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Greenwashing in sustainable finance – key takeaways from EU developments

There are useful takeaways for EU and non-EU firms arising from the European Supervisory Authorities' (**ESA**) latest thinking on greenwashing. In June 2023, the ESAs issued progress reports examining greenwashing risks and related policies in sustainable finance. Based on the progress reports (as well as the ESAs' final reports which are due in May 2024), the Commission intends to refine its approach to assessing and monitoring greenwashing risks and will consider introducing further regulatory measures if necessary.

This article explores a number of notable findings in the progress reports, including possible forthcoming policy recommendations, which may indicate regulators' likely areas of focus when horizon scanning, monitoring and regulating greenwashing in the financial sector. The ESAs' common high-level understanding of greenwashing, together with examples they provide as to what constitutes *"misleading"*, can inform firms' approaches to mitigating greenwashing risks.

Background

In May 2022, the Commission requested that each ESA (namely the European Banking Authority (**EBA**), European Securities and Markets Authority (**ESMA**) and European Insurance and Occupational Pensions Authority (**EIOPA**)) provides:

(a) progress reports on greenwashing and its related risks to take stock of the status quo in supervising and enforcing against greenwashing under the existing regulatory frameworks, as well as to identify key areas where greenwashing may potentially arise; and

(b) final reports building on the findings of the progress reports, including by critically assessing the adequacy of existing sustainable finance policies aimed at preventing greenwashing, related supervisory measures and their implementation.

The sectors primarily covered by the ESAs' progress reports are:

– ESMA: issuers, investment managers, benchmark administrators and investment service providers;

– EBA: banking sectors and, to a more limited extent, investment firms and payment service providers; and

– EIOPA: all stages of the insurance lifecycle (eg entity level, product manufacturing, delivery and management) and pensions lifecycle (eg scheme design, delivery and management).

Common high-level understanding of greenwashing

The ESAs' progress reports set out a common high-level understanding of greenwashing, which goes beyond the existing definitions of greenwashing within the EU regulatory framework. They understand greenwashing as *"a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services. This practice may be misleading to consumers, investors, or other market participants"*.

The ESAs consider that the existing EU definitions of greenwashing (which are not, in any event, legally binding) are *"not sufficient"* and *"do not encompass all potential forms of greenwashing under the ESAs' respective remits"*. Specifically, the ESAs understand that greenwashing is not limited to product-level claims, is not pegged to *"basic environmental standards"*, is not limited to environmental claims, and is not subject to a precondition of gaining a competitive advantage. In addition, the ESAs consider that greenwashing should be kept in check regardless of whether it results in *"immediate damage to individual consumers or investors… or the gain of an unfair competitive advantage"*.

Although the ESAs have not taken a position on whether their definition of greenwashing should be integrated into EU law, it is likely that future regulatory enforcement and supervision in respect of greenwashing will be extended to cover a wider range of scenarios.

Misleading qualities

The ESAs have identified numerous qualities falling within the general umbrella term of *"misleading"*, including:

– omission or lack of disclosure;

– selective disclosure or *"cherry picking";*

– unsubstantiated claims;

– inconsistent claims;

– vague claims;

– lack of meaningful comparisons;

– misleading imagery; and

– irrelevant or outdated information.

While market and supervisory practices continue to develop in respect of greenwashing, the ESAs' common definition, together with examples in the progress reports as to what constitutes *"misleading"*, provide a reference point for firms to design and embed processes and controls to mitigate the risk of greenwashing. Firms should review their relevant internal processes and controls to appropriately reflect key factors and risk indicators highlighted by the ESAs' common understanding.

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Areas with high exposure to greenwashing risks

The ESAs' progress reports identified channels and sustainability topics which are high-risk areas for greenwashing, which firms should take heed of when managing greenwashing risks.

Channels

Notably, firms should stay vigilant about greenwashing risks that could arise in the following channels:

(a) **Voluntary and regulatory reporting**: Voluntary reporting appears to be the most used channel for net-zero and climate-neutral claims. However, greenwashing risks in regulatory reporting should not be overlooked, and they can be difficult to manage in view of the divergent interpretations of certain regulatory requirements.

(b) **Entity-level, product/service-level and financial instrument level statements**: For the banking sector in particular, the most common type of alleged greenwashing appears to be at entity level, in relation to business strategy. However, this may be because product-level greenwashing in the banking sector is more difficult to detect as access to private data is necessary. While the materiality of greenwashing risk to banks is currently perceived as rather low, the EBA expects this to increase to medium or even high in the future.

(c) **The full value chain of sustainable finance**: Greenwashing could spillover from one stage of the insurance and pension lifecycles to another. Similarly, *"misleading impact claims found in marketing materials of a fund or of an SLB can be passed along by financial advisers to retail investors"*. Relatedly, EIOPA considered that there would be merit in having legislation that covers business to business greenwashing.

(d) **Claims relating to ESG ratings**: Greenwashing may arise through firms' inadequate use of ESG ratings, for example, by cherry picking ESG ratings that present them favourably, or presenting ESG ratings in a manner that is inconsistent with their underlying methodologies. With the recent introduction of the Commission's proposal (on 13 June 2023) for regulating ESG ratings providers, firms can expect their use of ESG ratings to be subject to increasing scrutiny.

Channels for greenwashing include:

– Advertising and marketing materials;

– Annual reports;

– Distribution channels;

– Due diligence failures;

– ESG ratings;

– Labels;

– Online comparison platforms;

– Product information documents (eg IPID and PRIIP's KID);

– SFDR disclosures and other regulatory reporting;

– Social media;

– Sustainability reports; and

– Transition plans.

Sustainability topics

The ESAs identified several topics of sustainability-related claims as posing a high risk of greenwashing (although the relevance of each topic can vary by industry, sector and asset class):

(a) **Impact**, for example real-world impact, additionality, impact measurement and attribution;

(b) **ESG strategy, objectives and characteristics**, for example in claims relating to an entity's financing activities, underwriting activities and investment strategies (eg exclusions applied);

(c) **Engagement with stakeholders**, including voting behaviour, lobbying activities and statements made to accede to stakeholders' expectations that are inconsistent with an entity's investment strategy and sustainability commitments;

(d) **ESG qualifications, labels and credentials**, such as overstating the significance of a label, award, commitment, or rating. Statements citing third party ratings may constitute greenwashing if it is unclear whether the ratings measure sustainability risk or sustainability impact;

(e) **Corporate resources and expertise**, such as claims on governance and resources being presented as actual progress in achieving decarbonisation, and claims regarding the level of expertise relating to ESG activities and non-financial areas (eg climate, ecology, and biodiversity);

(f) **ESG performance in future**, in particular net-zero commitments, transition plans, taxonomy alignment plans and claims on financing the transition. Greenwashing could arise, for example, where the successful realisation of a commitment cannot be reasonably ascertained in the near term, where there is a credibility gap in the entity's ability to deliver on its commitments, or where the entity's overall business activities are inconsistent with a particular sustainability commitment. In particular, the EBA noted that as a result of tougher scrutiny from advertisement, competition and market conduct authorities and NGOs regarding alleged greenwashing on net-zero commitments, institutions may be exposed to heightened financial and reputational risks;

(g) **ESG performance to date or at present**, for example where there is a lack of data and assurance on sustainability disclosures;

(h) **Board and senior management's role in sustainability**, for example, the extent to which internal organisation processes and practices are ESG-aware, and whether there is sufficient oversight as to both sustainability risks and sustainability impacts; and

(i) **Sustainability management policies**, for example the extent to which sustainability risk is taken into account.

The channels and topics identified by the ESAs provide a useful reference point for firms to conduct internal lessons learned – or 'could it happen here' – reviews, to assess the adequacy of internal processes and controls in those (or related) areas. Taking a risk-based approach to mitigating greenwashing risks is critical, given the range of scenarios and forms in which they can arise. The high-risk areas highlighted by the ESAs may be useful in directing firms' focus in terms of more resource-intensive internal review and control activities.

Supervisory practices and tools

The ESAs' progress reports include feedback from European national regulators on their existing supervisory approaches to greenwashing, covering aspects such as mandates, resources and expertise, and tools available. While responses varied, notable themes included the following:

(a) Regulators considering they do not have sufficient resources or expertise to tackle greenwashing. However, the progress reports note plans to address this gap and raise supervisory activity in the future (eg ESMA indicated that it and the national regulators will pay particular attention to climate-related matters and taxonomy-related disclosures in 2022 annual financial reports).

(b) Regulators not identifying occurrences of greenwashing due to the inadequacy of relevant sustainable finance requirements (eg lack of clarity and divergent interpretations), particularly as they are not fully in place. That appears to be a key reason as to why 22 of the 30 national regulators (73%) surveyed by the EBA in late 2022 reportedly identified no actual or potential instances of greenwashing. The progress reports provide indications of **possible forthcoming policy developments** to address existing inadequacies in the sustainable finance regulatory framework, **as discussed on the next page**.

(c) Regulators considering that current and forthcoming supervisory mandates and powers allow them to address greenwashing risks (or aspects thereof) – however, regulators' ability to effectively discharge their mandates are subject to various limiting factors such as resource, expertise and data quality/availability.

(d) Regulators seeing value in new or advanced supervisory technologies to help tackle greenwashing (eg ESMA notes the potential use of AI tools to support the supervision of ESG related disclosures, and EIOPA will be assisting 4 national regulators in developing supervisory technologies tools and guidance to identify greenwashing in 2024).

Firms should expect increased supervisory activity with a sharper focus on greenwashing. The progress reports broadly reflect a desire to step up on regulatory efforts, including through developing common approaches to the supervision of sustainability disclosures. Regulators may also increasingly incorporate a preventative approach when tackling greenwashing, which was highlighted by EIOPA as an important regulatory approach.

As supervisory activity increases and sustainability-related rules embed, firms should ensure that their strategy, processes and controls for mitigating greenwashing risk are clear, robust and up-to-date, and should be able to articulate and evidence how they are effectively tackling the issue on a firm-wide basis.

Possible forthcoming policy developments

The ESAs are continuing to develop policy recommendations for the Commission, which will be set out in their final reports in May 2024. Presently, several themes in the progress reports are indicative of areas where remediation actions will likely be considered or recommended.

(a) **Transition finance**: There may be appetite to clarify concepts relating to transition finance. There is presently no clear definition as to what can be labelled transition finance, and no clear thresholds to calculate transition-aligned trajectories. There are also no binding standards on sustainability-linked loans and sustainability-linked bonds. The EBA's progress report noted stakeholders' relevant suggestions such as developing principle-based guidelines to clarify what types of financing can be called *"transition finance"*, and developing labels through a framework for credible transition plans with science-based transition milestones. To enhance the recognition of transition finance, preliminary remediation actions identified by ESMA include creating a credible definition of *"transition investment"*, and featuring transition finance when developing labelling schemes and naming conventions for sustainable bonds or benchmarks.

(b) **Social taxonomy**: Greenwashing risks could arise in the absence of an EU-level uniform standard for measuring impact on social factors. ESMA indicated that social factors are a key concept of the EU sustainable finance framework that requires further consideration using a robust methodical approach, potentially by way of a social taxonomy. EBA similarly noted from stakeholders' feedback that the lack of clear framework for the social (and nature) aspects of sustainability creates room for divergent expectations on what is socially-positive (or nature-positive).

(c) **Key concepts in the SFDR and across the EU sustainable finance framework**: The progress reports acknowledge the lack of clarity in certain key concepts such as 'sustainable investment', the DNSH principle and differences in DNSH criteria and tests across the EU sustainable finance framework. The progress reports identified particular challenges in the implementation and application of aspects of the SFDR, eg the *"labelisation"* of SFDR (despite products having differing levels of sustainability within the same class), defining the minimum contribution to a sustainable objective, and disclosures relating to stewardship and engagement. The ESAs' final policy recommendations in respect of SFDR will also be informed by their ongoing joint consultation on the review of SFDR Delegated Regulation.

(d) **Benchmarks Regulation** (BMR): ESMA stated that several changes to the BMR would be useful in addressing certain greenwashing risks. These include revising the ESG factor list by including Taxonomy alignment (and references to transition finance and transitioning activities), introducing an ESG benchmark label, and requiring more transparency on expected or likely benchmark and fund portfolio holdings and overall exposures.

(e) **Naming conventions for financial instruments**: To support transparency and comparability, ESMA noted that it might be beneficial to extend the development of naming conventions (that is already being considered regarding funds) to financial instruments.

The reversed sequencing of EU legislation – with CSRD coming into force after SFDR – has led to difficulties accessing data needed by financial market participants. Looking ahead, the application of various sustainable finance legislation will be aimed at improving the availability and quality of standardised, audited forward-looking data, as well as improve entities' sustainability conduct. EBA also noted that the banking package (CRR/CRD) which is currently under revision *"will likely introduce new obligations for institutions to ensure a robust management of ESG risks, under which financial risks resulting from greenwashing should be considered"*.

How can we help?

Effectively addressing greenwashing risks will require a firm-wide approach, embedded across internal processes, controls and frameworks, to ensure consistency. Firms should ensure that their strategy for managing greenwashing risks are aligned with the latest developments in the shifting sustainable finance regulatory landscape.

This prompts a number of questions for firms:

- Can you substantiate your claims and, if so, with what metrics and evidence? This may require conducting due diligence, audits, reviews and assessments of sustainability-related claims and engagement with your supply chains.
- Do you have sufficiently robust governance and processes for the collection, verification and review of claims including those set out in transition plans and other potential channels of greenwashing, particularly those claims concerning forward-looking information and other high-risk topics?
- How widespread is your use of labels and ESG claims on your products and services, and are they credible, compliant and consistent?
- Have greenwashing considerations been adequately taken into account in the development and implementation of your ESG strategies, plans, and initiatives?
- To what extent is your board, your legal team, and the business more broadly, trained on the latest relevant regulatory developments impacting on greenwashing, and the making and publishing of sustainability-related claims?

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