments and the Italian civil law provisions on the suspension or termination of contracts at the initiative of one of the parties.

It should be noted that the suspension and termination provisions use fluid concepts that are difficult to quantify, for example, the 'potential adverse effects' of the relationship with the other party, or the 'manifestly greater severity' of the effects the suspension or termination, which is left to the company's assessment.

However, the Directive entrusts the Commission with the adoption of specific guidelines to 'provide support to companies or to Member State authorities on how companies should fulfil their due diligence obligations'.[23] These guidelines could therefore help to make the due diligence obligations more concrete.

In any event, the introduction of these provisions will result in operational and procedural burdens for companies (and for financial intermediaries, should the Directive apply to financial services in the future) for the assessment of the conditions set out in the legislation.

In addition, the decisions taken by companies with regard to suspension and termination may lead to an increased risk of disputes and/or litigation. This applies to both the exercise and non-exercise of this power:

- in the former case (exercise of the power of suspension or termination), the company may be exposed to actions by the counterparty to which the suspension or termination was applied. For example, the counterparty could try to argue that such remedies were not necessary because the milder risk prevention measures set out in Articles 10 and 11 were sufficient. The company could then face claims for financial and reputational damages suffered by its business partners;
- in the latter case (failure to exercise the power of termination), the company could be held civilly liable for breach of the duty of care under Article 29 of the Directive (infra, sub ii).

(ii) *Civil liability*

[22] The suspension must be provided for in an appropriate ad hoc enhanced action plan adopted for the specific impact in question; see Article 10(6)(a) and Article 11(7)(a).

[23] Recitals 67 and 68 and Article 19; see also Recital 66 and Article 18, which provide Commission guidelines on the model contract clauses set out in Articles 10 and 11 as prevention and mitigation measures.

Article 29 introduces a civil liability regime for companies for damage caused by their failure to take appropriate measures to prevent, mitigate or bring to an end adverse human rights or environmental impacts.[24]

Specifically, civil liability[25] is subject to four conditions:

a) the violation of the due diligence obligations under Articles 10 and 11, namely the failure to take the necessary measures to prevent potential adverse impacts and to bring to an end actual adverse impacts (including the suspension and termination described above);

b) damage to a natural or legal person;

c) a causal link between the failure to comply with the due diligence obligation and the damage;

d) a subjective element (intention or negligence).

Where a company is held liable, the Directive provides for full compensation for the damage caused, clarifying that overcompensation and punitive damages are not allowed.[26]

A company cannot be held liable if the damage was caused only by its business partners in its chain of activities.[27] If the damage is caused jointly by the company and its business partner, both companies are jointly and severally liable. As regards corporate groups, the fulfilment of certain due diligence obligations at the group level does not affect the liability of the subsidiaries, provided that the relevant conditions are met.[28]

The limitation period for bringing actions to enforce liability is set at a minimum of five years.[29] As to the *dies a quo*, the limitation period begins to run when the infringement has ceased and the injured party knows or can reasonably be expected to know, *inter alia*, of the harmful conduct in breach of the due diligence obligations, the damage caused to him/her by the infringement and the identity of the infringer.

In line with a proposal made by the Parliament during the preparatory work, the legal standing for damages is extended to trade unions, civil society organizations and human rights institutions. These entities may be authorized to bring actions to enforce the rights of the alleged injured party, in accordance with the requirements of national law.[30]

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[24] Recital 79 ('In order to ensure that victims of adverse impacts have effective access to justice and compensation, Member States should be required to lay down rules governing the civil liability of companies for damages caused to a natural or legal person, under the condition that the company intentionally or negligently failed to prevent and mitigate potential adverse impacts or to bring actual impacts to an end and minimise their extent, and as a result of such a failure a damage was caused to the natural or legal person […]').

[25] The CSDDD only provides for the civil liability of the company. Conversely, in other recently adopted legislation, the European legislator has expressly provided for the liability not only of the company but also of the members of its administrative, management and supervisory bodies (Article 15 of EU Regulation 2023/1114 on markets in crypto-assets, MiCAR, regarding the information provided in the White Paper).

[26] Article 29 (2).

[27] Article 29 (1), last period.

[28] Article 29 (5) and Recitals 21 e 22.

[29] And, in any event, within a period not shorter than that provided for by the national tort system (Art. 29(3)(a)).

[30] These requirements may include a permanent presence in the member state and a statutory commitment to work, in a non-temporary and non-commercial manner, towards the realisation of the rights protected by the directive (Art. 29 (3) (d)).

This is followed by specific provisions on the acquisition of evidence, which are intended to amend the general rules on the allocation of the burden of proof – in particular, by strengthening the powers of judges – in order to correct any imbalance in procedural positions.[31] Indeed, it may be difficult for the alleged injured party, who is not part of the company's organization, to prove that the company has breached its due diligence duty.

Finally, Article 29 specifies that 'Member States shall ensure that the provisions of national law transposing this Article are of overriding mandatory application in cases where the law applicable to claims to that effect is not the national law of a Member State'.[32] In other words, the liability rules of the Directive take precedence over any non-European law applicable under the rules of private international law with a view to improving access to justice. [33]

Against this background, the Directive lays down the conditions for liability. Within these conditions, it is left to the Member States to define their civil liability regime, taking into account the specificities of each legal system. For example, as mentioned above, the rules on limitation periods are, in principle, left to the discretion of the Member States: the Directive only sets a minimum period of five years. The causal link[34] and the allocation of the burden of proof[35] are also left to the national systems: on these profiles, the Directive only lays down minimum harmonization rules.

This solution could lead to application outcomes that are not easily foreseeable. The CSDDD rules on civil liability are intended to avoid distortions in the single market resulting from different treatment in the various national systems.[36] At present, only a few Member States explicitly provide for civil

[31] For example, Article 29 (3) provides that 'when a claim is brought, and a claimant presents a reasoned justification containing reasonably available facts and evidence sufficient to support the plausibility of its claim for damage and has indicated that additional evidence lies in the control of the company, courts are able to order that such evidence be disclosed by the company in accordance with national procedural law' (emphasis added).

[32] Article 29 (7) and Recital 90.

[33] The German KiK case comes to mind, following the dramatic fire in September 2012 at the factory of Ali Enterprises in Pakistan, its exclusive supplier. Some of the Pakistani company's workers took KiK to the German courts, claiming that KiK was responsible for the damage caused by the fire due to its failure to comply with minimum safety standards in the workplace. The case was decided by the Dortmund Regional Court on 21 February 2019: the application of the Pakistani statute of limitations resulted in the dismissal of the workers' claims (see G. C. Corvese, op. cit. who, on this point, refers to S. Brabant, C. Bright, N. Neitze, and D. Schönfelder, 'Enforcing Due Diligence Obligations: The Draft Directive on Corporate Sustainability Due Diligence (Part 2)', VerfBlog, 16 March 2022; G. B. Portale, 'La corporate social responsability alla ricerca di effettività', in M. Miglietta and E. Pederzini (ed.), *Percorsi giuridici tra diritto interno e comparazione*, pp. 12 and 13).

[34] See Recital 79, which clarifies that '[...]Causality within the meaning of civil liability is not regulated by this Directive', and that the Directive only covers damage directly caused by a breach of the duty of due diligence ('The condition that the damage has to be caused to a person as a result of the company's failure to comply with the obligation to address the adverse impact, when the right, prohibition or obligation listed in the Annex to this Directive, the abuse or violation of which is resulting in the adverse impact that should have been addressed, is aimed to protect the natural or legal person to whom the damage is caused, should be understood as meaning that derivative damage (caused indirectly to other persons who are not the victims of adverse impacts and who are not protected by the rights, prohibitions or obligations listed in the Annex to this Directive) is not covered. For example, if an employee of a company suffered damage due to the company's violation of safety standards in the workplace, the landlord of such an employee should not be allowed to bring a claim against the company for an economic loss caused by the employee not being able to pay the rent'.

[35] See Recital 81, according to which 'The liability regime does not regulate who should prove the fulfilment of the conditions for liability under the circumstances of the case, or upon which conditions civil proceedings can be initiated, therefore those questions are left to national law'.

[36] See Recital 99.

liability related to non-compliance with due diligence obligations.[37] However, the decision to leave the definition of many aspects of liability to national law could exacerbate rather than eliminate the distortions and gaps that currently exist.[38]

From a systematic point of view, the civil liability outlined by the Directive appears to mirror, in its general approach, the civil liability regime provided for in the Italian legal system by Article 2043 of the Civil Code,[39] which requires, in addition to the existence of indemnifiable damage caused by unlawful conduct and of a causal link, the existence of a subjective element, i.e. malice or negligence. It is therefore not an 'aggravated' liability regime.

This is confirmed by the explicit exclusion of companies' liability for the acts of others, i.e. for damage caused by the unlawful conduct of third parties (e.g. business partners) over which companies have no control.

Further evidence of this is the provision of a limitation period of at least five years. This term is typical of non-contractual liability in the Italian legal system.[40]

As to the possible impact of the provisions on financial intermediaries, excluding business partners that receive their financial services or products from their chain of activities reduces the scope of their liability. The due diligence obligations set out in Articles 10 and 11 of the Directive do not extend to financed entities,[41] so any failure to comply cannot give rise to liability under the Directive.

Liability is further limited, at least in theory, by the fact that civil liability generally arises solely for breaches of the obligations set out in Articles 10 and 11, and not for the other duties of care imposed on companies by the Directive. These include, for example, the obligation to set up a procedure for processing complaints from third parties who have legitimate concerns about negative impacts on human rights and the environment (Article 14) or the obligation to periodically monitor the effectiveness of the prevention and minimization measures adopted (Article 15).

[37] Specifically, France (Loi n° 2017-399 du 27 Mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordreè) and Germany, where the law on supervisory duties (Lieferkettensorgfaltspflichtengesetz, also known as the Supply Chain Act) expressly excludes that the breach of the duties in question may give rise to a specific hypothesis of civil liability (on this point, A. Guercini, 'La legge tedesca sugli obblighi di due diligence nella supply chain (Lieferkettensorgfaltspflichtengesetz, LkSG)', in *Rivista diritto societario*, No. 2/2022, p. 412).

[38] These concerns were echoed, among others, by the Federation of European Risk Management Associations (FERMA), which noted that 'the civil liability regimes will eventually be framed by Member States. We are therefore concerned that gaps may arise across countries, or even be reinforced. This possible patchwork of regimes can contribute to an already challenging compliance map for multinational companies operating in different EU Member States. Furthermore, it could lead to an unlevel playing field' (see 'Position paper on the European Commission's proposal for a Corporate Sustainability Due Diligence Directive (CSDD)', FERMA, 23 May 2022); see also C. Corvese, 'La proposta di direttiva sulla Corporate Sustainability Due Diligence e i suoi (presumibili) effetti sul diritto societario italiano', in *Imprese, mercati e sostenibilità: nuove sfide per il diritto commerciale,* 14th Annual Conference of the Italian Association of University Professors of Commercial Law, Rome, 26-27 May 2023.

[39] Article 2043 of the Italian Civil Code ('Any wilful or negligent act that causes unjustified damage to others obliges the person who committed the act to compensate for the damage').

[40] Article 2947(1) of the Italian Civil Code ('The limitation period for the right to compensation for damage caused by an unlawful act is five years from the day on which the act occurred').

[41] Therefore, companies are not required to take account of the characteristics of these persons – e.g. when preparing the prevention plan required by Article 10(2)(a) – for the purpose of assessing the potential negative impacts of their own operations.

It should be noted, however, that the content of the obligations set out in Articles 10 and 11 is rather broad and vague, as it only specifies the objectives of preventing and eliminating adverse impacts, which could lead to uncertainty when it comes to defining their scope in relation to the other due diligence obligations, such as those set out in Articles 7 and 8 (on 'integrating due diligence into company policies and risk management systems' and on 'identifying and assessing actual and potential adverse impacts', respectively).

It is however foreseen that the Commission will issue specific guidelines to 'provide support to companies and Member State authorities on how companies should fulfil their due diligence obligations'.[42] These guidelines, together with any clarifications that national legislators may provide when implementing the Directive, could help to better define the due diligence obligations in question.

From another point of view, the legitimacy of trade unions and civil society organizations – i.e. entities that are better placed than individual injured parties to initiate complex legal actions and find the necessary resources to support them – requires some considerations on climate-related litigation.

On this point, recent evidence highlights the increase in this type of litigation, which initially targeted states (in relation to climate policies) and institutions (e.g. ClientEarth v. EIB[43]). More recently, litigation has increasingly involved companies, in particular fossil fuel companies (carbon majors) and energy companies (Shell,[44] ENI[45]), but also car manufacturers, airlines, food companies, and cement and plastics manufacturers. Finally, banks and other financial intermediaries have been involved.[46] In most cases, the actors are – or are supported by – non-governmental organizations (such as Greenpeace, the aforementioned ClientEarth, etc.). The Directive, thus, seems to capture the current trend. It is up to the national legislator, at the time of transposition, to assess the possible contribution to litigation that might result from it and the advisability of introducing precautions to avoid, as far as possible, vague or reckless initiatives.[47]

2.2 Supervision and enforcement

Over the years, national regulators have adopted different strategies to supervise compliance with and ensure the enforcement of due diligence obligations aimed at protecting human rights and the environment (see Box 1). Some countries, such as France, have decided to rely solely on monitoring by the general public and stakeholders to enforce the corporate due diligence obligations of their national laws. Other countries, such as Germany, have tasked public authorities with enforcing compliance with relevant national due diligence requirements.

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[42] Recitals 67 and 68 and Article 19; see also Recital 66 and Article 18, which provide for Commission guidelines on the standard contractual clauses referred to in Articles 10 and 11 as preventive and mitigating measures.

[43] See European Union General Court, T-9/19, ClientEarth v. EIB, and Court of Justice, Joined Cases C-212/21 P and C-223/21 P, EIB v. ClientEarth; see also European Union General Court, Joined Cases T-682/21 and T-683/21, ClientEarth AISBL and Päivi Leino-Sandberg v. Council of the European Union.

[44] Milieudefensie et al. C. Royal Dutch Shell plc.

[45] Greenpeace Italy et. Al. v. ENI S.p.A., Ministero dell'Economia e delle Finanze and Cassa Depositi e Prestiti.

[46] In France, the first direct lawsuits have recently been filed against a bank (BNP Paribas) for its role in financing the expansion of fossil fuels, as well as for its involvement in the deforestation of the Amazon and in human rights violations (Notre Affaire à Tous Les Amis de la Terre and Oxfam France v. BNP Paribas; Comissão Pastoral da Terra and Notre Affaire à Tous v. BNP Paribas, respectively). The judgments were based on national due diligence legislation.

[47] As highlighted above, the Directive allows national legislators to make the legitimacy of trade unions and civil society organizations conditional on the fulfilment of certain requirements, such as a specific statutory commitment to operate in a non-temporary and non-commercial manner for the purpose of realizing the rights protected by the Directive.

Against this background, the EU co-legislators have decided to combine public and private enforcement mechanisms to ensure the enforcement of the CSDDD obligations. This choice was informed by the observation of national experiences, which have shown that private solutions, while useful on their own, are better able to ensure adequate levels of compliance and deterrence when combined with public oversight.[48] Accordingly, the CSDDD requires Member States to designate one or more supervisory authorities to monitor compliance with national legislation transposing the obligations of the CSDDD, including the requirement to develop a transition plan to mitigate their impact on climate change.[49] To this end, the designated supervisory authority should be given adequate powers, which may be exercised either directly by the authority, in cooperation with other national authorities, or through judicial authorities in accordance with national frameworks.[50] Specifically, the supervisory authorities must be able to:[51] require companies to provide information; carry out investigations on their own initiative or as a result of substantiated concerns raised by natural and legal persons about non-compliance with CSDDD obligations;[52] conduct inspections;[53] order supervised entities to cease any infringements or refrain from any repetition of the relevant conduct; provide remediation proportionate to the infringement and necessary to bring it to an end; impose penalties, including pecuniary penalties;[54] and adopt interim measures in the event of an imminent risk of severe and irreparable harm. The exercise of these powers should be without prejudice to the civil liability of the companies concerned. [55]

Provided there is a clear division of competences, the CSDDD allows each Member State to confer supervisory tasks and powers to multiple authorities with different areas of sectorial expertise, including existing financial sector supervisors.[56] This choice is in line with recent developments in EU financial regulation and supervision, which are paying increasing attention to the impact of ESG risks on the business model and soundness of supervised financial entities. Indeed, ensuring that financial entities adopt effective systems to comply with the CSDDD obligations can be seen as a tool to mitigate potential ESG risks, though for the time being only in relation to their upstream chain of activities.

The CSDDD sets out granular rules to anchor supervisory responsibilities in the competent Member State. The baseline is that supervision is carried out by the authority of the Member State where the in-scope company has its registered office or, in the case of a third-country company, its branch. If a third-country company has branches in several Member States or no branches at all, the authority of the

[48] *Final Report Study on due diligence requirements through the supply chain*, EU Commission, January 2020; 'UN Guiding Principles on Business and Human Rights', UN, 2011; and Juliette Camy, 'The French law on the duty of vigilance: the challenges of the preventive approach', Cambridge CoreBlog, 2023.

[49] Article 24(1). The designated authority and its staff must be independent, including from supervised entities, and must have the financial and human resources to carry out its tasks; see Article 24(9).

[50] Article 25(1, 6).

[51] See Article 25(2-7) and Article 23(5). Natural and legal persons have the right to an effective judicial remedy against a legally binding decision by a supervisory authority concerning them, in accordance with national law. In any case, supervisory authorities are subject to a record-keeping requirement.

[52] The submission of substantiated concerns is subject to the conditions and safeguards set out in Article 26.

[53] Companies should be warned of the planned inspection unless this undermines its effectiveness. Inspections in other Member States must be carried out with the assistance of their supervisory authority.

[54] See Article 27. The maximum limit of pecuniary penalties shall be not less than 5 per cent of the consolidated net worldwide turnover of the company. Decisions on penalties must be publicly available for at least five years.

[55] Article 25(9).

[56] Article 24(5-6). The list of national supervisory authorities and their competences must be provided to the Commission, which must publish and regularly update it; see Article 24(7-8).

Member State where the company has generated most of its net turnover in the EU is the one responsible for supervising compliance with the Directive.[57] In any case, third-country companies must appoint an EU-based representative authorised to receive communications from supervisory authorities on all matters necessary for compliance with and enforcement of the CSDDD obligations.[58]

There are general and specific obligations for supervisory authorities to cooperate with each other at the EU level.[59] In order to facilitate cross-border cooperation, the Commission is mandated to establish a European Network of Supervisory Authorities to facilitate coordination between different Member States, the alignment of regulatory, investigative, sanctioning and supervisory practices, and the sharing of information, including on the net turnover of third-country companies generated in their respective jurisdictions. In addition to the Commission, the Network comprises representatives of the competent national supervisory authorities and, upon invitation, other EU agencies with relevant expertise in the areas covered by the CSDDD.[60]

Relations with the supervised companies will be managed through a hub-and-spoke model. Specifically, companies will be able to direct their requests for information and regulatory guidance to a single helpdesk, which will have the mandate to support them to fulfil their obligations under the CSDDD. In turn, national authorities will have to support the helpdesk in tailoring its work to national sensitivities and in spreading its guidance in each Member State.[61]

Box 1: A cross-country comparison

Before the adoption of the CSDDD, several countries, including EU and EEA Member States, had passed legislation aimed at ensuring that companies take into account human rights and environmental concerns across their value chains. Some of the supervisory and enforcement strategies include:

France: France was the first major jurisdiction in the world to pass corporate due diligence legislation, which has strongly influenced the content of the CSDDD's due diligence obligations. However, unlike the CSDDD, French law does not provide for public oversight and enforcement mechanisms. Instead, it allows private parties to sue companies that breach their due diligence obligations. If a violation is found, judges can issue a cease and desist order to be complied with within three months. If the company fails to comply, judges can order the publication of a remedial plan and the payment of periodic fines.

Germany: the mandate of the German Federal Office for Economic Affairs and Export Control (Bundesamt für Wirtschaft und Ausfuhrkontrolle, BAFA) comprises the supervision and the enforcement of the due diligence obligations set out in the German Supply Chain Act. To this end, BAFA is empowered to issue regulatory guidelines, conduct on-site and off-site inspections, and impose sanctions. Compliance is primarily verified through the submission of an annual report by the in-scope companies to BAFA, which must contain the following: whether human rights and the environment are at risk across value chains and to what extent; what measures the companies have taken to comply with the due diligence obligations; how the impact of these measures has been assessed; and what the companies plan to do in the future to continue to comply with the obligations of the Supply Chain Act. If companies fail

[57] Article 24(2-4).

[58] Article 23.

[59] For example, cooperation must be ensured among supervisory authorities of entities in the same in-scope cross-border groups; see Article 24(4).

[60] Article 28. The Network should also publish the penalty decisions taken by the member supervisory authorities and an indicative list of third-country companies subject to the CSDDD.

[61] Article 21 and Recital 70.

to comply with their due diligence obligations, including the submission of the annual report, BAFA can impose penalties of up to €8 million or 2 per cent of their global annual turnover.

Norway: Norway has adopted a mixed model of supervision and enforcement similar to the CSDDD to monitor compliance with its corporate due diligence requirements, although the specifics differ from the new EU framework. In particular, the Norwegian Transparency Act requires in-scope companies to respond to any written and reasonable enquiry from individuals on how they mitigate the actual and potential adverse impacts of their general or specific activities on human rights and the environment. In addition, the Norwegian Consumer Agency has been granted regulatory, investigative, and sanctioning powers to ensure that in-scope companies comply with the Transparency Act.

2.3 Interaction of the CSDDD with other EU laws

The CSDDD interacts with a number of existing pieces of EU legislation, such as the CSRD, the Taxonomy Regulation, the EBA's Implementing Technical Standards (ITS) on Pillar 3 ESG Disclosure and the Capital Requirements Directive (CRD VI)[62] requirements for institutions to identify, measure, manage and monitor ESG risks.

Although these regulations focus on similar issues, they have different purposes: the CSRD, the Taxonomy Regulation and the EBA's ITS on Pillar 3 ESG Disclosure are primarily concerned with the disclosure of corporate sustainability information and aim to facilitate the transition in an indirect way, through the functioning of markets; the CSDDD imposes behavioral duties on companies and CRD VI requires institutions to integrate ESG risks into their regular risk management frameworks by considering their role as potential drivers of all traditional categories of financial risk, including credit, market, operational, reputational, liquidity, business model, and concentration risks.

The main differences between the aforementioned pieces of legislation, apart from their purpose, are reported below.

- Scope of application: CRD VI and the Pillar 3 ESG Disclosure ITS, when fully implemented, will apply to all credit institutions, while the other regulations will only apply to certain institutions.[63] Specifically, the CSRD and the Taxonomy Regulation cover large[64] and/or listed institutions (except for listed microenterprises), while the scope of the CSDDD includes large institutions with a net turnover of more than €450 million and over 1,000 employees.
- Requirements: although these pieces of legislation are all based on similar principles, they impose different disclosure and conduct obligations. Specifically, the CSRD, the Taxonomy Regulation and the Pillar 3 ESG Disclosure ITS only require qualitative and quantitative disclosure of ESG factors, while the CSDDD also provides for due diligence to ensure that companies' own operations and those carried out along their chain of activities do not violate human and environmental rights. In particular, the environmental and social due diligence obligations introduced by the CSDDD complement, for financial undertakings, the prudential requirements on ESG risks set out in CRD VI, which requires institutions to have a robust and sound approach to managing and mitigating ESG risks in the short, medium and long term.

[62] Articles 73, 74, 76, 87a.

[63] Currently, the Pillar 3 ESG Disclosure ITS cover large institutions which have issued securities that are admitted to trading on a regulated market of any Member State. Starting from 2025, this obligation will be extended to all banks.

[64] Based on the thresholds set out in the 'Accounting Directive'.

- Transition plans: the requirement to develop a transition plan under the CSDDD and the CSRD, which focus on achieving net zero greenhouse gas emissions by 2050, should be consistent with the criteria, methodologies, assumptions, and targets of the plan required under Article 76 of CRD VI, which has a prudential purpose and is intended as a new risk management tool. According to CRD VI, institutions should develop specific plans to monitor and manage the financial risks arising from ESG factors, including those related to the process of adjustment and to the transition trends in the context of the relevant Union and Member State regulatory objectives, as well as, where relevant for internationally active institutions, third-country legal and regulatory objectives.

The above comparison of EU ESG legislation is summarized in the following Table and described in more detail in the following sub-sections.

Table 1 - Comparison between the CSDDD and other EU legislation on ESG risks and opportunities				
	CSDDD	**CSRD and Taxonomy Regulation**	**Pillar 3 ESG Disclosure**	**CRD VI on integrating ESG risks into risk management frameworks**
Date of application	Starting from FY 2027.	- Starting from FY 2022 **[Taxonomy Regulation]** - Starting from FY 2024 **[CSRD]**	Starting from FY 2022.	Depending on the publication of the final version of the EBA's guidelines on the management of ESG risks.
Subject matter	- Rules on actual and potential human rights and environmental adverse impacts - Application of the inside-out perspective, with possible positive or negative consequences from the outside (outside-in).	- Classification of environmentally sustainable economic activities, based on technical screening criteria established by the European Commission through the adoption of delegated acts **[Taxonomy Regulation]** - Impacts, risks and opportunities arising from sustainability matters, based on the double materiality approach (inside-out and outside-in perspectives) **[CSRD]**	Prudential disclosures on ESG risks in accordance with Article 449a of CRR II, and EBA's ITS in accordance with Article 434a of CRR II. The new Article 449a of CRR III extends the Pillar 3 ESG disclosure requirement to all institutions from 2025.	Integrating ESG risks into risk management frameworks as potential drivers of all traditional categories of financial risk **[Articles 73, 74, 76, 87a CRD VI]**.
Scope of application	Large companies with a net turnover of over €450 million and more than 1,000 employees.	Large companies and listed SMEs (based on the thresholds set out in the 'Accounting Directive') **[Taxonomy Regulation and CSRD]**.	Large institutions which have issued securities that are admitted to trading on a regulated market of any Member State. Starting from 2025 this obligation will be extended to all banks.	All credit institutions and investment firms.
Requirements	Carrying out due diligence to ensure that companies' own operations and those carried out along their chain of activities do not violate human and environmental rights enshrined in international treaties.	- Percentage of CapEx, Opex and turnover associated with taxonomy-aligned and taxonomy-eligible economic activities for non-financial institutions **[Taxonomy Regulation]** - Green Asset Ratio (GAR) for financial institutions **[Taxonomy Regulation]** - Sustainability report based on the European Sustainability Reporting Standards (ESRS) developed by	Qualitative information on ESG risks and banking book KPIs (EBA templates), including Green Asset Ratio (GAR) and Banking Book Taxonomy Alignment Ratio (BTAR).	Institutions should have a robust and sound approach to managing and mitigating ESG risks in the short, medium and long term – including a time horizon of at least 10 years – and should use a range of risk management tools, including engagement with counterparties. Institutions should embed ESG risks in their regular processes, including risk appetite,

		the European Financial Reporting Advisory Group (EFRAG) and adopted by the European Commission through delegated acts **[CSRD]**		internal controls and ICAAP [**Articles 73, 74, 76, 87a CRD VI]**.
Transition plans	Companies are required to develop and implement a transition plan for climate change mitigation in line with the Paris Agreement.	Undertakings are required to disclose any transition plan they may have to ensure that their business model and strategy are compatible with the transition to a sustainable economy and with the objective of limiting global warming to 1.5 °C, in line with the Paris Agreement and with the goal of achieving climate neutrality by 2050.	N/A	Financial institutions are required to implement specific plans to monitor and address the financial risks arising from the process of adjustment and from transition trends in the context of the relevant Union and Member State regulatory objectives in relation to ESG factors, as well as, where relevant for internationally active institutions, third-country legal and regulatory objectives. It is intended as a new risk management tool.
Value chain/Chain of activities	<u>Chain of activities</u>: it does not cover the disposal of products. As regards financial undertakings, only the upstream but not the downstream part of their chain of activities is covered.	<u>Value chain</u>: it refers to companies' business operations and their upstream (e.g. suppliers) and downstream (e.g. distributors, customers) actors, as described in the ESRS.	It does not provide a definition of value chain, but requires disclosure of ESG information relating to financial institution counterparties.	It does not provide a definition of value chain, but requires the management of ESG risks stemming from financial institution counterparties.
Supervisory authorities	TBD	In Italy, the Italian Companies and Stock Exchange Commission (Consob), only for listed companies.	For significant institutions, the European Central Bank. For less significant institutions, the competent national authorities.	For significant institutions, the European Central Bank. For less significant institutions, the competent national authorities.

Source: our own elaboration

2.3.1 CSRD

The CSRD (Directive 2022/2464) replaces the NFRD (Directive 2014/95), transposed into Italian law by Legislative Decree 254/2016.

The CSRD requires larger companies to disclose to the public information on ESG factors affecting their business and the impact of their business on sustainability. This information must be included in a dedicated section of the companies' management reports.

These requirements will come into force gradually over the next few years, depending on the size of the companies involved. Compared with the NFRD, this Directive has a broader scope and covers listed companies (except for listed microenterprises), large companies[65] (including unlisted ones), and foreign companies with a significant turnover from their activities in the territory of the EU.

The fact that the CSRD also applies to companies that are not listed on regulated markets and therefore do not issue widely traded securities shows that the aims of the Directive go beyond the logic of transparency for investors that is typical of financial market regulation in the narrower sense. Indeed, the CSRD should also enable lending banks to assess the sustainability profiles of borrowers and other stakeholders interested in these issues to obtain information on how business is conducted. Disclosure provides the necessary information for all stakeholders (supervisors, consumers, investors, NGOs, workers, etc.) to learn about sustainability profiles in order to make their own informed choices.

The Directive aims to overcome some of the issues that arose from the reporting carried out under the NFRD, namely the omission of information deemed relevant, the poor quality and reliability of the information disclosed and its dissemination in ways that are difficult to compare. For these purposes, one of the main innovations of the Directive is the provision of detailed European disclosure standards, the content of which is specified in delegated acts of the Commission, the European Sustainability Reporting Standards (ESRS). General reporting standards were issued in summer 2023 (these are cross-cutting and thematic standards that apply to all companies regardless of their sector), while sectoral standards are to be adopted in the coming years. The general reporting areas cover environmental factors (including climate change, pollution, water, biodiversity, and resource use), social factors (including equal opportunities, working conditions, and human rights), and governance factors (including stewardship, risk management, ethics, and conduct in business management).

Companies must provide very detailed information in their management reports. In particular, they are required to:

- describe the main risks and opportunities relating to sustainability;
- describe the impact of their own operations and those in their value chain on sustainability;
- identify actions, including financial plans, to align their business activity with the climate transition and the climate goals of the Paris Agreement;
- set sustainability targets by defining their timeframe and the path to achieve them;
- describe the duties of corporate bodies and their responsibilities in relation to sustainability.

[65] Large companies are those that (individually or at a consolidated level) exceed at least two of the following three thresholds: (1) 250 employees, (2) €40 million net turnover, and (3) €20 million balance sheet total.

Finally, to ensure the reliability of the information reported, the information provided to the public must be verified by a third party.[66]

2.3.2 Taxonomy Regulation

Regulation (EU) 2020/852 (Taxonomy Regulation) creates a system for classifying economic activities that can contribute to environmental sustainability according to a set of parameters. The purpose of this regulation is to encourage investment in these activities and to combat greenwashing. The Regulation requires companies to report on key performance indicators (KPIs) defined in delegated acts adopted by the Commission.[67] Companies subject to the disclosure requirements of the CSRD must report the information required by the Taxonomy Regulation. The disclosure requirements have already come into force for some companies, and the process will be fully phased in over the coming years.[68]

The Regulation distinguishes between taxonomy-eligible and taxonomy-aligned activities: i) taxonomy-eligible activities are the economic activities identified in the delegated regulations, regardless of whether they meet any or all of the technical screening criteria to be considered taxonomy-aligned. Therefore, the fact that an economic activity is eligible for the taxonomy does not provide any indication of its actual environmental performance and sustainability; ii) taxonomy-aligned activities are defined as those that meet certain requirements to be considered environmentally sustainable.

An economic activity is defined as environmentally sustainable if it meets the following requirements: i) it contributes substantially to at least one of the six environmental goals set out in the Regulation (climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems); ii) it does not cause significant harm to one or more of the other environmental objectives, i.e. the do no significant harm (DNSH) principle; iii) it complies with certain minimum social safeguards; and iv) it meets the technical screening criteria (TSC) laid down by the Commission in its delegated acts.

Information requirements are different for financial and non-financial companies. For non-financial companies, the KPIs to be reported on include: i) the share of turnover (Turnover) from products or services associated with economic activities that qualify as environmentally sustainable; ii) the share of capital expenditure (CapEx) related to assets or processes associated with economic activities that qualify as environmentally sustainable; and iii) the share of operating expenses (OpEx) related to assets or processes associated with economic activities that qualify as environmentally sustainable. Financial institutions must report on, among other things, the greenness of their financial assets (Green Asset Ratio, GAR).

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[66] For more details on the CSRD, see T. Loizzo and F. Schimperna, 'ESG disclosure: regulatory framework and challenges for Italian banks', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 744, 2022; and L. Lavecchia, J. Appodia, P. Cantatore, R. Cappariello, S. Di Virgilio, A. Felettigh, A. Giustini, V. Guberti, D. Liberati, G. Meucci, S. Piermattei, F. Schimperna, and K. Specchia, 'Data and methods to evaluate climate-related and environmental risks in Italy', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 732, 2022.

[67] For more details, see the 'Climate Delegated Act' (Commission Delegated Regulation (EU) 2021/2139) and its two amendments (Commission Delegated Regulation (EU) 2022/1214 and Commission Delegated Regulation (EU) 2023/2485); the 'Disclosure Delegated Act' (Commission Delegated Regulation (EU) 2021/2178); and the 'Environmental Delegated Act' (Commission Delegated Regulation (EU) 2023/2486).

[68] According to Commission Delegated Regulation (EU) 2021/2178, the phase-in period will end on 1 January 2026.

2.3.3 EBA ITS on Pillar 3 ESG Disclosure

In January 2022, the EBA published implementing technical standards (ITS) on the prudential disclosure of ESG risks to strengthen the current Pillar 3 framework. [69] The EBA ITS require large institutions which have issued securities that are admitted to trading on a regulated market of any Member State[70] to disclose qualitative and quantitative information on ESG risks, with a particular focus on climate risk, and quantitative information based on key performance indicators (KPIs), including the GAR and the Banking Book Taxonomy Alignment Ratio (BTAR).[71]

The EBA ITS includes three tables that institutions can use to disclose qualitative information on environmental, social and governance risks (one for each type of risk), divided into the following three sections: i) business strategy and processes; ii) governance; and iii) risk management.[72] Quantitative information must be disclosed using: i) templates for climate change-related transition risk; ii) a template for climate change-related physical risk; iii) templates for KPIs and other mitigation actions not covered by Regulation (EU) 2020/852.[73]

2.3.4 CRD VI

CRD VI introduces new provisions and adjustments to several articles to strengthen the focus on ESG risks faced by institutions in their prudential framework. Specifically:

- Articles 73 and 74 were amended to require that short-, medium- and long-term horizons of ESG risks be included in credit institutions' strategies and processes for evaluating internal capital needs as well as adequate internal governance;
- Article 76 was amended by adding a reference to the current and forward-looking impacts of ESG risks and the requirement for management bodies to develop concrete plans to address these risks.

Additionally, the new Article 87a requires competent authorities to ensure that institutions have, as part of their robust governance arrangements including the risk management framework required under Article 74(1), robust strategies, policies, processes and systems for the identification, measurement, management and monitoring of ESG risks over the short, medium and long term. These strategies, policies, processes and systems shall be proportionate to the scale, nature and complexity of the ESG risks of the business model and scope of the institution's activities, and consider short-, medium- and a long-term horizon of at least 10 years. Competent authorities shall ensure that institutions test their resilience to long-term negative impacts of ESG factors, both under baseline and adverse scenarios within a given timeframe, starting with climate-related factors.

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[69] https://www.eba.europa.eu/activities/single-rulebook/regulatory-activities/transparency-and-pillar-3/implementing-technical-standards-its-prudential-disclosures-esg-risks-accordance-article-449a-crr

[70] With the entry into force of CRR III, this obligation will be extended to all institutions.

[71] The GAR shows the ratio of a credit institution's assets used to finance taxonomy-aligned economic activities to its total covered assets in accordance with points 1.1.2 and 1.2 of Annex V to Delegated Regulation 2021/2178. The BTAR differs from the GAR in that its numerator also includes taxonomy-aligned exposures to non-financial corporations that do not fall within the scope of the CSRD (i.e. SMEs).

[72] The third table (for qualitative information on governance risk) does not have a section on business strategy and processes.

[73] For more details, see T. Loizzo and F. Schimperna, 'ESG disclosure: regulatory framework and challenges for Italian banks', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 744, 2022.

3. Potential scope of application for Italian non-financial and financial companies and breadth of their respective chains of activities

The CSDDD applies to financial undertakings and non-financial companies. The following section analyses the two categories separately.

3.1 Non financial companies

Based on an analysis of the 2022 financial statements, the number of Italian non-financial undertakings that meet the size thresholds set out in Article 2 of the CSDDD (excluding those that could qualify due to royalty income) is estimated at almost 650;[74] more than two thirds are parent companies of large groups. Companies that would be subject to the CSDDD employ about 3.9 million workers and generate nearly €348 billion in value added (equivalent to 26 per cent of the total value added of the non-financial private sector;[75] Figure 1). These numbers may underestimate the scope of the Directive, as other enterprises with different legal forms for which we do not have firm-level information, may exceed the size thresholds.

Figure 1: the estimated CSDDD phase-in plan for Italian non-financial companies

	2027	2028	2029
Phase-in thresholds: - *# employees* - *Net turnover*	 > 5,000 > €/mln 1,500	 > 3,000 > €/mln 900	 > 1,000 > €/mln 450
Number of non-financial companies	131	233	649
Number of workers (millions of people)	2.3	2.9	3.9
Value added (billions of euros)	209	255	348

Source: our own calculations based on Cerved data (2022)

The number of firms in scope is therefore much lower than that of the companies covered by the CSRD. According to our calculations, the CSRD, when fully implemented, will cover about 9,400 non-financial corporations (of which about 3,700 are parent companies). These employ approximately 6.6 million people and generate about €585 billion of value added (44 percent of the total value added of the non-financial private sector).

The companies potentially subject to the CSDDD are distributed unevenly across Italy: about two fifths of them are located in Lombardy and over 90 per cent are in the center and north of the country, reflecting the higher concentration of firms (especially large ones) in this area.[76] In terms of sectoral composition, over 50 per cent operate in manufacturing. Among manufacturing activities, the production of basic metals and the processing of metal products (19 per cent of manufacturing companies), the food and beverage industry (14 per cent), and the manufacture of machinery and equipment (13 per cent) would be most affected by the Directive.

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[74] Including real estate and holding companies.

[75] Consolidated financial statements are considered for companies at the head of groups.

[76] Enterprises are located according to their legal seat. The location of production facilities and that of their economic activities may therefore be different, at least in part.

The economic weight of Italian companies subject to the CSDDD in relation to the national economy is estimated to be lower than that in other major European economies, reflecting the smaller average size of firms in Italy. According to Eurostat data, the turnover of large Italian companies (defined as those with at least 250 employees) was 37 per cent of the total private sector, compared with 45 per cent in Spain and over 60 per cent in France and Germany.

The due diligence process for EU companies and non-EU companies operating in the EU extends to their subsidiaries. The number of subsidiaries of Italian companies falling within the scope of the Directive amounts to about 2,650.[77]

The due diligence obligations cover the whole chain of activities, with the limits described in Section 2 of the CSDDD. The Directive provides a broad definition of this concept: its operational implementation, as well as the type of supervision and inspections to be carried out by the national competent authorities, remain to be defined. The stringency of operational details and supervisory practices will determine the effectiveness of the Directive in mitigating violations of human rights and environmental standards, as well as the resulting administrative burden for companies.

Quantifying the scope of the chain of activities is difficult from both an analytical and a conceptual point of view. Istat's permanent census of enterprises, which provides information on the type and number of business relationships between firms (Table 2), may offer some preliminary insights. According to the census, 57 per cent of large companies – defined as those with at least 250 employees, which is a much lower threshold than that used in the Directive – had principal-agent relationships with other companies in 2022, i.e. they ordered and/or purchased goods or services by providing technical specifications and a required design (as asked in the survey question). In a significant number of cases, these relationships involve many counterparties. Some 41 per cent of small firms (those with 10 to 49 employees) have at least one subcontracting relationship. However, it is impossible to tell from the aggregate data whether these client relationships are with larger or smaller firms. Based on this data, it is possible to argue that the number of suppliers to large companies could be in the tens of thousands.

These analyses, however, might measure the extent of the chain of activities with some error, as the definition of client relationship might not be in line with that of the CSDDD. In addition, some other Italian companies are likely to be affected by the CSDDD due to their participation in the chain of activities of large European companies.

Table 2: Firms' client relationships

	Total	*Type of relationships:*		
		at least one relationship	at least one principal-agent relationship	at least one subcontracting relationship
Small (10-49)	189,222	110,010	67,825	76,654
Medium-sized (50-249)	22,861	16,112	10,797	11,519
Large (250+)	3,969	3,057	2,273	2,147

Source: Istat's permanent census of enterprises (2022)

[77] The figure refers to partnerships or companies with at least 50 per cent of the share capital directly owned by companies covered by the Directive.

3.2 Financial undertakings

For the purposes of the CSDDD, 'net turnover' for financial undertakings is defined in accordance with the Corporate Sustainability Reporting Directive (CSRD) amendment to Directive 2013/34/EU (the 'Accounting Directive') in Article 2(5). Specifically, the amendment requires the use of the definition of 'net turnover' based on Article 43(2)(c) of Council Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions.

However, even if the concept of net turnover is the same for the purposes of the CSRD and the CSDDD, the two directives apply different thresholds to establish whether a financial undertaking is subject to their provisions. The CSDDD requires a higher net turnover than the CSRD: the former requires a minimum net turnover of €450,000,000, while the latter requires €10,000,000 if the undertaking is listed on a regulated financial market and qualifies as a small or medium-sized enterprise under the Accounting Directive, or €50,000,000 if the undertaking qualifies as a large enterprise under the Accounting Directive (even if it is not listed).

To define the scope of application for Italian financial undertakings it should be noted that the vast majority of banks and non-bank financial institutions apply IFRS accounting standards for their annual accounts. Therefore, in order to estimate the number of financial undertakings subject to the CSDDD, it is necessary to reconcile the balance sheet items required by the IFRS accounting standards with those required by Council Directive 86/635/EEC.

Specifically, Article 43(2)(C) of Council Directive 86/635 requires the inclusion of certain profit and loss account items in the calculation of net turnover, which in some cases are not so readily reconcilable with the balance sheet items presented by IAS/IFRS adopters.

With this in mind, in Table 3 we provide a reconciliation – based on our own assessment and interpretation of Article 43(2)(C) of Council Directive 86/635 – between the balance sheet items to be taken into account for the definition of net turnover for financial undertakings that apply IAS/IFRS.

Table 3 maps out the profit and loss items required by Article 43(2)(C) of Council Directive 86/635 and the profit and loss items required by the FINREP framework for financial undertakings applying IAS/IFRS, as laid down in Regulation (EU) 2021/451 – ITS on supervisory reporting for institutions, Annex III and V.

Table 3: Reconciliation between Council Directive 86/635 and FINREP balance sheet items

Article 43(2)(C); Article 27 (1), (3), (4), (6) and (7) – Directive 86/635		FINREP items taken into account for the definition of net turnover in the CSRD and the CSDDD
Balance sheet items	*Description*	
1. Interest receivable and similar income, showing separately that arising from fixed-income securities	These items shall include all profits and losses arising out of banking activities, including: (1) all income from assets entered under Assets items 1 to 5 in the balance sheet, however calculated. Such income shall also include income arising from the spreading on a time basis of the discount on assets acquired at an amount below, and liabilities contracted at an amount above, the sum payable at maturity; [...] (3) income and charges resulting from covered forward contracts, spread over the actual duration of the contract and similar in nature to interest; (4) fees and	**010.** Interest income

	commission similar in nature to interest and calculated on a time basis or by reference to the amount of the claim or liability (Article 29 of Council Directive 86/635).	
3. Income from securities: a) Income from shares and other variable-yield securities; b) Income from participating interests; c) Income from shares in affiliated undertakings	This item shall comprise all dividends and other income from variable-yield securities, from participating interests and from shares in affiliated undertakings. Income from shares in investment companies shall also be included under this item (Article 30 of Council Directive 86/635).	**160.** Dividend income
4. Commissions receivable	Without prejudice to Article 29, commissions receivable shall include income in respect of all services supplied to third parties, and commissions payable shall include charges for services rendered by third parties, in particular: commissions for guarantees, loans administration on behalf of other lenders and securities transactions on behalf of third parties; commissions and other charges and income in respect of payment transactions , account administration charges and commissions for the safe custody and administration of securities; commissions for foreign currency transactions and for the sale and purchase of coin and precious metals on behalf of third parties; and commissions charged for brokerage services in connection with savings and insurance contracts and loans (Article 31 of Council Directive 86/635).	**200.** Fee and commission income
6. Net profit or net loss on financial operations	Net profit or net loss on financial operations. This item covers : 1) the net profit or loss on transactions in securities which are not held as financial fixed assets together with value adjustments and value re-adjustments on such securities, taking into account, where Article 36(2) has been applied, the difference resulting from application of that article; however, in those Member States which exercise the option provided for in Article 37, these net profits or losses and value adjustments and value re-adjustments shall be included only in so far as they relate to securities included in a trading portfolio; 2) the net profit or loss on exchange activities, without prejudice to Article 29, point 3; 3) the net profits and losses on other buying and selling operations involving financial instruments, including precious metals (Article 32 of Council Directive 86/635).	**280.** Gains or losses on held for trading (HFT) **287.** Gains or (-) losses on non-trading financial assets mandatorily at fair value through profit or loss, net **290.** Gains or losses on financial assets and liabilities designated at fair value through profit or loss, net **300.** Gains or losses from Hedge Accounting **310.** Exchange differences, net **220.** Gains or (-) losses on derecognition of financial assets and liabilities not measured at fair value through profit or loss, net
7. Other operating income		**340.** Other operating income

Source: our own elaboration

Based on the above, and considering the relevant figures from the annual accounts of Italian financial undertakings for the financial years 2022 and 2023 (i.e. net turnover and average number of employees), the scope of application of the CSDDD is estimated to include 12 significant banks, 8 non-significant banks and 2 non-bank financial intermediaries (Figure 2).

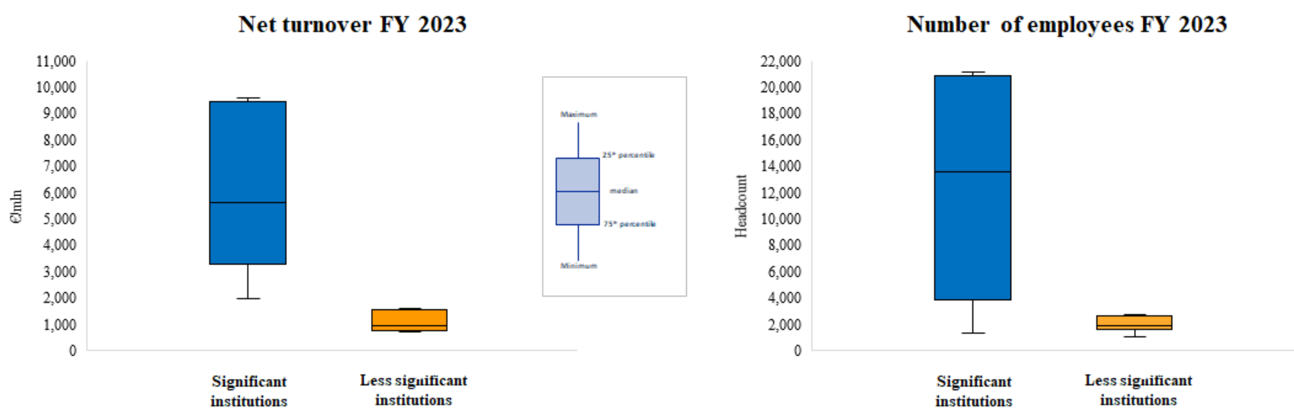
Figure 2: CSDDD phase-in plan for Italian financial undertakings

	2027	2028	2029
Phase-in thresholds: - *# employees* - *Net turnover*	> 5,000 > €/mln 1,500	> 3,000 > €/mln 900	> 1,000 > €/mln 450
Significant institutions	9	11	12
Less significant institutions	1	1	8
Other financial institutions	1	1	2

Source: our own calculations based on the annual accounts of Italian financial undertakings for the financial years 2022 and 2023. The values in Figure 2 refer to the number of financial undertakings

As shown in Figure 3, the data for the Italian financial undertakings covered by the CSDDD show significant differences in terms of both net turnover and number of employees.

Figure 3: Net turnover and number of employees of significant and less significant institutions that are estimated to be affected by the CSDDD for the financial year 2023



Source: our own calculations based on the annual accounts of Italian financial undertakings for the financial year 2023

As financial services are excluded from the definition of chain of activities, it is reasonable to assume that for supervised intermediaries, due diligence obligations will in practice have a limited impact, primarily on the relationships with the industrial suppliers from whom they procure the goods and services essential to financial service activities (e.g. software houses, outsourcers, etc.).

3.2.1 What-if analysis of the review clause of the CSDDD

In view of the aforementioned review clause of the CSDDD, which could potentially lead to the future inclusion of financial service recipients in the chain of activities of financial undertakings, a what-if analysis of the potential breadth of the chain of activities for Italian banks and other financial intermediaries was carried out.

This assessment provides an initial quantification of the commitment that could be required of Italian banks and other financial intermediaries in terms of due diligence obligations in relation to entrusted counterparties in their chain of activities, as well as the potential legal risks arising from non-compliance with such obligations.

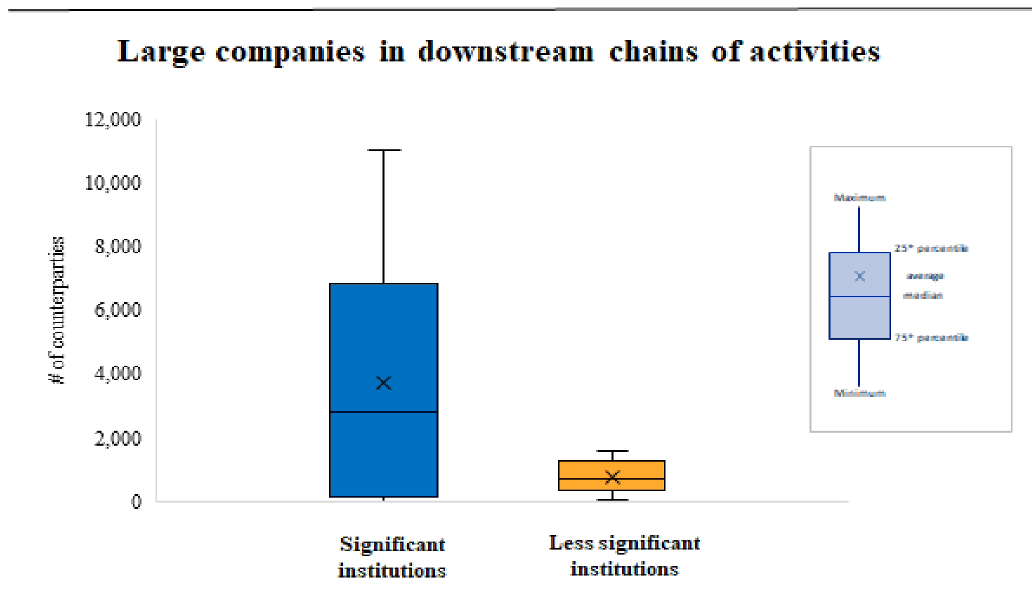
To quantify the potential breadth of this 'extended' chain of activities for the financial sector, the following steps were taken:

- it was assumed that the extension of the chain of activities would lead to the inclusion of the activities of all large companies entrusted by banks and non-bank financial institutions (in line with the European Commission's proposal of the CSDDD, which excluded only small and medium-size enterprises from the chain of activities of financial undertakings);
- data from Banca d'Italia's Central Credit Register were used to identify the large companies entrusted by banks and non-bank financial institutions;
- for each bank and other financial intermediary falling within the scope of the CSDDD, the number of large companies entrusted was calculated.

The results show that the number of counterparties to be considered as part of the of the chain of activities for significant institutions (SIs) may vary considerably. In particular, the number of counterparties in the chain of activities may vary between 1 and 11,000, with an average of about 3,700.

The Italian less significant banks falling within the scope of the CSDDD would also be affected, although to a lesser extent than the SIs, with a chain of activities consisting on average of around 800 companies. Again, there would be significant differences in the number of relevant counterparties for the banks in the sample (Figure 4).

Figure 4: Number of large undertakings receiving financial services in the chain of activities of significant and less significant institutions



Source: our own calculations based on the annual accounts of Italian financial undertakings for the financial year 2023 and Banca d'Italia's Central Credit Register

Finally, only two of the other financial intermediaries would fall within the scope of the CSDDD, and only one of these has counterparties that could be considered in its chain of activities (as they are large companies).

It should be noted that the quantification of non-financial companies that could fall within the chain of activities of banks presents a much higher number than the scope of the Directive for directly affected non-financial companies, as the thresholds taken into account are different. Indeed, for the estimation of the non-financial companies that will fall within the scope of the CSDDD, the size thresholds envisaged by the final text of the Directive were taken into account, i.e. average number of employees exceeding 1,000 and average turnover exceeding € 450 million. On the other hand, for the estimation of non-financial companies that could potentially be part of the banks' chain of activities, the size thresholds assumed by the European Commission and the European Parliament in the previous texts of the CSDDD, which prescribed the obligation - later eliminated - to consider non-financial companies receiving financial services in the banks' chain of activities, were considered. In particular, the size thresholds taken into consideration are those considered for the definition of large undertaking provided for in Article 3, paragraph 4 of Directive 2013/34/EU, which defines large undertaking as those companies that exceed two of the following three criteria: a) balance sheet total: € 25,000,000; b) net revenues from sales and services: € 50,000,000; c) average number of employees during the financial year: 250.

4. The potential effects of the CSDDD

4.1. Sustainability-enhancing effects of the Directive

The importance of the environmental and social impact of economic activity is widely recognized and regulated at European and national level (labour law, environmental law, etc.). Albeit innovative for EU law, the CSDDD is part of the so-called 'modern anti-slavery laws' that have been implemented in various jurisdictions in recent years, but whose effects are difficult to assess.[78] The stated goal of the CSDDD is to limit violations of human rights and environmental law by forcing large companies that directly or indirectly contribute to them to change their business practices.

Compared with other pieces of EU financial regulation aimed at promoting sustainability and respect for human rights, the CSDDD has a different logic. Directives imposing disclosure requirements harness the functioning of markets to induce firms to adopt behaviours that are difficult to impose through regulation (not least because of the complexity and dynamic nature of production processes). Extensive disclosure requirements should affect the cost of capital for (more or less) sustainable companies, thereby inducing them to adopt behaviours that are consistent with sustainability goals. Moreover, the CSRD might also have an impact on product markets, insofar as consumers prefer more sustainably produced goods or services, and on the labour market, as workers prefer to work for companies with a more sustainable record. These laws act on the markets to push companies towards a more sustainable path. Since they do not impose specific actions, but rather require the provision of information to the market, the disclosure duties are far-reaching in terms of the detail of ESG factors. Conversely, the CSDDD goes beyond disclosure requirements and directly imposes substantive obligations on companies (e.g. the assessment of actual or potential adverse impacts; remediation of actual damages; monitoring to prevent breaches, etc.). The scope of these obligations, however, is rather limited compared with disclosure-based legislation, as they only cover fundamental human rights and key principles to tackle environmental degradation and climate change.

The effectiveness of the Directive in pursuing its goal is difficult to assess at this stage based on the available data. It will depend on how the chain of activities will be defined, how private enforcement rights will be exercised and how public supervision will be carried out.

Conceptually, it is not easy to define the boundaries of a chain of activities and therefore the scope of due diligence, especially regarding relationships with business partners that are indirectly involved in the production processes and with whom there are no direct commercial agreements. From an operational standpoint, it is important that the European Commission issues detailed guidelines to ensure the effectiveness of the Directive, maintains a level playing field, and reduces the risk of regulatory arbitrage.[79]

A key question is whether the companies subject to regulation actually align their activities with the requirements of the CSDDD or if there is scope for circumventing regulatory constraints by complying

[78] P. Zumbansen, 'Global value chain legislation, modern slavery, climate change and finance: lessons from the European Corporate Sustainability Due Diligence Directive("CSDDD")', McGill Research Paper, 8, 2024.

[79] Article 19 of the CSDDD states that 'in order to provide support to companies or to Member State authorities on how companies should fulfil their due diligence obligations in a practical manner, and to provide support to stakeholders, the Commission, in consultation with Member States and stakeholders, the European Union Agency for Fundamental Rights, the European Environment Agency, the European Labour Authority, and where appropriate with international organisations and other bodies having expertise in due diligence, shall issue guidelines, including general guidelines and sectors pecific guidelines or guidelines for specific adverse impacts. The guidelines to be issued pursuant to paragraph 1 shall include: […] practical guidance on the transition plan as referred to in Article 22 […]'

without taking tangible action. While it is difficult to make an assessment specific to the CSDDD, there is evidence of purely formal compliance with ESG disclosure requirements. This may occur, for example, when disclosure obligations are met by reporting only on the sustainable operations of a company and omitting those activities that are not in line with the ESG objectives (greenwashing). There is evidence in the literature that there is a mismatch between the content of the disclosure and the tangible actions taken by companies, for example in the banking sector[80] and in a large sample of private equity firms.[81] Legislators need to avoid that organizational changes and due diligence activities under the CSDDD are merely formal measures rather than a real commitment to the objectives of the Directive. Moreover, some studies in the literature have highlighted the risks arising from strategic behaviour by companies that redesign their boundaries (and in particular outsource the most polluting activities to suppliers) to appear compliant, even without a significant overall impact on their production cycle.[82] The CSDDD addresses this risk, at least in part, by extending due diligence obligations to subsidiaries and the chain of activities of companies.

Another important issue is the actual enforcement of the Directive's provisions. The Directive provides for both private and public enforcement mechanisms. According to national experience (see Box 1), their interaction usually leads to greater compliance. Private enforcement can be a helpful tool, although organizations representing collective interests are not granted autonomous rights of action against firms. The possibility of seeking injunctions in addition to damages may increase the ability of civil society organizations to have an impact and to stop harmful behaviour while it is still taking place. Some aspects of the Directive would require attention as they could weaken enforcement. First, the burden of proof is mainly on the actors. Secondly, firms might be held liable only on the basis of fault rather than strict liability. Finally, the approved version of the Directive states that the 'company cannot be held liable if the damage was caused only by its business partners in its chain of activities' which, depending on how the provision is interpreted by future case, could substantially limit the liability of undertakings for the activities taking place along their chain of activities.

Finally, appropriate public supervision of the due diligence obligations is key to ensuring effective, rather than formal, compliance with the Directive. Coordination between national supervisory authorities in both their supervision practices and enforcement strategies is essential to guarantee a level playing field for EU companies and to make the most out of the extraterritorial reach of the Directive so as not to hamper the competitiveness of EU firms.

4.2. Economic effects of the Directive

The Directive entails costs for companies to carry out due diligence and to set up the organizational structure for this activity. It is impossible to assess these costs based on the available data, but there is evidence that firms falling within the scope of the Directive may already be carrying out some form of due diligence in line with emerging international best practices. Furthermore, costs will depend crucially on the development of a competitive market for this type of professional service and on the ability of firms to carry out some of the activities necessary for due diligence internally.

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[80] M. Giannetti, M. Jasova, M. Loumioti and C. Mendicino, '"Glossy Green" Banks: The Disconnect Between Environmental Disclosures and Lending Activities', Swedish House of Finance Research Paper, 7, 2023; P. Sastry, E. Verner and D. Marques-Ibanez, 'Business as usual: bank climate commitments, lending, and engagement', European Central Bank Working Paper Series, 2921, 2024.

[81] J. K. Abraham, M. Olbert and F. P. Vasvari, 'ESG Disclosures in the Private Equity Industry', Accounting for Transparency Working Paper Series, 132, 2023.

[82] R. Duchin, J. Gao and Q. Xu, 'Sustainability or Greenwashing: Evidence from the Asset Market for Industrial Pollution', *Journal of finance*, forthcoming.

While there are no data available to fully assess these costs – partly because there are no accurate data on the full extent of the human and environmental rights violations – some evidence can be gathered indirectly through the information that companies disclose about the measures they take to reduce the environmental impact of their operations. This exercise only provides a general sense of the costs associated with the Directive, with a high degree of uncertainty: on the one hand, the estimated costs of improving environmental performance may exceed what is necessary to respect the rights enshrined in the international treaties listed in the Annex to the Directive, and may therefore be overestimated; on the other hand, the costs disclosed by firms generally relate to their operations and do not take account of the costs arising from their chain of activities, therefore they might be underestimated. Finally, these disclosed costs relate only to environmental action and not to the respect of human rights.

Data from Istat's permanent census of enterprises show that a large share of companies pay attention to environmental sustainability (Table A1). In 2018, about 84 per cent of large businesses (with at least 250 employees) reported taking actions to reduce the environmental impact of their operations.[83] The spread of environmental actions is fairly even across Italy: it is above 80 per cent in all geographical areas and decreases slightly from the north to the south of the country. Environmental awareness is higher in the manufacturing sector, where about 95 per cent of large companies are involved in reducing the environmental impact of their operations, while the percentage is lower in services with a high carbon footprint, such as transport and storage. The share of businesses taking action to reduce their environmental impact was lower among smaller companies, which could be indirectly affected by the CSDDD because they are subsidiaries of large companies or are part of the chains of activities concerned.

Environmental sustainability measures are taken both to align with the corporate strategy and to improve stakeholder relations; other reasons, such as tax benefits, play a secondary role. These statements are confirmed, at least in part, by tangible corporate actions (Table A2). Nearly 60 per cent of the large businesses surveyed by Istat report having invested in machinery that reduces energy consumption, nearly 30 per cent in improving the energy efficiency of their buildings, almost 20 per cent in the production of renewable energy and a similar percentage in the purchase of electric or hybrid vehicles. Only a small share of these investments – between 25 to 50 per cent, depending on the type of investment – were made using incentives (Table A2).

Overall, this evidence suggests, albeit indirectly, that the costs imposed by the European ESG Directives (and therefore not only by the CSDDD) may not be particularly high. Indeed, large companies have the capacity to take the necessary organizational measures and have already started to reduce the environmental impact of their production processes. The impact on smaller companies may be more complex to assess.

The Directive is also likely to have positive economic effects. In general, empirical studies confirm the hypothesis of a positive effect of ESG awareness on the value of companies[84] or their resilience[85]. First, better functioning of internal processes in a company, such as accounting practices, governance

[83] A qualitatively similar picture emerges from the most recent business census data, covering the period 2021-2022. These data show that the most common actions in the area of environmental sustainability are waste management, energy efficiency improvement plans, pollution monitoring (including CO^2 emissions) and the use of recycled materials.

[84] E. Dimson, O. Karakaş and X. Li, 'Active Ownership', *The Review of Financial Studies*, 28, 12, 2015, pp. 3225-3268; A. Ferrell, H. Liang and L. Renneboog, L., 'Socially Responsible Firms', Journal of Financial Economics, 122, 3, 2016, pp. 585-606.

[85] K.V. Lins, H. Servaes and A. Tamayo, 'Social Capital, Trust, and Firm Performance: The Value of Corporate Social Responsibility during the Financial Crisis', *The Journal of Finance*, 72, 4, 2017, pp. 1785-1824.

and labour productivity, might improve the economic performance of a company, for example because workers may find greater satisfaction in working in companies that strive for sustainable growth, greater safety and better working conditions, or because the pressure to adopt more advanced management and evaluation systems may lead to organizational improvements. Other benefits may come from external stakeholders, such as higher revenue growth or reduced business risk, [86] as consumers may be more inclined to purchase products and services from compliant businesses.[87] Conversely, companies that are sanctioned for violating the Directive may also be punished by stakeholders. Moreover, due diligence requirements may propagate along the supply chain and influence environmental and social corporate policies through business relationships.[88] Second, increased corporate transparency and the ability to conduct due diligence on companies' own operations could have positive effects because firms may obtain more favorable credit terms (although these favorable terms may sometimes have unintended effects[89]).

The Directive could also affect the geographical localization of production activities – with an impact that is not clearly predictable in advance – depending on how evenly the CSDDD is applied across jurisdictions, on business assessments of compliance costs and benefits of due diligence, and on the degree of enforcement by foreign suppliers of European businesses. On the one hand, the Directive may encourage the reshoring of activities, increasing output and employment in the EU at the expense of production and supply partners previously located in areas with lower standards of human rights and environmental protection. Furthermore, second-order effects may arise from the higher cost of sourcing intermediate inputs from outside the EU. On the other hand, if compliance with the Directive is considered excessively costly and the degree of enforcement by suppliers located in other parts of the world is lower, offshoring to areas outside the EU could occur.

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[86] E. Dimson, O. Karakaş and X. Li, 'Active Ownership', *The Review of Financial Studies*, 28, 12, 2015, pp. 3225-3268; A. Ferrell, H. Liang and L. Renneboog, L., 'Socially Responsible Firms', Journal of Financial Economics, 122, 3, 2016, pp. 585-606; K.V. Lins, H. Servaes and A. Tamayo, 'Social Capital, Trust, and Firm Performance: The Value of Corporate Social Responsibility during the Financial Crisis', *The Journal of Finance*, 72, 4, 2017, pp. 1785-1824; R. Albuquerque, Y. Koskinen and C. Zhang, 'Corporate Social Responsibility and Firm Risk: Theory and Empirical Evidence', Management Science, 65, 10, 2019, pp. 4451-4469; C. Flammer, 'Does Corporate Social Responsibility Lead to Superior Financial Performance? A Regression Discontinuity Approach', *Management science*, 61, 11, 2015, pp. 2549-2568.

[87] Similarly, negative reputational effects (press campaigns, etc.) – on the environmental impact of production, violations of workers' rights, etc. – could reduce demand. J.-M. Meier, H. Servaes, J. Wei and S. C. Xiao, 'Do Consumers Care About ESG? Evidence from Barcode-Level Sales Data', European Corporate Governance Institute – Finance Working Paper, 926, 2023.

[88] C. Shiller, 'Global Supply-Chain Networks and Corporate Social Responsibility', 13th Annual Mid-Atlantic Research Conference in Finance (MARC) Paper, 2018; R. Dai, H. Liang and L. Ng, 'Socially responsible corporate customers', *Journal of financial economics*, 142, 2, 2021, pp.598-626.

[89] S. Hartzmark and K. Shue, 'Counterproductive Sustainable Investing: The Impact Elasticity of Brown and Green Firms', 2023.

5. Conclusions

Financial and non-financial undertakings operating in Europe should prepare for the entry into force of the CSDDD, starting by considering whether they fall within its scope or whether their main business partners might. Undertakings in the scope of the Directive, either directly or indirectly through their business partners, should also compare their due diligence policies with the new requirements of the CSDDD in order to identify gaps and determine the necessary actions. The EU Commission's guidelines on how companies should fulfil their due diligence obligations will be crucial to ensure a level playing field and the effectiveness of the Directive.

The CSDDD intersects with several pieces of European prudential and non-prudential ESG legislation. In particular, the environmental and social due diligence obligations introduced by the CSDDD complement, for financial institutions, the prudential requirements on ESG risks set out in CRD VI and CRR III and in the EBA's draft guidelines on the management of ESG risks. Furthermore, the requirement to produce a transition plan under the CSDDD and the CSRD – focusing on the compatibility of business models with the objective of achieving net-zero GHG emissions by 2050 – should be consistent with the criteria, methodologies, assumptions, and targets of the plan required under Article 76 of CRD VI, which has a prudential purpose and is intended as a new risk management tool. However, there is not complete consistence in the scope of application of these pieces of legislation and, as a consequence, in the supervisory authorities: i) the scope of application of the CSDDD is narrower than that of both the CSRD and the ESG prudential regulation (which will apply to all financial intermediaries when fully implemented); ii) the supervisory authority for the CSDDD will be appointed in the coming years by UE Members States, while for CSRD the competent authority is the Italian Market Authority (Consob) for listed entities and for ESG prudential regulation (CRD VI and CRR III) are the ECB and Banca d'Italia for significant and less-significant institutions, respectively.

The aforementioned ESG level 1 regulation will also need to be complemented by guidelines and implementing technical standards in the coming years. For example, the European Commission will need to work on guidelines to assist companies in complying with the due diligence obligations introduced by the CSDDD, including practical guidance on transition plans; EBA will publish the final version of the guidelines on the management of ESG risks, and will specify, among other things, the content of prudential transition plans; the EFRAG will work on sectoral standards for the ESG disclosure under the CSRD for the banking sector. In this context, coordination and discussion between different regulatory and supervisory authorities is paramount to ensure a robust implementation of this new regulatory framework.

In terms of impact, although the scope of the CSDDD is limited to the largest financial and non-financial companies, the overall effect of the Directive is difficult to assess. While it complements other pieces of EU law harnessing the functioning of markets to promote sustainability, its effectiveness depends largely on real rather than formal compliance and on the ability of supervisory authorities to enforce compliance, both within the EU and along the chains of activities on which modern industries depend. The economic effects are also difficult to evaluate: compliance costs may not be particularly high and the organizational effects of the due diligence obligations might bring positive economic results. Moreover, compliant firms may be more competitive in the product, labour and financial markets. The effects on the geographical localization of business activities are also difficult to predict, but consistent enforcement can prevent offshoring (or even encourage reshoring) and create an effective level playing field for companies.

Over the next two years the European Commission will evaluate the need for additional sustainability due diligence requirements tailored to regulated financial undertakings in relation to the provision of financial services and investment activities in the chains of activities. In order to avoid unintended effects, this assessment could benefit from a constructive discussion with supervisory authorities and trade associations in the financial and non-financial industry.

Table A1: Share of companies that report taking action to reduce their environmental impact and their motivation (1)

	% of companies that reduce the environmental impact of their operations	Motivation:					
		It is in line with the main activity or with the legal form of the company	It is part of the company's strategy or mission	It improves the company's image with clients or suppliers	It strengthens ties with the local community	It is profitable due to specific tax benefits or subsidies	Other reasons
Micro (3-9)	65%	28%	22%	32%	17%	5%	26%
Small (10-49)	71%	27%	32%	32%	14%	6%	22%
Medium-sized (50-249)	76%	27%	46%	37%	17%	6%	17%
Large (250+)	84%	26%	61%	44%	25%	8%	15%

(1) The percentages shown refer to firms that report taking action to reduce their environmental impact (Column 1) and their motivation for doing so.

Source: Istat's permanent census of enterprises (2018).

Table A2: Share of companies investing to reduce their environmental impact and the role of tax incentives (1)

		Thermal insulation of buildings or construction of low energy consumption buildings	Installation of equipment for the production of renewable electricity	Installation of equipment for the production of renewable thermal energy	Installation of equipment for cogeneration, trigeneration or heat recovery	Purchase of electric or hybrid vehicles	Other investment
Micro (3-9)	25% (4%)	8% (2%)	4% (2%)	3% (1%)	2% (0%)	3% (1%)	9% (2%)
Small (10-49)	33% (9%)	12% (4%)	8% (4%)	4% (2%)	3% (1%)	5% (1%)	12% (3%)
Medium-sized (50-249)	45% (14%)	18% (6%)	13% (7%)	5% (2%)	5% (2%)	10% (2%)	16% (4%)
Large (250+)	58% (16%)	28% (9%)	19% (9%)	9% (3%)	12% (5%)	19% (4%)	23% (5%)

(1) The percentages shown refer to companies making a given type of investment as a share of the total number of companies in the same size category. Percentages in brackets refer to companies that invest using tax incentives as a share of the total number of companies in the same size category.

Source: Istat's permanent census of enterprises, (2018).

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