Reduction of the greenwashing risk: product classification, ESG data and rating

1. Inadequacies of the EU framework

The Chair asked how EU standards and labels can help to prevent greenwashing, whether it is necessary to regulate environmental, social and governance (ESG) data more, and whether the current frameworks are sufficient to limit the risk of greenwashing.

A regulator detailed that the European Supervisory Authorities (ESAs) have produced a report covering the status of the sustainable finance regulatory framework in combating greenwashing. There is intense work underway to design the sustainable finance framework. The whole value chain of sustainable finance is covered by various pieces of legislation. That is bound together by the taxonomy. However, there is more work to do for there to be good standards that combat greenwashing.

Retail investors are vulnerable to greenwashing. They have difficulties understanding even the simplified Sustainable Finance Disclosure Regulation (SFDR) disclosures. The regulatory technical standards (RTS) that ESMA has provided create dashboards to alleviate the problem.

Article 8 and 9 products are seen as labels, which is not helpful. The advice in the Markets in Financial Instruments Directive (MiFID) sustainability preferences also unhelpfully incorporates jargon from the sustainable finance regulatory framework. The SFDR revision can be used to explore the possibility for labels.

A regulator highlighted that it is often not clear what greenwashing exactly is. A set of rules and regulations is needed. The current SFDR does not give clear guidance to suppliers. Some fear so much for their reputation that they under-represent the greenness of their products. SFDR provides no guidance for investors, so they rely on marketing and fund names. The existing framework information needs to be clear and fair. Instead of Articles 8 and 9 there should be a focus on consumer-friendly labels.

An industry representative remarked that their firm has a corporate mission for all its decisions to be directed towards building a more sustainable society. It does not want to greenwash, but help is needed to allow it to give underwriters of insurance contracts and investors clear and transparent information about sustainability. Recent regulations are a first step, but they are not precise enough and their scope is insufficient.

There is a lack of understanding about what the ratings under SFDR mean. SFDR 9 does not provide a clear definition of what is sustainable at the European level. Many actors withdrew from SFDR 9 because they feared an accusation of greenwashing due to SFDR 9's imprecision. For a fund with 40% sustainable components, it is unclear whether that is because all components have an average of 40% sustainable or because only 40% of the total is sustainable.

There are multi-option products in life insurance in Italy, Sweden, and France. They have a euro component and are unit linked. Looking at SFDR only for unit linked, there will be difficulty explaining the contract. A methodology that covers all markets is needed.

An industry representative indicated that, from an ESG rating perspective, SFDR is a step in the right direction in terms of increasing the quality and level of transparency. Banks use the EU taxonomy extensively. It is the basis of how they identify something as being green. That requires them to know certain things about their clients, and the level of technical expertise goes beyond what banks normally would be looking at, which limits application. The Corporate Sustainability Reporting Directive (CSRD) is increasing transparency. There will be more data and comparability. However, there is a need to focus on how these different standards talk to each other, particularly the International Financial Reporting Standards (IFRS) and CSRD.

There are ways to prevent greenwashing through how ESG data is handled. Applying traditional data governance will work well, in terms of ensuring there is quality, and that the source and lineage of the data are known. Banks are increasingly putting ESG product guidelines in place, to have a more clarified definition on how to apply the taxonomy and to guide the company in terms of consistency and comparability.

An industry representative emphasised the importance of having a US-EU dialogue. Greenwashing is potentially corrosive to the financial system. It is about fraud and deception. There are rules in the financial markets to pursue fraudulent or misleading behaviour that should be used. The question is whether greenwashing is fundamentally different to any other type of fraud on the market.

The EU has built a radically different set of regulatory frameworks around the question of sustainable finance. However, there is a first mover disadvantage in that context as well, and the EU did not get everything right. The UK has developed relatively straightforward greenwashing rules that require fair and clear disclosures that are not misleading. The EU has created a very complex piece of architecture with the new frameworks, and not everything makes sense. Entities accidentally and unintentionally fell into Articles 8 and 9, and that is a form of greenwashing itself.

Market abuse laws are about price. If an entity is disseminating misleading information that influences the price of a security, then that is considered market abuse. In the Sustainable Finance Disclosure Regulation (SFDR), there are so-called labels that need to be replaced with real labels. A higher level must be reached to demonstrate being deserving of the labels. In that respect, the EU green bond standard (EUGBS) is a much better template.

Greenwashing can happen anywhere along the value chain, so data is the starting point. The sequencing of the EU policy agenda is unfortunate in that regard, as it started with disclosures for financial products and financial market participants. Before ending up regulating all data everywhere, the results of the CSRD in the following year should be considered. That will help set a new benchmark in the quality of data in the system.

At the global level, $4 trillion must be found every year to invest up to 2030. That increases to $4.5 trillion from 2030 to 2050. Greenwashing must be eradicated as soon as possible to get to the next phase.

An industry representative agreed that the problem is not greenwashing; the problem is transition and getting there faster. For the European taxonomy to work, data is needed to test the significant contribution aspect. That data was expected in CSRD, but it is not there. Mandatory Public Interest Entities (PIEs) were expected in CSRD, but they are not there. The CSRD consists of more than 1,000 metrics, which is difficult to manage. Consistency on materiality is needed.

2. ESG rating agencies and data providers

An industry representative detailed that the EU is at the forefront of having a general sustainability framework. Almost all parts of the value chain are covered from a regulatory perspective. There was recently political agreement on legislation covering ESG rating providers. The missing piece in the value chain for ESG is data providers. ESG data products are composed of two parts. First is the data coming from issuers' reports, which are re-disseminated by ESG data product providers. The second is estimates, calculated by ESG data product providers themselves.

These are fundamental to the framework for preventing greenwashing. ESG data being wrong, or ESG data estimates being unclear in their methodologies, have later impacts. Asset managers and asset owners must report sustainable investments through SFDR. If the underlying data provided are not reliable, asset managers will be caught from a regulatory perspective. Regarding the taxonomy regulation, there is supposed to be investment in sustainable investments, based on data received from providers. If the underlying data are not reliable, asset managers may also be caught from a regulatory perspective by not fitting with that investment intent.

There is also a fiduciary duty to clients. If asset managers promise ESG investment to clients, and it appears that there was reliance on external data that do not fit with the intent on ESG investments, clients could sue the asset managers.

Obvious mistakes or errors are frequently identified in the ESG data received from providers. Any issuer has a scope 1 emission of greenhouse gases above zero. Individuals also have scope 1 emissions above zero. Nonetheless, scope 1 information coming from data providers that are equal to zero, and supposedly coming from issuers, are regularly identified. The most obvious mistakes from providers can be identified by asset managers when receiving them, but there is no guarantee that everything is caught. There is a need to report subsequently, and to invest, preferably in ESG investments, so it is critical that the ESG data are made reliable when re-disseminated or estimated by ESG data providers.

ESMA issued a report on greenwashing in May 2023, asking for regulation of ESG data providers. One month later, the European Commission issued a proposal capturing ESG rating providers but not ESG data providers. There is some inconsistency between what ESMA proposed and the actions of the European Commission, the European Parliament and the Council. The EU pretends to be at the forefront, but not tackling ESG data providers is a major missing piece in the EU framework.

The International Organization of Securities Commissions (IOSCO) asked for a regulatory framework on ESG data providers in 2021. This was followed in Asia. Japan applied a code of conduct. It was followed by Singapore last year. It is going to be applied by Hong Kong. A few months ago, the FCA in the UK, with a working group composed of industry professionals, developed a code of conduct for ESG data providers. There are still two regions not following IOSCO's request for action yet. One is the US, though that is understandable from a political perspective. It is probably difficult to replicate and apply IOSCO's request on ESG data providers considering the current Congress' positioning on ESG. The other region not applying IOSCO's request is the European Union. The EU has not adopted or even proposed any code of conduct or regulation on ESG data providers up to now. The European Commission and/or ESMA should initiate such an EU code of conduct. That has to be done urgently.

3. The SEC approach to climate-related disclosures

A regulator agreed that Europe has been far ahead in terms of developing rules and regulations around this topic. The US has a very straightforward, principled enforcement approach, called truth in advertising. Entities cannot make false or misleading statements, or statements that would be false or misleading without certain omitted information. For example, one asset manager stated that it would do an ESG quality score for each position in its portfolio but, in fact, only did so for a third of the positions in its portfolio. The simple requirement is for entities to say what they do and do what they say.

One difficult issue is that there are many different views about what ESG and sustainable finance are. For example, how one weighs the G factor in the ESG calculation can differ as whether there is dual class stock or whether there is an independent board chair. This could extend to other G issues like succession planning.

Financial materiality in the US is generally what a reasonable investor would think is important when making an investment decision. One way of looking at that is whether it affects stock price or enterprise value. There have been several proposals and rules adopted in recent years. On the fund or financial product side, one was about fund names. If there is a name that suggests a particular area, including sustainable finance or ESG, then 80% of the assets in that fund need to be invested in those types of investments.

One pending rule concerns what a fund manager should do with the disclosures when offering ESG products. One proposal is to look at whether it is an ESG integration fund, an ESG focus fund or an ESG impact fund, and to provide various disclosures. Some have suggested that this might increase the risk of greenwashing. Others suggest that the increase in transparency would help combat greenwashing. Over the coming 12 months there will be continued attention given to these matters.

4. Implementing the EU framework

A regulator recommended using resources to generate a better system, to explain that system, and to help investors and suppliers, rather than using them on enforcement for the rare cases of intentional greenwashing.

An industry representative emphasised the need to act in a coherent way internationally, respecting the long history of how efficient financial markets work, while moving to a system that takes account of externalities not currently being priced. There should be clarity regarding the principles that will apply to the future system. There should be a system that enables truth, transparency, and full and fair disclosures along the value chain.

An industry representative remarked that the European taxonomy has already indicated what materiality consists of. By starting with strong, validated, and audited data that is available when the companies report the data to the financial sector, the domino effect will be much stronger. Data is needed to ensure that data providers can help investors drive money to the right companies.

The UK and US have taken a pragmatic approach to ESG ratings. Rules must be simple and easy to implement in order for progress to be made. In Europe, investors highlight that 80% of their time is spent on compliance. There is a need to lead with success, which does not start from creating litigation concerns and fears about what data will be disclosed. It instead starts by identifying what needs to be done to ensure that more people devote more time to finding green investments that can help reach the target faster. Rather than managing from fear, greenwashing issues or litigation, there should be consideration of how regulation can be an enabler for businesses to create value. 50% of the global market cap now is in the US, and the question is what Europe can do to ensure that it can lead the transition, not just in terms of regulation, but also value.

There should be simplicity when significant changes occur in the economy. The space is currently extremely complex. There are different rules, which do not talk to each other, and that creates confusion. Confusion then results in greenwashing, which creates fear and therefore slowness and paralysis. Simplification is needed, along with a global leadership mindset, so there can be a single rule that everybody can understand, and which only has a handful of data points. The Chair noted that the challenge is that the world is becoming increasingly complex.

An industry representative highlighted the importance of international convergence and consistency, particularly for global players. An industry representative remarked that CSRD and other regulations are expected to help with making the right choices when voting in general meetings, and for not forgetting that being 100% green will take longer than a single day. There must be help with the transition. An industry representative noted that clear, consistent, and simple legislation is sought for greenwashing prevention. In the social area of ESG, that would also cover social washing prevention. More clarity is needed on the definitions for social and the social taxonomy. Banks looking at ESG are trying to balance the E and S. That is an area of the legislation where there are gaps.

Conclusion

The Chair summarised that what is sought is simplicity, coherence, and clarity. A regulator noted that the ESG ratings provide a step forward. It is hoped that they will move capital in the right direction. Having minimum standards on transparency and governance around ESG ratings is positive. However, the data providers are missing from this exercise. They also play a very important role in combating greenwashing. It is also important for market participants to fulfil their due diligence requirements.