Greenwashing
Product Development Considerations for Financial Services Firms
May 2021
ESG Product development & emerging trends

The merits of the development of ESG, Green and Sustainable products also comes with additional risks that need to be suitably identified, measured and mitigated.

Background
For providers of ESG (Environmental, Social and Governance), Green and Sustainable related financial products, 2021 looks set to be driven by three emerging trends:

1. Growth in Sustainable and Green Products
The demand and supply of ESG-related products across financial markets continues to rise considerably, and sharply. From green mortgages and green savings accounts, to sustainability-link loans and impact bonds, the range of products available and the breadth of offering across the consumer base will continue to expand.

2. Liability Risk - Greenwashing & Insufficient Disclosures
Concerns about greenwashing – the attempt to make things appear more green than they are in reality – are already starting to emerge and will continue to do so. The absence of a common definition of what constitutes a “Green” product, and a lack of consistency and professionalism in the verification market, creates an opportunity to accentuate ESG credentials.

Insufficient climate disclosures (e.g. physical risks) in bond / equity issuances and financial statements may also lead to elevated risks of litigation in the event of physical risks crystallising.

3. Regulator Oversight
The FCA first registered its concerns about greenwashing in 2018 and in 2019 put the industry on notice that it will take action if customers are being mislead. It has committed to analyse and directly challenge firms that it suspects of not meeting their expectations and where consumers are being misled and greenwashing looks set to be one of the regulators main areas of focus for 2021 and beyond.

What is the impact of these trends?
In one way, these trends are not new and are simply a continuation of risks that are driven by new products and opportunities. The opportunities for firms and the wider economy in relation to ESG-related products is clear but the accumulation of the trends leads to increased ESG conduct risk and greater risk of Greenwashing.

1. Climate Change and Green Finance – DP18/8: [https://www.fca.org.uk/publication/discussion/dp18-08.pdf]
2. Climate Change and Green Finance: summary of responses and next steps Feedback to DP18/8 – FS19/6: [https://www.fca.org.uk/publication/feedback/fs19-6.pdf]
Greenwashing: Drivers and examples
The proliferation of ESG-related products, inconsistency in their features, and verification of their criteria, creates the opportunity for Greenwashing risks to emerge.

Definition of Greenwashing
To attempt to make a company, their policies, products or services more “green” than they actually are, thereby misleading clients / customers and other market participants.

The potential drivers causing the emergence of Greenwashing are:
• **Increased Demand:** As more customers demand ESG-related products, the onus is on the market to supply them.
• **Lack of common definition and credentials:** The absence of a common definition of what constitutes an ESG product, and a lack of verification of product claims is inevitably fuelling concerns that not all products have the ESG credentials they claim.
• **Firms self interest:** The emergence of a “greenium” (lower interest rate) on ESG-related finance, provides further incentives for applicants to accentuate the ESG performance of the underlying assets.
• **Availability of data:** Scepticism is to be expected especially given that ESG products have only just become mainstream and product providers themselves have significant challenges in gathering the data required to support sustainability criteria are met.

Examples of Greenwashing
There are an increasing number of examples of “greenwashing” globally, that is causing concern amongst investors and regulators.

“Volkswagen Emissions scandal – mass lawsuits open in Germany”
The Guardian 2019
VW was discovered to be cheating on emissions tests in 2015 and has since had to pay out over $25 billion in fines, legal bills and compensation.

“Investors probe ESG credentials of bond sellers on ‘greenwashing’ fears”
Financial Times 2020
It is estimated that 15% of green bonds are issued by companies with practices that breach environmental standards. Investors are also avoiding issuers with poor environmental records.

“Asia’s biggest market for ESG debt hit by ‘greenwashing’ concerns”
Financial Times 2020
Assurance providers find that less than 3% of ESG notes issuances in South Korea were for environmental projects leading to serious investor concerns.

Third of “low carbon funds” invest in oil and gas stocks
Common Wealth 2020
Common Wealth found that a third of climate funds sold in the UK had invested in oil and gas companies. They also tended to have greater exposure to technology and financial sectors which have indirect links to climate change.
Greenwashing: An emerging conduct and liability risk

Greenwashing risks can quickly develop and accumulate, leading to wide and varied impacts.

Accumulation of Risk

- **Increase of Sustainable Products**
  The product offering in ESG products and services continues to rapidly increase, across retail, wholesale, institutional, corporate and debt capital markets.

- **Increasing Concerns over Greenwashing**
  Regulators are not the only stakeholders concerned with Greenwashing. Investors, rating agencies, consumers and many others have a growing interest in firms and products ESG credentials.

- **Lack of Oversight**
  Oversight of ESG-related products is extremely challenging. Due to many new and differing products, providers are facing difficulties defining criteria and gathering the data required to support ESG criteria.

- **Cross-Product Contagion**
  The greater availability of products and interaction between them is already causing cross-product contagion. E.g., where ESG funds hold green bonds from issuers that may support non-green initiatives.

Crystallisation of Risk

- **Strategic Risk**
  Evidence of Greenwashing may emerge as firms look to pivot their business models rapidly to adapt to the lower carbon economy and as part of the race to Net Zero.

- **Increased Legal Risk**
  Firms could be subject to re-dress or court action from products that do not perform as investors expect, in terms of their ESG criteria.

- **Regulatory Action**
  The FCA has clearly stated it will take action against firms if consumers are misled and if they are found to be involved in Greenwashing.

- **Reputational Damage**
  Any incidents of Greenwashing could realistically leave firms with similar reputational damage as other conduct issues. E.g. miss-selling incidents.

Financial Impact

The accumulation of risk and potential crystallisation of the risk (not limited to just the issues above) could lead to a significant financial impact.

Greenwashing: Product and market considerations

Greenwashing risks will vary by product and customer type, and hence careful consideration is needed when identifying inherent and residual levels of this risk across the product base.

<table>
<thead>
<tr>
<th>Green Retail Products</th>
<th>Green Loans, Bonds &amp; Sustainability Linked Bonds</th>
<th>Private Wealth Management</th>
<th>ESG Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>The FCA is particularly concerned about Greenwashing risks for retail clients ¹</td>
<td>$500 billion of green bonds expected to be issued in 2021 ²</td>
<td>46% of wealth advisers believe that ESG is a key priority for their clients ³</td>
<td>Funds that invest using ESG principles have grown to $1 trillion AUM ⁴</td>
</tr>
<tr>
<td>• Green Mortgages and Home Equity Loans: Adequacy of suitability process &amp; advice provided by mortgage advisors. E.g. explaining terms, explaining costs and assessing suitability</td>
<td>• Green Loans &amp; Sustainability-Linked Bonds: Lack of terms in place to prevent green loans / bonds being used for non-environmentally friendly purposes and taking advantage of favourable loan terms without making material sustainability achievements.</td>
<td>• Suitability: Effectively translating customer ESG preferences stated in the suitability process into client portfolios, particularly for vulnerable customers.</td>
<td>• Lack of clear definition on what sustainable investment is: the vast number unregulated rating and scoring providers means the definitions of what makes a company ESG investable are inconsistent</td>
</tr>
<tr>
<td>• Carbon Offset Savings Accounts: Firms are unable to demonstrate how they meet the green targets that are promised to clients in lieu of account interest</td>
<td>• Green Bonds: Projects financed by green bonds do not have a positive environmental impact or the companies issuing green bonds have a negative environmental impact elsewhere in their business.</td>
<td>• Portfolio make-up: Ensuring ongoing adherence of portfolios to client preferences. (e.g. what data is available to monitor a companies “green” status)</td>
<td>• Investment Criteria: A lack of standards over sustainable investment means that fund managers’ disclosures vary considerably, which has fuelled greenwashing concerns. ⁵</td>
</tr>
<tr>
<td>• Sales and Marketing Activity: Ensuring Marketing materials are clear and not misleading where the benefits of “green” products are being communicated</td>
<td>• Re-Financing: Issuing Green Bonds off the back of historical “Green” projects.</td>
<td>• Advice &amp; Disclosures: Ensuring that the advice process is clear and clients are provided with sufficient information about ESG investment criteria (e.g. disclosures).</td>
<td>• Fund Holdings: ensuring that funds holdings follow ESG principles. This includes consideration of the sector (e.g. oil and gas) and whether a company may have an indirect role in climate change. ⁶</td>
</tr>
</tbody>
</table>

² https://www.ft.com/content/021329aa-b0bd-4183-8559-0f3260b73d62
³ https://www.ft.com/content/5430ff68-2a73-4e1b-bf40-8de6a76389a2
⁴ https://www.ft.com/content/cd819461-1925-48e0-86af-e81a56c0d3f8
⁵ https://www.ft.com/content/5430ff68-2a73-4e1b-bf40-8de6a76389a2
With common metrics on products and sustainability standards still being developed and with growing public policy focus on green finance, the FCA is concerned about the potential for greenwashing. DP18/8¹ and FS19/6² (Climate Change and Green Finance) focus on issuer disclosures on climate change, the integration of climate risk into firms’ decision-making processes, and the widening access to green financial products and services to consumers. This includes addressing the risk of “greenwashing” and how the FCA will take action against this to prevent consumers being misled.

### Challenging Firms

- The FCA has promised to challenge firms that it suspects are greenwashing products in order to protect consumers from being misled.
- In FS19/6, the FCA commented that deterring green washing and ensuring consumers can assess if a product is genuinely green would remain an active area of focus in its “supervisory and policy work”.  

### Product Labelling and Misleading Investors and Consumers

- The FCA has noted that the “sustainable” label is applied to a “very wide” range of products, some of which don’t appear to have materially different underlying exposures to products that are not marketed as sustainable.
- The regulators focus on this aspect is to ensure that investors and consumers are not misled or mis-sold products that do not meet their needs and would result in greenwashing.

### Communicating with Clients

- The FCA is keen for firms’ to clarify if and how their products environmental and social objectives are pursued and to do so in a way that is “fair, clear and not misleading.” Where consumers can’t validate firms’ claims on how they achieve these objectives, the products will be at risk of greenwashing.⁴
- The FCA’s view is that this could undermine confidence in the green sector, reducing the participation and investment in creating a greener economy.

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¹ Climate Change and Green Finance – DP18/8: [https://www.fca.org.uk/publication/discussion/dp18-08.pdf](https://www.fca.org.uk/publication/discussion/dp18-08.pdf)
² Climate Change and Green Finance: summary of responses and next steps Feedback to DP18/8 – FS19/6: [https://www.fca.org.uk/publication/feedback/fs19-6.pdf](https://www.fca.org.uk/publication/feedback/fs19-6.pdf)
Greenwashing: The Industry & Regulatory response
Continued global industry and regulatory convergence and scrutiny is driving change

<table>
<thead>
<tr>
<th>Pre-2021</th>
<th>2021</th>
<th>2022</th>
<th>Beyond 2022</th>
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**Background**

**NFRD - 2017**: The non-financial reporting directive (NFRD) requires large companies to disclose relevant, useful information regarding the impact of their activity. In-scope companies must publish reports on policies they implement in relation to environmental protections (and other areas).

**SFDR - 10th March 2021**: New requirements for Financial Market Participants (FMPs), to comply with SFDR’s Level 1 rules on ‘disclosure’ over their investments ESG risks and investments in ESG. RTS of SFDR applies from 2022.

**PRA Dear CEO Letter (2020)** – Firms are expected to embed their approaches to managing climate-related financial risks by the end of 2021. TCFD disclosures are required by 2022.

**SFDR RTS – 1st January 2022**: Proposed application of the RTS from SFDR.

**Taxonomy Regulation – Q1 2022**: Establishes an EU wide classification system to provide a common language on what constitutes an environmentally friendly activity.

**MiFID II, UCITS and AIFMD – March 2022**: FMPs need to adhere to changes to existing regulations that incorporate ESG risks and considerations into risk management processes.


- While the immediate focus is on managing financial risks, the requirement to enhance risk management frameworks to consider climate risks more broadly, includes non-financial risks. This means that action should still be taken in 2021 to address the risks of greenwashing.

- The requirements include non-financial disclosures, which is a key area where greenwashing could arise.

- Disclose financial resilience and targets.

- Set targets for the firm and disclose qualitative information and quantitative (as advanced as possible) metrics.

- Full disclosure, including targets and commitments (including on executive remuneration) that the firm is deploying to actively contribute to achieving a net zero carbon economy by 2050.
Actions firms can take to mitigate Greenwashing risks

To effectively address the risks that greenwashing presents firms can take the early steps in a range of areas to identify the potential for greenwashing and mitigating potential conduct risk issues.

### Identifying and Assessing the Risks of Greenwashing and enhancing the control environment

<table>
<thead>
<tr>
<th>Governance &amp; Risk Frameworks</th>
<th>Where can the risk of greenwashing be mitigated?</th>
<th>Examples of control enhancements to consider?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• To what extent has Climate Risk been integrated into other risk frameworks? E.g. conduct risk, operational risk, credit risk etc.</td>
<td><strong>Annual reviews of risk frameworks.</strong></td>
<td></td>
</tr>
<tr>
<td>• Is there an SMF responsible for Climate Risk?</td>
<td>• Incorporate Green considerations into Product Governance Forums and NPA/NTA processes.</td>
<td></td>
</tr>
<tr>
<td>• Consider where various conduct obligations (e.g. under MiFID II) may need to consider the risk of greenwashing.</td>
<td>• Reviewing and updating SMF responsibilities, relevant committees’ membership and Terms of Reference to include Climate Risk responsibilities.</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Risk Management Processes</th>
<th>Where can the risk of greenwashing be mitigated?</th>
<th>Examples of control enhancements to consider?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• What risk identification and assessment processes can be leveraged that your existing Conduct Risk Framework uses to identify, assess and manage the potential for greenwashing?</td>
<td>• Identify where products incorporate green credentials and establishing a plan to continuously identify, monitor and manage these to reduce the risk of greenwashing</td>
<td><strong>Set-up process to monitor and manage climate-related risks and exposures</strong></td>
</tr>
<tr>
<td>• What, if any, data is available from green products in order to monitor and report on their credentials or performance?</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Products and Marketing</th>
<th>Where can the risk of greenwashing be mitigated?</th>
<th>Examples of control enhancements to consider?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• How does the NPA/NTA process consider the risk of greenwashing?</td>
<td><strong>Develop reporting on green products</strong> to assess if they perform as expected.</td>
<td></td>
</tr>
<tr>
<td>• Can ESG credentials be monitored? (Similar to investment guidelines or limits for UCITS schemes).</td>
<td>• Controls around valuation and MI reporting to ensure adherence to the relevant Green standards.</td>
<td></td>
</tr>
<tr>
<td>• Is there sufficient input and review of documentation and/or financial promotions so clients can identify products green credentials?</td>
<td>• Clearly articulate ESG credentials and disclosures via KIID, KID or financial promotions.</td>
<td></td>
</tr>
</tbody>
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<thead>
<tr>
<th>Three Lines of Defence</th>
<th>Where can the risk of greenwashing be mitigated?</th>
<th>Examples of control enhancements to consider?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• How are relevant staff made aware of greenwashing and how it may materialise?</td>
<td><strong>Upskilling relevant stakeholders by implementing awareness, cultural and/or ESG training programme.</strong></td>
<td></td>
</tr>
<tr>
<td>• Are the 2nd and 3rd line (e.g. Compliance testing, IA reviews) considering greenwashing as a risk in their review programmes for the coming year?</td>
<td>• Identify where highest risk of greenwashing exists currently across business lines and incorporate into review programmes.</td>
<td></td>
</tr>
</tbody>
</table>
The time to act to mitigate the risk of Greenwashing is now

The risk of Greenwashing has grown with the proliferation of ESG-related financial products. Where conduct issues have previously arisen (e.g. FX Manipulation, mis-selling, LIBOR rigging), the firms that took action early to put in place appropriate mitigants tended to avoid fines, reputational damage and expensive remediation exercises.

<table>
<thead>
<tr>
<th>A growing area of risk</th>
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<tbody>
<tr>
<td>• With the adoption of key regulatory milestones in 2021 Greenwashing concerns are likely to be allayed as more standardised definitions and regulatory frameworks are implemented. However, the risk of Greenwashing is not mitigated by meeting disclosure requirements – particularly with the growth of products and growing cross-product contagion.</td>
</tr>
</tbody>
</table>

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<thead>
<tr>
<th>Client priorities</th>
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<tbody>
<tr>
<td>• Increased investor and press scrutiny has led to a increasing number of Greenwashing incidents coming to light and therefore increased reputational risk. ESG investments are a top priority for customers and investors. Robust ESG product development and investment criteria will help differentiate from the competition.</td>
</tr>
</tbody>
</table>

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<thead>
<tr>
<th>Existing control frameworks</th>
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<tbody>
<tr>
<td>• The risk of Greenwashing can arise across a multiple of different products of services but firms can utilise existing frameworks or controls to start to identify, measure, monitor and report on the risk of Greenwashing. However, can is made challenging by multiple taxonomies.</td>
</tr>
</tbody>
</table>

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<thead>
<tr>
<th>Many Shades of Green</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Greenness is not binary - even if you start green the product may not stay green.</td>
</tr>
</tbody>
</table>

### Actions all firms should consider

- **Existing Frameworks**
  - Use existing Risk and/or Conduct Risk frameworks to assess where Greenwashing may arise.

- **Product Governance**
  - Firms should be comfortable that any “green” products or services can withstand scrutiny.

- **Sources of Data**
  - Focus on where data can be sourced to measure and report on the risk, or where additional data is required to do so.

- **Client Communications**
  - Ensure client communications and marketing for ESG-related products are not adding to the risk of Greenwashing.

- **Governance**
  - Ensure Greenwashing considerations are built into committees or forums.

- **Training**
  - Provide training to ensure sufficient knowledge of how conduct may lead to Greenwashing.

- **Tools**
  - Implement the use of tools to monitor the “greenness” of a product.

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Many Shades of Green

[Greenness is not binary - even if you start green the product may not stay green.]
Appendices
Appendix A: Product growth

A greater number of sustainable or green finance products are being developed to serve a rapidly expanding market

<table>
<thead>
<tr>
<th>Retail</th>
<th>Asset management</th>
<th>Asset finance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Green Mortgages</strong></td>
<td><strong>ESG Funds</strong></td>
<td><strong>Securitisation</strong></td>
</tr>
<tr>
<td>57% of lenders plan to launch a green mortgage offering (IMLA)(^1)</td>
<td>ESG funds are forecast to outnumber conventional funds by 2025(^3)</td>
<td>Demand for green securitisation is likely to grow in line with growth in other product lines (e.g. Green ABS and RMBS)</td>
</tr>
<tr>
<td><strong>Green Credit Cards</strong></td>
<td><strong>Green &amp; Sustainability-linked Bonds</strong></td>
<td><strong>Trade Finance</strong></td>
</tr>
<tr>
<td>A number of credit card providers have released Green Credit Cards</td>
<td>$500bn in green bonds are expected to be issued in 2021(^2)</td>
<td>Green trade facilitation programme has supported 600 transactions in 15 countries (EBRD)(^5)</td>
</tr>
<tr>
<td><strong>Green Savings Accounts</strong></td>
<td><strong>Green &amp; Sustainability-linked Loans</strong></td>
<td><strong>Green Asset Finance</strong></td>
</tr>
<tr>
<td>Banks are moving towards marketing current account as sustainable</td>
<td>Sustainability-Linked Loan Principles have been developed to help bring consistency as the market grows</td>
<td>Green asset finance initiatives will become mainstream as the uptake and requirement to fund the purchase of electric vehicles grows(^4)</td>
</tr>
</tbody>
</table>

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\(^1\) [imla green-mortgages.pdf](https://www.ft.com/content/021329ba-b0bd-4183-b559-0f3260b73d62)

\(^2\) [https://www.ft.com/content/021329ba-b0bd-4183-b559-0f3260b73d62](https://www.ft.com/content/021329ba-b0bd-4183-b559-0f3260b73d62)

\(^3\) [https://www.ft.com/content/021329ba-b0bd-4183-b559-0f3260b73d62](https://www.ft.com/content/021329ba-b0bd-4183-b559-0f3260b73d62)

\(^4\) [https://www.ft.com/content/021329ba-b0bd-4183-b559-0f3260b73d62](https://www.ft.com/content/021329ba-b0bd-4183-b559-0f3260b73d62)

Appendix B: A case study on the emergence of Greenwashing in “Green Bonds”

What are the conduct risks with Green Bond issuances and how can they be managed?

Greenwashing should be seen as an emerging and increasingly significant conduct risk for firms. Greenwashing has an external impact in that it damages confidence in the fair and orderly functioning of markets and may lead to investors and consumers being misled.

<table>
<thead>
<tr>
<th>Participant</th>
<th>Risk of Greenwashing</th>
<th>How to manage the associated conduct risks</th>
<th>Regulators and standards</th>
</tr>
</thead>
</table>
| **Issuer** | • Further diligence for subsequent issuances  
• Damage to investor appetite for future issuances  
• Bond prices increase in the market  
• Price of subsequent issuances is elevated  
• Increased coupon for missed targets | • Engaging third party assurance providers to conduct reviews against robust standards to help build investor confidence for subsequent issuances  
• Monitoring of ongoing sustainability targets linked to the bond | • Regulators are increasingly concerned about market and consumer detriment via greenwashing in the green bond market |
| **Underwriter, Arranger & Guarantee Providers** | • Risk that marketing materials mislead investors  
• If the underwriter “hard underwrites” the bond then there could be significant market risk exposures  
• Mispricing of bonds based on weak disclosures | • Performance of own targeted due diligence, where appropriate.  
• Establishing clear criteria and principles that issuers must fulfil before underwriting a green bond. | • Pre-issuance assurance against pre-agreed standards is one way to address the risk. Those most commonly used include the International Capital Market Association (ICMA) Green Bond Principles, the Climate Bond Initiative (CBI) or the EU Green Bond Standards. |
| **Investor** | • Impact to bond prices and / or liquidity e.g. if removed from sustainability index  
• Impact on other investments due to commitments on portfolio allocations  
• Knock-on impact to other bonds from the same issuer due to reputational damage  
• Transparency for own clients / shareholders | • Monitoring compliance with investment criteria and portfolio allocations  
• Establishing ESG investment criteria to ensure capital is directed to truly “green” companies and issuances | |

**Considerations for other market participants**

- **Exchanges & Indices**
  - Exchanges and Indices have green bond certification standards. If breached:
    - The re-structuring debt or the ability to raise for subsequent issuances may be challenging
    - Reduced demand if removed from index
    - Increased scrutiny over future submissions

- **Market Makers**
  - Risk of losses if market makers are holding significant positions in green bonds that are linked to greenwashing
  - If marketing and issuance to clients, there could be serious reputational risk if the bond does not meet ESG standards

- **Assurance Providers**
  - Assurance providers are a critical part of the green bond ecosystem to provide assurance over the “green” status of the bonds
  - Who an issuer selects to conduct assurance and the robustness of the analysis undertaken has a bearing on bond subscriptions / investor confidence