LMA | Loan Market Association

Ms Lara Wolters MEP
Parlement européen
Bât. ALTIERO SPINELLI
15G103
60, rue Wiertz / Wiertzstraat 60
B-1047 Bruxelles/Brussel

Loan Market Association
10 Upper Bank Street,
London
E14 5JJ

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BY EMAIL

Corporate Sustainability Due Diligence Directive

Dear Ms Lara Wolters,

The Loan Market Association ("**LMA**") has been closely following the development of the proposed Directive on corporate sustainability due diligence ("**CS3D**").

The LMA supports the CS3D's aim of fostering sustainable and responsible corporate behaviour. At the same time, we are keen to ensure the development of a framework that is proportionate, and which does not disrupt the operation of the syndicated loan market. In order to achieve this, we have indicated below where we would be supportive of amendments being proposed with respect to CS3D. Equally, other provisions within CS3D already help to ensure that the syndicated loan market will continue to function properly. It is essential that those provisions are retained in CS3D without amendment, and we therefore also draw your attention to those below.

The LMA is the trade body for the European, Middle Eastern and African syndicated loan markets. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 800 organisations across EMEA, including the European Commission, and consists of banks, non-bank investors, borrowers, law firms, rating agencies and service providers.

'Value chain' definition

The LMA welcomes the fact that, in respect of regulated financial undertakings listed in Article 3(a)(iv) CS3D, the 'value chain' definition is limited to downstream activities. It would be extremely burdensome for these firms to conduct due diligence in respect of upstream activities, (i.e., all companies that provide services to those firms). We therefore strongly support retaining this aspect of the 'value chain' definition without amendment.

However, we request that targeted CS3D amendments be proposed in order to:

- narrow the downstream activities that are in scope of the 'value chain' definition (i.e., so that this is limited to the activities of the company receiving the loan); and
- make clear that secondary loan trading does not form part of the 'value chain' for regulated financial undertakings.

Background

Article 3(g) CS3D states that "*'value chain' means activities related to the production of goods or the provision of services by a company, including the development of the product or the service and the use and disposal of the product **as well as the related activities of upstream and downstream established business relationships of the company***" (emphasis added). However, as regards regulated financial undertakings, 'value chain' has a narrower meaning since it "*shall only include the activities of the clients receiving such loan, credit, and other financial services and of other companies belonging to the same group whose activities are linked to the contract in question. The value chain of such regulated financial undertakings does not cover SMEs receiving loan, credit, financing, insurance or reinsurance of such entities*". This language indicates that 'value chain' relates only to the 'downstream' activities of regulated financial undertakings.

As you will be aware, other associations have flagged that financial institutions will face significant challenges with applying due diligence obligations to their downstream value chains.[1] We agree with these concerns and request that an amendment be proposed, in order to narrow the downstream activities that are captured by the 'value chain' definition for regulated financial undertakings. This could be achieved by specifying that the definition only applies to the activities of the client receiving the loan. Currently, other companies belonging to the borrower's group would also be in scope where the activities of those group companies are linked to the loan agreement. In practice, it is likely to be extremely challenging to determine when a group company's activities are linked to the loan agreement. It is also relatively unlikely that a regulated financial undertaking could influence the behaviour of a group company that it does not have a contractual relationship with.

In addition, our members are keen to ensure that the 'value chain' definition is not broadened to include the 'upstream' activities of regulated financial undertakings, as it would be extremely burdensome for a firm to conduct due diligence in respect of every company that provides a service to it. Consequently, whilst we would reiterate the points made in our previous paragraph, we request that the 'value chain' definition remain limited to the 'downstream' activities of regulated financial undertakings.

We also request that an amendment be proposed to make clear that secondary loan trading does not form part of the 'value chain' definition for regulated financial undertakings. Given the number of secondary loan trades that take place, and the short space of time within which those trades are agreed, it would be impractical for due diligence to be undertaken on each secondary loan trade.

Due diligence

The LMA supports the wording currently included in Article 6(3) CS3D, which provides that the identification of actual and potential adverse human rights impacts and adverse environmental impacts shall only be carried out before providing the loan service (i.e., rather than throughout the life of the loan). We would therefore be happy for the wording of this provision to be retained without amendment.

However, we request that amendments be proposed in respect of Articles 7(5)(b) and 8(6)(b) CS3D, to ensure that regulated financial undertakings are not required to terminate the loan contract, in order to prevent potential adverse impacts or end actual adverse impacts identified during the life of the loan. In this respect we note the proposals put forward in the Council's adopted negotiating position ('general approach').[2]

Background

[1] See, for example, the joint trade association position paper issued by AFME, ISDA, FIA and EPIF.
[2] https://data.consilium.europa.eu/doc/document/ST-15024-2022-REV-1/en/pdf. See, in particular, Articles 7(6) and 8(7).

Article 6(3) CS3D confirms that when regulated financial undertakings provide loans, "*identification of actual and potential adverse human rights impacts and adverse environmental impacts shall be carried out only before providing that service*". Conducting the due diligence prior to the provision of the loan would already be a considerable undertaking that would involve practical challenges. Our members would be extremely wary of any proposal that seeks to broaden the scope of the due diligence obligation (e.g., by requiring it to be conducted throughout the life of the loan), as doing so would impose onerous obligations on lenders and would significantly disrupt the operation of the syndicated loan market. We therefore strongly support retaining this provision without amendment.

Articles 7(5)(b) and 8(6)(b) CS3D both require companies to terminate the business relationship in certain circumstances. Whilst these requirements include exceptions for regulated financial undertakings providing loans, the circumstances in which these exceptions can be relied upon is unclear, since they require that the termination "*be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided*", but do not specify what "substantial prejudice" would mean in these circumstances. As well as having a detrimental impact on clients, the requirement to terminate the business relationship also goes beyond the obligations set out in the UN Guiding Principles on Business and Human Rights and the OECD Guidelines, which simply state that the enterprise should consider ending the relationship. Given the potential negative impact on the syndicated loan market, we would be supportive of amendments that proposed to remove these requirements from Articles 7(5)(b) and 8(6)(b) CS3D.

Territorial scope of application

We request that an amendment to CS3D be proposed to make clear that, in respect of non-EU firms, it only applies to activities with an EU nexus (e.g., where the client is incorporated in an EU Member State, or where all lenders under a syndicated loan are incorporated in EU Member States).

We would also strongly support the coordination of measures at an international level to avoid EU banks being rendered uncompetitive when pitching for business outside the EU.

Background

CS3D will apply to non-EU firms that satisfy one of the conditions laid down in Article 2(2)(a)-(b). To the extent that these non-EU firms undertake services that are within scope of CS3D, they would be required to comply with the obligations laid out in the Directive, irrespective of where those services are provided and who those services are provided to. This is because CS3D does not currently contain a provision limiting its scope to services that have an EU nexus. Consequently, services with no nexus would appear to be subject to the CS3D requirements. This extra-territorial obligation would be extremely onerous to comply with and could result in some non-EU firms exiting certain markets or ceasing to provide certain products which, in turn, would have a detrimental impact on market liquidity and overall competition within the market. We therefore request that an amendment be proposed to limit the scope of CS3D to activities that have a clear EU nexus.

EU firms will also be subject to the CS3D requirements when competing to provide in-scope services outside of the EU. These EU firms are likely to be placed at a disadvantage when competing for business with regional banks that are not subject to the CS3D obligations. In our view, measures should therefore be coordinated at an international level to avoid creating an uneven playing field for EU firms when providing services outside of the Union.

Liability

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We request that an amendment be proposed in respect of Article 22, to ensure that clients, rather than regulated financial undertakings, are made primarily liable for damage resulting from their actual adverse human rights impacts and adverse environmental impacts. Including firms in the chain of liability is likely to impact their willingness to extend credit in future, which would have a significant detrimental effect upon the syndicated loan market.

We also request that Article 7(2)(b) CS3D be amended, to provide for more practical actions that companies can take to avoid liability for damages. It is unfeasible to expect clients to give contractual assurances about their compliance with the company's code of conduct, as is currently contemplated in Article 7(2)(b) CS3D. This means that there are likely to be relatively few circumstances in which companies could rely on this exclusion to avoid liability for damages (even when those are caused by third parties).

Background

Article 22 contemplates that companies will be liable for damages where they have failed to comply with the obligations under Articles 7 and 8 CS3D, and an adverse impact, that should have been identified, prevented, mitigated, brought to an end or its extent minimised, occurred and led to damage. However, the limits of this liability are unclear (for example, what types of liability can be excluded, etc.,). The potential increased liability for damages could increase firms' regulatory capital requirements and make them less willing to extend credit in future, which would cause disruption to the syndicated loan market.

In order to potentially avoid liability for damages, Article 7(2)(b) CS3D contemplates that, where relevant, a company will "*seek contractual assurances from a business partner with whom it has a direct business relationship that it will ensure compliance with the company's code of conduct*". However, this is unlikely to be feasible as it would result in many clients being contractually obliged to comply with numerous codes of conduct. If EU firms are, in practice, unable to rely on this exclusion, they may opt to no longer provide certain services. This would reduce liquidity and negatively impact competition within the market. Consequently, we would be supportive of an amendment that sets out more practical actions that companies can take to avoid liability.

We would be very happy to discuss this further with you if that would be helpful. Please contact Gemma Lawrence-Pardew at the LMA (gemma.lawrencepardew@lma.eu.com) if you would like to arrange a meeting or call.

Yours faithfully,

Gemma Lawrence-Pardew

Director