

LEGAL OPINION

BAFA Guidance on the Application of the German Supply Chain Due Diligence Act (LkSG) to the Banking and Insurance Industry

Summary

Germanwatch and FIAN Germany commissioned the attorney Simon Simanovski to analyse whether the guidance issued by the Federal Office for Economic Affairs and Export Control (BAFA) on the application of the Supply Chain Due Diligence Act (LkSG) to the banking and insurance industry is legally compatible with the provisions of the LkSG. The focus of this expert opinion is on the banking industry.

Contrary to the BAFA guidance, the expert opinion concludes that financial institutions have a supplier relationship within the meaning of the LkSG with their customers for a number of financial products. **According to the expert opinion, in many cases, the due diligence obligations of the LkSG therefore also apply to financial institutions in relation to their core business (e.g. lending or the management of investment assets).**

First of all, the opinion clarifies that BAFA is limited insofar as its guidance may not fall short of the requirements set out in the LkSG. If it did, BAFA would risk binding itself to its own guidance, which in return would restrict the 'scope of the law as defined by the parliament'.

On this premise, the expert opinion examines whether the BAFA guidance correctly applies the scope of the law to the banking industry. It finds that the scope includes all steps that are **necessary** for the manufacture of a product or the provision of a service and that **range from the extraction of the raw materials to the provision of the service to the customer**. In addition, the scope only covers actions in a company's own sphere of business or actions by direct or indirect suppliers.

The legal opinion, **firstly**, argues that the guidance follows a methodologically flawed interpretation of the LkSG, as it ignores the regulatory intention of the legislators to include the financing business of financial institutions in the law's due diligence obligations. The opinion finds this intention to be clearly expressed both in the text of the law's explanatory memorandum (Gesetzesbegründung) and in an explicit reference to the relevant international soft law provisions, in particular the United Nations Guiding Principles on Business and Human Rights.

Secondly, the opinion argues that various services provided by the customers of financial institutions are in fact 'necessary supplies' within the meaning of the LkSG and therefore fall within its scope. With regard to:

- **Lending**, this 'supply' consists in providing debt to the bank that can be resold on the capital market, as well as in the provision of an asset that embodies a suitable risk-return profile, as is necessitated by European Banking regulation. The particular characteristics of the financial sector must be taken into account here, the nature of which being precisely the trade in money and debt.
- **Underwriting**, a supply within the meaning of the LkSG arises through the provision of a marketable security by the respective company.
- **Asset management**, a supply exists because the underlying securities and other assets are necessary to pay returns to the investors.

The expert opinion does not determine whether the relationship between a financial institution and its customers in the above-mentioned cases falls into its own sphere of business or whether the customers act as a direct or indirect supplier in each case.

Thirdly, the legal opinion criticises that the guidance is contradictory in various respects or makes unfounded assumptions, in particular:

- The guidance argues that refinancing transactions are not a part of a financial institution's supply chain because there is 'no sufficient link' to a specific financing transaction. This contradicts the wide understanding of the term 'necessity' as put forward elsewhere in the guidance.
- With regard to the sale of debt and derivative transactions, the guidance finds that there is no 'typical supplier–manufacturer relationship'. This concept is not explained in more detail and has no basis in the LkSG. The legal opinion argues that nonetheless, there is in fact a clear manufacturer–supplier–customer relationship in the relevant transactions.
- With regard to shareholders and subscribers of bank bonds, the guidance conflates the terms 'supply' and 'provision of a product or service' and therefore the differing standards of § 2 subsections 7 and 8 LkSG.
- When explaining why the provision of money is not to be understood as a supply within the meaning of the LkSG, the guidance argues that it is not the 'main focus' of the respective contract. The legal opinion finds that this criterion has no legal basis in the LkSG and threatens to create legal uncertainty.

The legal opinion concludes that in summary, the **guidance in its current form is unlawful**, since it unduly restricts the scope of the LkSG on the one hand and, by providing contradictory information, creates legal uncertainty on the other. The Federal Ministry for Economic Affairs and Climate Action (BMWK) is therefore obliged to order the withdrawal and revision of the guidance as part of its mandate for technical and legal supervision of BAFA.

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