LEGAL UPDATE

Managing ESG risks in bank-client relationships

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This summer, the amended Capital Requirements Directive (CRD VI) for banks has entered into force. In it, specific attention is given to managing Environmental, Social and Governance (ESG) risks. In practice, we see many banks experiencing challenges with managing ESG risks, including in the relationship with an individual borrower or account holder. Entering into or continuing a banking relationship with a client involved in unsustainable activities (e.g. deforestation or child labour) may violate laws, regulations or internal ESG policies and may ultimately damage the bank's own reputation. Banks are therefore increasingly trying to identify and minimise their exposure to ESG risks. This can be done by refusing certain non-sustainable parties as clients, requesting additional information from existing clients, urging clients to become more sustainable or, as an ultimate remedy, offboarding clients who do not (or no longer) fit within the ESG risk appetite.

Background management of ESG risks by banks

Banks increasingly attach importance to their customers (also) doing business in a responsible manner, given the financial and reputational risks that may arise if this is not the case. Despite the financial sector being exempted (for now) from the applicability of the European Corporate Sustainability Due Diligence Directive ("**CSDDD**") for its downstream activities (the activities of its customers and end-users), several other obligations addressing the management of ESG risks do apply. Banks' ESG controls are based on a combination of regulatory expectations, legal and regulatory obligations and, of course, banks' own commitments to minimise ESG risk exposures.

For instance, the ECB states in its ECB Guide on Climate and Environmental Risks (in Dutch) that it expects banks to establish policies for onboarding clients, responding to controversies and periodically screening clients for potential ESG risks. This requires banks to conduct client due diligence before entering into a relationship, as well as on an ongoing basis. Conducting such know your customer (KYC) checks is a well-known method for banks to determine their risk exposure and is also required under the Dutch Anti-Money Laundering and Anti-Terrorist Financing Act ("**AML Act**", *Wwft*). Regarding ESG risks, KYC-checks include testing clients against reputation-sensitive exclusion factors and identifying economic activities that are typically associated with negative ESG risks. The ECB expects the findings from the KYC-checks are taken into account when deciding whether or not to enter into or continue a client relationship. The changes in CRD VI that deal with managing ESG risks mainly build on and formalise the ECB's (already existing) expectations. CRD VI must be implemented in the Netherlands by January 10, 2026. As a result, the management of ESG risks is expected to become a permanent part of the controlled and sound business operation requirements (via Section 3:17 Dutch Financial Supervision Act ("**FSA**", *Wft*) and Section 4.2 Decree on Prudential Rules for Financial Undertakings (*Bpr Wft*)).

How do ESG policies affect the relationship with individual clients?

As is the case with regard to the AML Act and the FSA, which, among other things, aim to prevent involvement in financial economic crime, banks are reducing their exposure to ESG risks. The ESG risk appetite is reflected in the ESG policies of various banks. Each bank makes its own choices in this regard and may choose to not (or no longer) provide their services to certain sectors or impose specific requirements on clients to limit ESG risks. These choices are constantly changing and can also change under political pressure (see for example, the NVB position paper on defense financing (in Dutch)).

As a result of the ESG policies, banks screen (potential) clients for ESG-related negative media reports or involvement in sensitive sectors from a sustainability perspective. For instance, a 'hit' on a media report about oil pollution at sea or the supply of controversial weapons may lead a bank to be extra alert and conduct enhanced customer due diligence. A next step may be to ask a client about its activities, trading partners or purpose of its spendings. If it turns out a client facilitates unsustainable activities that fall outside the bank's ESG risk appetite, the bank may decide to not enter into the banking relationship with the client, ask the client to reduce its revenue share in unsustainable activities or ultimately terminate the banking relationship.

We expect an increase in proceedings on imposed ESG measures and 'ESG exits'. Banks should be able to adjust their ESG strategy and policy and therefore should also be able to decide not to accept certain sectors as clients (anymore). Here, we see possible parallels with the early years of the application of anti-money laundering rules, which provide useful insights on how to deal with forming policies regarding the acceptance, monitoring and offboarding of clients that do not (or no longer) fit within the bank's *risk appetite*. However, banks are always subject to a specific duty of care (*zorgplicht*). The decisive factor will then often be whether the client (group) is able to contract for banking services or obtain financing elsewhere.

For clients of banks, this means they should also assess the applicable banking framework. This applies specifically to clients operating in sectors with increased ESG risks. These risks are not only limited to their own operations and also extend to the larger distribution chain their operations are embedded in.

Do you have questions about ESG risk management policies? Or about the effect or implementation of ESG policies with regard to the individual client (portfolio)? Please feel free to contact one of our specialists.

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