Consultation Response

ESAs Call for Evidence on Greenwashing

10 January 2023

Introduction

The Association for Financial Markets in Europe (AFME)[1] welcomes the opportunity to respond to the Joint ESAs Call for Evidence on Better Understanding Greenwashing (the "Call for Evidence"). The Call for Evidence is a welcome opportunity to strengthen our collective understanding of the key features, drivers and risks associated with greenwashing. The findings collected by the European Supervisory Authorities can inform a review of the measures in the EU sustainable finance framework aimed at addressing misleading practices and enhancing trust in sustainable finance markets. We are pleased to share our recommendations to support and inform the continuous efforts put forward by authorities to strengthen the integrity and effectiveness of EU sustainable finance markets.

AFME has been a keen contributor to the development of the regulatory framework for sustainable finance from its earliest stages and our members are active market participants including banks and investment firms. We are therefore pleased to provide input into the ESAs' important work on addressing greenwashing risks.

Actual or perceived misrepresentation of sustainability claims may have a detrimental impact on investor and consumer participation in sustainable financial markets and we strongly support authorities' goal to maintain trust in the market. This is crucial to support the further development of sustainable finance and, in turn, the vital objectives that it is seeking to achieve. We set out below our input to the Call for Evidence, followed by answers to the specific questions raised by the ESAs.

The need for a focused and internationally aligned approach to addressing greenwashing in the financial sector

As the ESAs have identified in the Call for Evidence, a key initial question is how to appropriately define "greenwashing" for this purpose and determine the scope of the ESAs' work in this area. The term "greenwashing" is used in various contexts by media, NGOs, consumers, etc. but it is important to clarify what the harm is that needs to be addressed and consider what legal and regulatory tools already exist for this purpose. As discussed further below, it is important to consider this harm in the context of the existing legal and regulatory framework addressing misrepresentation and misleading statements.

While greenwashing can potentially be interpreted broadly and can occur across economic sectors, we encourage the ESAs to consider definitions in the financial sector such as that put forward by IOSCO[2] which refers to "misrepresenting sustainability-related practices or the sustainability-related features of investment products" and the "anti-greenwashing rule" proposed by the UK FCA[3] which proposes to reaffirm that existing requirements around clear, fair and not misleading communications apply in the context of sustainability-related claims. There are also different references to greenwashing in the EU Taxonomy Regulation and SFDR Delegated Regulation. We strongly encourage the ESAs to coordinate with their international counterparts in their efforts to address greenwashing.

[1] AFME is registered on the EU Transparency Register, registration number 65110063986-76.
[2] IOSCO Consultation Report CR01/21 *Recommendations on Sustainability Related Practices, Policies, Procedures and Disclosure in Asset Management*
[3] FCA CP22/20 on Sustainability Disclosure Requirements (SDR) and investment labels

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The ESAs questionnaire provides an extensive list of possible core features of greenwashing. By taking all these features together, it is important to avoid coming up with a definition that, despite being all-encompassing, does not help – either authorities or market participants – develop targeted measures to fight greenwashing.

We propose that the ESAs' work to address greenwashing in the financial sector should be focused on specific gaps in the existing framework, and on addressing risks arising from greenwashing which involve misleading practices or claims where an element of fault is present i.e. the claim was intentionally misleading or resulted from negligence, for instance where a firm does not have appropriate systems and controls in place. Focusing on such misleading practices and claims would address the most significant areas for potential harm. As discussed below, our recommendations aim to minimise the risk of greenwashing through, for example, clarifying the existing regulatory framework and aiding investor and consumer understanding.

It is important that work to address greenwashing does not adversely impact firms' inclination to set ambitious sustainability targets, make voluntary disclosures, make use of market standards or develop innovative sustainable finance products.

For example, we have recently seen reported cases of investment managers downgrading significant volumes of sustainable investment funds due to concerns regarding their future ability to comply with rapidly evolving regulation, in light of further guidance being developed, and fears of being accused of greenwashing for processes and methodologies they developed in good faith at a time where such guidance was not available. This is a potential example of concerns around possible disincentives for financial institutions to make legitimate sustainability claims due to uncertainty over data or regulatory and reputational risks, limiting the availability of sustainable investment products in the market and undermining the ability of investors to make informed choices and ultimately efforts to channel investments in line with sustainability objectives.

The Call for Evidence highlights different potential drivers of greenwashing and potential roles that market participants can play. It is important to recognise that greenwashing may occur outside financial institutions but could be spread through the investment value chain. Following the example provided by the ESAs, where corporate issuers trigger greenwashing with a misleading claim, we can observe elements of intentionality and/or negligence. At the intermediate segment of the investment value chain, lie financial institutions, which could act as either triggers, spreaders and/or receivers of greenwashing. These roles, however, can overlap and are not mutually exclusive – for example a "spreader" would also be a "receiver". Further, these categories do not provide a full picture over which market participants should be held accountable for misleading claims. To avoid over-simplification, the notions outlined above could be used to distinguish these roles based upon where an element of fault is present.

For example:

- A financial institution could be deemed to trigger greenwashing when intentionally misrepresenting a sustainability claim to gain a competitive advantage.
- A financial institution could be deemed to spread greenwashing when, at no fault of its own, and despite its best efforts demonstrated by ESG screening and due diligence, it fails to identify misleading sustainability claims by its borrowers and investees.
- A financial institution may be a "receiver" of a misleading statement and could be impacted by greenwashing, despite its best efforts to detect it, for example if it would impact the risk management for a client or its own disclosures.
- If not appropriately provided for, a financial institution could also be exposed to claims of misrepresentation when required to disclose publicly its ESG risks and key metrics by supervisors when, despite acting in good faith, it has to rely on inaccurate data, is forced to use proxies when data is not available, and has to use methodologies which are still nascent.

We consider it important to distinguish between cases that involve an element of fault, whether an intentional or negligent misrepresentation, from cases where a financial institution is not at fault but, through its role, may spread a misrepresentation made by a third party. In each case, the element of fault (i.e. *intentionality* or *negligence*) and the materiality of the damage would help us distinguish cases in which a firm, through its intentional or negligent action, harms trust in the market from cases where a firm had no intention to mislead and despite taking appropriate steps, was unaware that they were spreading a misleading statement.

It is also worth noting that greenwashing can be subjective and what is perceived to count as greenwashing may differ between individuals. In turn, firms can be subject to allegations brought by investors and members of the civil society with different views on what constitutes a misleading sustainability claim. One key example is companies who have strong ESG credential or sound commitments, but operate in highly-emitting sectors. Regardless of how such companies act, investors may find their inclusion in 'sustainable' funds counterintuitive due to the sector they operate in. With that in mind, the FCA proposed that sustainable investment product disclosures include information on 'unexpected investment' i.e. holdings that consumers may find 'surprising' given the fund's sustainability objectives. For this reason, we consider that any measures to address greenwashing should be based on the principles outlined above and on a focused approach.

Accordingly, measures intended to deter greenwashing practices would be designed to:

- Hold accountable companies **at fault** for greenwashing by intentionally or negligently misrepresenting sustainability claims, thereby causing or exacerbating adverse sustainability impacts or misleading investors, or doing so intentionally to gain an unfair competitive advantage.
- Provide safeguards against reputational risks and support market participants along the sustainable investment value chain which are **not at fault** for greenwashing (and those at the receiving end of misleading claims, such as investors and consumers.

These principles can guide a practical approach to address greenwashing while enabling the ambition and role that financial institutions play in financing the transition to sustainability. For example, it should not dissuade firms from setting ambitious voluntary targets, developing innovative products or unnecessarily restricting the market for sustainable products and investments.

Addressing greenwashing risk

It is of paramount importance to consider how to address greenwashing risk within the framework already in place, and appreciate that many existing principles and legal frameworks already apply to address misleading statements. Examples include financial promotion, conduct of business rules, misrepresentation, fraud, unfair consumer commercial practices[4], disclosure rules etc. Greenwashing is a form of misrepresentation, but is by no means unique or not covered by existing frameworks. It is therefore necessary to recognise this in the ESAs' work and consider the regulatory and legal framework already in place to address misleading statements and unfair commercial practices before assessing whether any specific further measures are required to complement and support it.

[4] For example, 2021 guidance on the application of the EU Directive on Unfair Commercial Practices confirms that it applies to sustainability claims. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021XC1229(05)&from=EN

It is also important to recognise the areas of sustainable finance regulation and supervision of financial institutions and products already at work to mitigate – or, where interpretations is uncertain or firms lack information, may increase – risks of greenwashing allegations. The current EU sustainable finance regulatory framework is still under development and thus it gives rise to implementation challenges for financial institutions and leaves some space to interpretation. Examples include:

- The EU Taxonomy Regulation, which establishes science-based criteria for environmental sustainability and introduces associated disclosure requirements. The Taxonomy offers an important classification framework but, at the same time does not cover all aspects of sustainability or all activities which, despite providing incremental benefits on a transition pathway, do not yet meet its strict criteria.
- The Sustainable Finance Disclosure Regulation (SFDR) which establishes detailed disclosure requirements for sustainable investments. SFDR enhances disclosures made available to investors for products with environmental or social characteristics or sustainability objectives, but firms face interpretation and implementation challenges. It could also potentially mislead users of disclosures if interpreted as a labelling regime.
- The Corporate Sustainability Reporting Directive (CSRD) which will significantly enhance the availability, comparability and reliability of sustainability information while introducing new data-points for companies to gather and measure, but the data will not be available for several years.
- Pillar 3 disclosure requirements for banks, with detailed templates for reporting on climate metrics which can also bring concerns regarding potential greenwashing allegations due to the sequencing of disclosures and a lack of availability of verifiable data.
- Integration of climate and environmental risk into banks' risk management frameworks including implementation of the ECB's expectations for Climate and Environmental Risk.; and
- The ESG disclosures required for BMR benchmarks and specific criteria for Climate Transition / Paris Aligned benchmarks, which rely on the reporting of ESG data described above and affect the disclosures provided to consumers and investors.

Work is also underway in several further areas including the creation of an EU Green Bond Standard, oversight of ESG Ratings and ESG Data providers and ESMA proposals on the naming of ESG investment funds.

The ESAs should carefully consider the existing and planned regulatory and supervisory framework and identify any gaps and required clarifications before embarking upon additional initiatives that could further increase complexity for financial institutions and investors. The importance of a stable legal and regulatory framework should also be kept in mind as a constantly changing framework can add to confusion in the market. To this end, we would encourage policy makers to perform a stocktake and assess the current sustainability regulatory framework, prior to taking any further actions to this fast-growing and complex environment.

Attention should also be brought to the coherence and consistency between the regulatory frameworks in various jurisdictions. Harmonisation between standards and methodologies is key in order to ease clarity and avoid misinterpretation of disclosures by analysts, investors and/or consumers. Finally, when considering greenwashing risks, it is important to consider this from a wholesale and a consumer perspective as the risks are likely to be different and the latter will be more vulnerable to greenwashing practices.

We make these recommendations to address concerns around the misrepresentation of sustainability claims:

1. Review the coherence of the existing regulatory framework, in the EU and internationally, and address areas of uncertainty, inconsistency or lack of appropriate sequencing that could increase greenwashing risk. We recommend enhancing the legal clarity of existing measures, monitoring their implementation, and offering targeted guidance to financial market participants, for example:
    a. Address implementation challenges and data gaps and consider the findings of this call for evidence as part of the input into a review of the EU Sustainable Finance regulatory framework, also taking account of the Platform on Sustainable Finance's work on the usability and coherence of the EU Taxonomy and the broader regulatory framework;
    b. Help investors and consumers understand the objectives (and limitations) of product-level disclosures, for instance by clarifying that the inclusion of sustainability-related information in product templates to meet the disclosure requirements in Article 8 SFDR does not entail the classification of a fund into a sustainable category;
    c. Provide further guidance on sustainable investment (including on sustainable derivatives and sustainability-linked bonds and loans) in the EU framework, based on existing industry initiatives and best practices, and facilitate the distribution of sustainable investment products by ensuring that the guidelines on sustainability aspects of the MiFID II suitability requirements help retail investors set realistic expectations and make more informed sustainable investment decisions.
    d. Address the sequencing challenges for disclosures, which create greenwashing risks due to lack of underlying data required for mandatory reporting requirements. Provide appropriate safe harbour provisions in mandatory disclosures where data gaps exist and ensure that disclosures for the financial sector are appropriately sequenced to apply only after the relevant data is available from the non-financial sector.
    e. Foster coordination internationally, to address the risks of regulatory fragmentation across different jurisdictions which increase the risks for greenwashing allegations for international firms. Harmonisation of EU regulation with future initiatives in other jurisdictions (e.g., FCA Sustainability Disclosure Requirements and investment labels, including naming and anti-greenwashing rules) is desirable.
2. Complete and support the implementation of the new rules in the EU sustainable finance framework which will provide its science-based foundations (EU Taxonomy Regulation), narrow down ESG data gaps (CSRD), and foster confidence and integrity in the market (EU Green Bond Standard).
3. Address the lack of a transition finance framework by evaluating the feasibility of setting out measurable, science-based transition milestones for specific sectors in the real economy, alongside principles for designing credible transition plans to enhance accountability (developed in collaboration with international organisations and standards). Regulators should prioritise further work to develop an effective transition finance framework, underpinned by guidelines on the design of credible and measurable transition plans for corporates and financial institutions:
    a. Develop harmonized and proportionate framework for transition plans that enable banks to assess the credibility of companies' transition plans. Credible transition plans with sufficient details are a key enabler for transition finance, reducing the risk of greenwashing.
    b. It is crucial in this context, to avoid fragmentation of transition plan reporting requirements across different regulations (e.g., EU CSRD Art. 19a; EU CSDDD Art. 15). Transition plan reporting requirements should also be aligned with recently published international best practices and guidance.

We also recommend that policymakers review their current legislative framework with a "transition finance" lens to identify opportunities to facilitate transition finance and ensure that it is appropriately provided for and not disincentivised in the regulatory framework.

4. Foster transparency on the methodologies used by market participants to gather and process ESG information, provide ESG data and ratings, and develop sustainability benchmarks. Transparency would aid understanding and use of ESG scores, ratings and benchmarks.
5. Mobilise resources to improve investor education, providing market participants and especially retail investors with the tools to identify opportunities aligned with their interests and articulate better their sustainability preferences. ESAs and market regulators have a role to play in "educating" and disseminating information on robust standards and global frameworks to ensure that stakeholders have well-founded opinions.
6. Mobilise resources and implement initiatives to assist and support financial institutions to enhance understanding, develop and strengthen skills and know-how of their workforce in order to deal with the complexity and new requirements of the European legislative framework.

The ESAs should consider the necessary balance between protecting consumers of financial products and the need to protect financial institutions (and other companies) from unsubstantiated greenwashing allegations. Such allegations tend to receive more attention than the reporting made by firms on the methodologies, data sources and any limitations for embedding sustainability considerations into risk management, sustainable investing, target setting, and scenario analysis, leading to risks to markets and reputational risks for institutions which can be difficult to be repaired.

Finally, while we note that the scope of the ESAs' mandates relate to misrepresentation in the financial sector, it is important to recognise that, in many cases, financial institutions are likely to be the recipients of misleading statements or data. Measures should therefore not be limited to the financial sector but should also be addressed throughout the real economy. Addressing greenwashing risks in the real economy would significantly reduce the prospects of greenwashing in the financial sector.

We hope that this response provides useful input into the ESAs' work on addressing greenwashing. We would be very happy to answer any questions and discuss these important issues further.

ESAs common questionnaire

1.1 Core features of greenwashing

This part of the survey enquires about the views of respondents on what can be seen as core characteristics of greenwashing, including:

1) Similarly with the communication of other misleading claims there are several ways in which sustainability-related statements, declarations, actions, omissions or communications may be misleading. On the one hand, communications can be misleading due to the omission of information that consumers or investors would need to take an informed transactional or investment decision (including but not limited to partial, selective, unclear, unintelligible, inconsistent, vague, oversimplistic, ambiguous or untimely information, unsubstantiated statements). On the other hand, communications can be misleading due to the actual provision of information, relevant to an informed transactional or investment decision, that is false, deceives or is likely to deceive consumers or investors (including but not limited to mislabelling, misclassification, mis-targeted marketing);

2) Greenwashing can occur either at entity level (e.g. in relation to an entity's sustainability strategy or performance), at product level (e.g. in relation to products' sustainability characteristics or performance) or at service level including advice and payment services (e.g. in relation to the integration of sustainability-related preferences to the provision of financial advice).

3) Greenwashing can be either intentional or unintentional (e.g. resulting from negligence or from misinterpretation of the sustainable finance regulatory framework requirement).

4) Greenwashing can occur at any point where sustainability-related statements, declarations or communications are made, including at different stages of the cycle of financial products/services (e.g. manufacturing, delivery, marketing, sales, monitoring) or of the investment value chain (e.g. issuer, benchmark/rating provider, investment firms, etc.).

5) Greenwashing may occur in specific disclosures required by the EU sustainable finance regulatory framework (e.g. SFDR Article 9 product-level disclosure requirements). Greenwashing may also occur as a result of non-compliance with general principles – as featured either in general EU financial legislation or more specifically in EU sustainable finance legislation (e.g. the requirement to provide information that is fair, clear and not misleading). In that context, greenwashing may occur in relation to entities that are currently outside of the remit of the EU sustainable finance legislation as it currently stands (e.g. ESG ratings).

6) Greenwashing can be triggered by the entity to which the sustainability communications relate or by the entity responsible for the product, or it can be triggered by third parties (e.g., ESG rating providers or third-party verifiers). 7) If not addressed, greenwashing will undermine trust in sustainable finance markets and policies, regardless of whether immediate damage to individual consumers or investors (in particular through mis-selling) or the gain of an unfair competitive advantage has been ascertained.

Q A.1: Please provide your views on whether the above-mentioned core characteristics of greenwashing reflect your understanding of and/or experience with this phenomenon and whether you have anything to add/amend/remove.

It is important to clearly define the scope of the term "greenwashing" as the term is frequently used in different contexts. The Call for Evidence appears to envisage a very broad interpretation of the term, potentially encompassing a wide range of statements and omissions. Please see our introductory comments above.

We consider that it is important to have a focused approach to greenwashing. An overly broad interpretation risks confusion amongst investors and other stakeholders and may hamper development of sustainable finance markets. The questionnaire provides an extensive list of possible core features of greenwashing. By taking all these features together, it is important to avoid coming up with a definition that, despite being all-encompassing, does not help – either authorities or market participants – develop targeted measures to fight greenwashing.

While greenwashing can potentially be interpreted broadly and can occur across economic sectors, we encourage the ESAs to consider definitions in the financial sector such as that put forward by IOSCO[5] which refers to "misrepresenting sustainability-related practices or the sustainability-related features of investment products" and the "anti-greenwashing rule" proposed by the UK FCA[6] which proposes to reaffirm that existing requirements around clear, fair and not misleading communications apply in the context of sustainability-related claims. There are also different references to greenwashing in the EU Taxonomy Regulation and SFDR Delegated Regulation. We strongly encourage the ESAs to coordinate with their international counterparts in their efforts to address greenwashing.

We propose that the ESAs' work to address greenwashing in the financial sector should be focused on addressing risks arising from greenwashing which involve misleading practices or claims where an element of fault is present i.e. the claim was intentionally misleading or resulted from negligence eg where a firm does not have appropriate systems and controls in place. Focusing on such misleading practices and claims would address the most significant areas for potential harm.

It is also important to note that in most cases, financial institutions will be the receivers of a misleading statement/data and that this can lead to "double counting" of greenwashing as financial institutions take the misleading information into account in their own progress towards commitments and disclosures.

Q A.2: Do you have or use a specific definition of greenwashing as part of your activities? If so, please share this definition.

Our members have established systems and controls internally to manage ESG risks but different firms are likely to have slightly different approaches to defining greenwashing, for instance by having a dedicated definition of greenwashing, or capturing it under a broader category of 'misleading claims', or awaiting to adopt a common understanding reached the market and regulators.

1.2 Dimensions of greenwashing

1.2.1. The potential roles market participants can play in greenwashing

Q A.3: Market participants could potentially play three main different roles (trigger, spreader, receiver) in any given occurrence of greenwashing. For instance, a corporate issuer can trigger greenwashing by understating its carbon emissions. This misleading claim could be communicated to both investment managers, ESG data providers and/or other market participants some of whom might continue to spread the misleading claim to the end investors/consumers, who will be the receiver of greenwashing.

Q A.3.1: Do you agree that market participants could be involved in three different ways in greenwashing, as described above? a) Yes b) No

Q A.3.2: If no, could you please further elaborate on the roles market participants could play in greenwashing, including on potential alternative or additional roles to the ones identified above?

[5] IOSCO Consultation Report CR01/21 *Recommendations on Sustainability Related Practices, Policies, Procedures and Disclosure in Asset Management*
[6] FCA CP22/20 on Sustainability Disclosure Requirements (SDR) and investment labels

It is important to distinguish between these different roles that financial institutions may play. These roles, however, can overlap and are not mutually exclusive – for example a “spreader” would also be a “receiver”. Further, these categories do not provide a full picture over which market participants should be held accountable for misleading claims. Therefore we do not find the characterisation of trigger, spreader, receiver as particularly helpful. For example a “spreader” will also be a “receiver”. There are cases where the market participants described by the ESAs do not fit the model. As highlighted above, there should be a clear distinction between cases where there is an element of fault, whether intentionally misleading or negligence and where a firm is not at fault, for example in using or communicating information which has been provided by a third party or based on proxies or estimates.

In each case, the element of fault and the materiality of the damage help distinguish cases in which a firm, through their intentional actions or negligence, harms trust in the market from cases where a firm had no intention to mislead and despite taking appropriate steps, were unaware that they were spreading a misleading statement.

This is an important distinction as it is not practicable or proportionate to hold market participants liable for misleading statements made by third parties unless they have themselves intended to mislead or been negligent in using or communicating the misleading information.

Q A.5.1: Please explain what types of impacts or harm and their consequences you anticipate as a result of greenwashing practices.

The occurrence of greenwashing and the perception of the risk thereof, like those of misrepresentation more generally, undermine trust in the market for sustainable finance products (and potentially in the broader market as a whole). This can constrain the potential for the development of sustainable finance products and demand from investors. Ultimately this can reduce the impact of the efforts to channel finance in support of sustainability objectives. Actual or perceived greenwashing may have a detrimental impact on investor and consumer perceptions of sustainable finance products and we are strongly supportive of regulators’ goal to maintain trust in the market. This is crucial to support the further development of sustainable finance and in turn the vital objective that it is seeking to achieve.

Q A.6: In addition to the three topics and eight sub-topics above, do you identify any additional topics which would be relevant to potential greenwashing issues? a) Yes b) No

Q A.6.1: If yes, please provide below more information on your answer including, if possible, a short example.

N/A

Q A.7: Please indicate below if you have any additional comments regarding the relevance of the above topics on which sustainability-related claims are made in the context of a given sector or entity.

N/A

1.2.3 The way in which a claim can be misleading

Q A.8.1: Please provide further comments to the identified misleading qualities of communication in the context of greenwashing. In particular, should any of the qualities be added, amended or deleted from the list and if so, why?

We view the proposed list of potential misleading qualities as comprehensive.

<u>1.2.5 At which stage of the lifecycle and where in the business model/management does greenwashing occur</u>

In addition to the different channels of transmission of claims, greenwashing can also occur at various stages of the product lifecycle, including: the product manufacturing stage (product development, product design, market targeting), the product delivery stage (marketing, product-related disclosure, distribution, sales), the product management stage (product monitoring/review, ongoing product-related disclosure). Beyond the product lifecycle, greenwashing can occur at the entity-level: in the business model (value chains, group structures, innovation and technology, outsourcing) or in the business management (culture, governance arrangements, systems and processes).

Q A.10: For each of the stages of product lifecycle and with regard to the business model and management, please indicate the likelihood of the occurrence of greenwashing. Please provide scores ranging from 1 (rather unlikely) to 5 (very likely):

a. Product manufacturing

b. Product delivery – marketing: advertisements, non-regulatory information

c. Product delivery – regulatory disclosure

d. Product delivery – distribution channels

e. Product delivery – sales: information asymmetry (this includes under or over emphasis of certain product features)

f. Product delivery – sales: misselling due to misleading information/disclosure

g. Product delivery – sales: misselling due to unsuitable product

h. Product delivery – sales: incentives at point of sale

i. Product management – product monitoring, product review, ongoing product disclosure j. Business model at entity level – value chain, group structure, innovation/digitalization, outsourcing k. Business management at entity level – culture, governance arrangements, systems and processes

We are not able to comment on the likelihood of the occurrence of greenwashing, but it is necessary to consider how it may occur at different stages of the product lifecycle as different measures may be appropriate. For example there could be specific risks for distributors. According to the amendments in the MiFID II Delegated Regulation, products suitable for distribution, where a firm is providing investment advisory or portfolio management services, will have to be identified via one or more of three different approaches based on the investment screening made under the Taxonomy's criteria, or the definition of sustainable investment in Article 2(17) of the SFDR, or against material PAI indicators. As a result, the assessment will involve, for financial advisors, a screening of the products' features and clients' sustainability preferences based on a variety of approaches and definitions, some of which are still open to interpretation. Distributors thus face the challenge of describing the different approaches, enquiring about sustainability preferences and presenting suitable options in a clear and effective manner, while retail investors may be asked seemingly redundant questions or presented with an overload of complex information and documentation, they may find difficult to navigate.

<u>1.2.6 Further considerations</u>

Q A.11: Are there any relevant elements or features of greenwashing which have not been referenced in the questions above? a) Yes b) No

Q A.11.1: If yes, please provide below more information on your answer including, if possible, a short illustration:

N/A

Q A.13 Do you want to raise any additional points that was not included in this survey?

While we welcome the ESAs' focus on addressing greenwashing, it is important to take into account that this call for evidence comes at a stage when some related EU legislation is just beginning to be implemented, while other regulations are still being finalised. Only once all this legislation is fully in place will we be able to see what greenwashing activity still slips through the gaps. In this context, it would be useful to carry out a thorough mapping exercise of greenwashing "topics" dealt with in EU legislation.

EBA section

Q9. Greenwashing can also generate financial risks to institutions. For credit institutions, what would be the risks most impacted by greenwashing? [For each of the following items, please provide a score from 1 (i.e. 'irrelevant') to 5 (i.e. 'extremely relevant') and elaborate if deemed appropriate].

a. Operational risk including losses related to litigation and liability risks 4

b. Conduct risk 4

c. Reputational risk 4

d. Strategic and business risk 4

e. Funding risk 2

f. Liquidity risk 2

g. Credit risk 2

h. Market risk 2

i. Other [specify]

Please briefly elaborate on your assessment. On an optional basis, you may also indicate what types of risks other (non-credit) institutions would be most materially exposed to as a result of greenwashing in your opinion.

We expect that the most relevant risks would include operational risk, conduct risk, reputational and strategic and business risks. We expect that funding risk, liquidity risk, credit risk and market risk would be less relevant.

Some examples of operational risks linked to greenwashing include:

- complaints for damages submitted by investors, non-governmental organisations or third parties arising from statements relating to the sustainability at entity or product level
- objections by any person made in connection with the falsehood or misleading nature of the sustainable statements and commitments provided within the regular financial statements or communications to the market.

Q10. In your view, the potential overall impact of greenwashing (understood here as any detriment that greenwashing may cause, including in terms of financial implications but not limited to) is:

a. for the credibility of sustainable financial markets: low, medium, high, I do not know?

b. for end-investors: low, medium, high, I do not know?

c. for individual customers: low, medium, high, I do not know?

d. for individual institutions (for example, in terms of impact on revenues or financial losses): low, medium, high, do not know?

e. For national (if applicable) financial stability (for example, in terms of impact on the functioning and stability of financial markets), low, medium, high, do not know?

f. For the EU financial stability (for example, in terms of impact on the functioning and stability of financial markets): low, medium, high, do not know?

Please briefly elaborate on your assessment

The occurrence of greenwashing and the perception of the risk thereof undermines trust in the market for sustainable financial markets. This can constrain the potential for the development of sustainable finance products and demand from investors. It may also dissuade firms from making commitments or adhering to initiatives. Ultimately this can reduce the impact of the efforts to channel finance in support of sustainability objectives.

The impacts for individual investors, customers or financial institutions will very much depend upon the particular circumstances so it is difficult to generalise in these terms. It is worth distinguishing between impacts on wholesale markets and institutions from consumers. However, we would not expect a significant risk to national or EU financial stability.

Addressing greenwashing risks

The questions below aim at identifying the potential challenges to prevent greenwashing and at determining how greenwashing risk within EU credit institutions, investment firms and payment service providers could be further tackled. For some of the items listed, please provide a score from 1 (i.e., 'irrelevant') to 5 (i.e., 'extremely relevant'), a brief explanation of the score as well as any justification or evidence underlying your response, whenever possible.

Q11. What are the main challenges to address greenwashing risk? [For each of the following items, please provide a score from 1 (i.e., 'irrelevant') to 5 (i.e., 'extremely relevant')?

a. Lack of relevant and reliable data on the sustainability credentials, performance and/or impacts: **5**

b. Uncertainty/ambiguity about sustainability standards, sustainability benchmarks, and sustainability eligibility criteria: **5**

c. Lack of internal resources and knowledge to implement and monitor sustainability standards: **3**

d. Lack of third-party verification or supervision: **3**

e. Inappropriate legal basis and tool to investigate and take legal actions against greenwashing: **1**

f. Other [specify]

Please briefly elaborate on your assessment

The availability of comparable, reliable sustainability data remains a key challenge that gives rise to the risk of greenwashing. The complexity and usability of the EU sustainable finance framework may also give rise to confusion and potentially differing interpretations. However, work is underway, for example to enhance the availability of corporate sustainability reporting, for the development of transition plans and ensuring transparency and trust in the market for ESG ratings. These efforts are still ongoing and we strongly support further progress in these areas which should, amongst other objectives, reduce greenwashing risk.

As discussed elsewhere in our response a lack of certainty regarding the interpretation of regulation is another key factor that should be addressed.

As also noted in our introductory remarks, there are a number of existing legal and regulatory frameworks and bases for investigation and taking legal action against greenwashing.

Q12. For institutions, which of the following types of tools and processes are used internally to address greenwashing? a. tools and processes for greenwashing specifically b. tools and processes related to regular business conduct, risk management and regulatory compliance c. None ☐ Please briefly elaborate on your assessment:

Banks have established tools and processes relating to business conduct, risk management and regulatory compliance which will progressively be able to address greenwashing risks. Firms are integrating ESG risks into processes and some are introducing additional specific processes to address greenwashing risk. Please see our recent publication on ESG and the role of compliance for further details of how banks are currently approaching ESG risk in their compliance functions.[7]

Q13. For institutions, what are the most important tools and processes you have in place (or are planning to put in place) to limit and address greenwashing risk. [For each of the following items, please provide a score from 1 (i.e., 'irrelevant') to 5 (i.e., 'extremely relevant').

1. At institution level:

a. Monitoring of factors and events that may give rise to reputational concerns 5

b. Code of conduct 3

c. Remuneration policies for sales staff that aim at mitigating the risk of mis-selling 5

d. Prudent communication for all sustainability -related communication 3

e. Internal control mechanism 4

e. Other [specify]

2. At the product/service level:

a. Applying market guidance and/or standards that contribute to anchor definitions and criteria 5

b. Using external reviews and third verification parties 4

c. Establishing a clear list of eligible projects and activities for sustainability lending/finance 5

d. Clear new product approval process and policy that applies to sustainability products 5

e. Other [specify] Dedicated internal rules for marketing materials and use of ESG data providers

Please briefly elaborate on your assessment.

[7] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME_ESGCompliance_2022_05.pdf

AFME, in collaboration with EY, recently published a report ESG and the Role of Compliance[8], which sets out observations on how compliance functions can support their firms in robustly and transparently managing the regulatory risks associated with ESG factors. The discussion paper is intended to be practical, to support the thinking and enable discussions within firms on shaping the role of compliance and ESG. It also includes output from a survey of members' current approaches and considers how firms can develop a compliance framework for ESG including addressing greenwashing risk.

Q14. In your opinion, to what extent is (/will) the EU regulations (or projects) on sustainable finance help addressing greenwashing risk within EU banks, investment firms and payment service providers? Please briefly elaborate on the expected benefits as well as on the potential shortcomings you may see in these regulations (/projects) presently?

A number of elements of the EU sustainable finance regulatory framework will help address greenwashing risk. It is important to recognise that significant areas of regulation and supervision of financial institutions already address a number of aspects of greenwashing risk. Examples include:

- The EU Taxonomy Regulation, which establishes science-based criteria for environmental sustainability and introduces associated disclosure requirements;
- The Sustainable Finance Disclosure Regulation (SFDR) which establishes disclosure requirements for sustainable investments;
- Pillar 3 disclosure requirements for banks;
- The Non-Financial Reporting Directive and Corporate Sustainability Reporting Directive (CSRD) which will significantly enhance the availability, comparability and reliability of sustainability data; and
- Integration of climate and environmental risk into banks' risk management frameworks including implementation of the ECB's expectations for Climate and Environmental Risk.

Work is also underway in several further areas including oversight of ESG Ratings and ESG Data providers, establishing an EU Green Bond Standard and ESMA proposals on the naming of ESG investment funds. While very significant progress has been made, we welcome the initiative to review the regulatory framework to maximise the usability and coherence of the framework as a whole.

The ESAs should carefully consider the existing and planned regulatory and supervisory framework and identify any gaps before embarking upon additional initiatives that could further increase complexity for financial institutions and investors. The importance of a stable legal and regulatory framework should also be kept in mind, as a constantly changing framework can add to confusion in the market. It is important to appreciate that the regulatory framework is still in a relatively early stage of implementation and that the market needs time to reach maturity and for the benefits of existing and forthcoming initiatives to be seen. Attention should also be brought on the coherence and consistency between the regulatory frameworks in various jurisdictions. Harmonisation between the standards and methodologies are key in order to ease clarity and avoid misinterpretation of disclosures by analysts, investors and/or consumers.

We make the following recommendations to address concerns around the misrepresentation of sustainability claims:

1. Review the coherence of the existing regulatory framework, in the EU and internationally, and address areas of uncertainty, inconsistency or lack of appropriate sequencing that could increase greenwashing risk. We recommend enhancing the legal clarity of existing measures, monitoring their implementation, and offering targeted guidance to financial market participants, for example:

[8] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME_ESGCompliance_2022_05.pdf

a. Address implementation challenges and data gaps and consider the findings of this call for evidence as part of the input into a review of the EU Sustainable Finance regulatory framework, also taking account of the Platform on Sustainable Finance's work on the usability and coherence of the EU Taxonomy and the broader regulatory framework;

b. Help investors and consumers understand the objectives (and limitations) of product-level disclosures, for instance by clarifying that the inclusion of sustainability-related information in product templates to meet the disclosure requirements in Article 8 SFDR does not entail the classification of a fund into a sustainable category;

c. Provide further guidance on sustainable investment (including on sustainable derivatives and sustainability-linked bonds and loans) in the EU framework, based on existing industry initiatives and best practices, and facilitate the distribution of sustainable investment products by ensuring that the guidelines on sustainability aspects of the MiFID II suitability requirements help retail investors set realistic expectations and make more informed sustainable investment decisions.

d. Address the sequencing challenges for disclosures, which create greenwashing risks due to lack of underlying data required for mandatory reporting requirements. Provide appropriate safe harbour provisions in mandatory disclosures where data gaps exist and ensure that disclosures for the financial sector are appropriately sequenced to apply only after the relevant data is available from the non-financial sector.

e. Foster coordination internationally, to address the risks of regulatory fragmentation across different jurisdictions which increase the risks for greenwashing allegations for international firms. Harmonisation of EU regulation with future initiatives in other jurisdictions (e.g., FCA Sustainability Disclosure Requirements and investment labels, including naming and anti-greenwashing rules) is desirable.

2. Complete and support the implementation of the new rules in the EU sustainable finance framework which will provide its science-based foundations (EU Taxonomy Regulation), narrow down ESG data gaps (CSRD), and foster confidence and integrity in the market (EU Green Bond Standard).

3. Address the lack of a transition finance framework by setting out measurable, science-based transition milestones for specific sectors in the real economy, alongside principles for designing credible transition plans to enhance accountability (developed in collaboration with international organisations and standards). Regulators should prioritise further work to develop an effective transition finance framework, underpinned by guidelines on the design of credible and measurable transition plans for corporates and financial institutions:

    a. Develop harmonized and proportionate framework for transition plans that enable banks to assess the credibility of companies' transition plans. Credible transition plans with sufficient details are a key enabler for transition finance, reducing the risk of greenwashing.

    b. It is crucial in this context, to avoid fragmentation of transition plan reporting requirements across different regulations (e.g., EU CSRD Art. 19a; EU CSDDD Art. 15). Transition plan reporting requirements should also be aligned with recently published international best practices and guidance.

We also recommend that policymakers review their current legislative and regulatory frameworks with a "transition finance" lens to identify opportunities to facilitate transition finance and ensure that it is appropriately provided for and not disincentivised in the regulatory framework.

4. Foster transparency on the methodologies used by market participants to gather and process ESG information, provide ESG data and ratings, and develop sustainability benchmarks. Transparency would aid understanding and use of ESG scores, ratings and benchmarks.
5. Mobilise resources to improve investor education, providing market participants and especially retail investors with the tools to identify opportunities aligned with their interests and articulate better their sustainability preferences. ESAs and market regulators have a role to play in "educating" and disseminating information on robust standards and global frameworks to ensure that stakeholders have well-founded opinions.
6. Mobilise resources and implement initiatives to assist and support financial institutions to enhance understanding, develop and strengthen skills and know-how of their workforce in order to deal with the complexity and new requirements of the European legislative framework.

Q15. Beyond the existing and forthcoming implementation of the EU sustainable finance regulations, what actions could be taken to further mitigate greenwashing risk? For each of the following items, please provide a score from 1 (i.e., 'irrelevant') to 5 (i.e., 'extremely relevant').

a. Develop further labels 4

b. Improve supervisory oversight 3

c. Develop regulatory guidance 5

d. Further increase transparency 3

e. Other [specify]

Please briefly elaborate on your assessment

In light of the progress made to date on establishing the regulatory framework, we consider that the most effective action would be to provide further guidance on existing regulaotion to enable the usability of existing initiatives, for example further FAQs and a resource for answering questions from a practical perspective.

In addition to the above recommendations on the existing and forthcoming implementation of the EU sustainable finance regulation, we make the following recommendations to address greenwashing risk:

1. Evaluate the feasibility of stablishing measurable, science-based transition milestones for specific sectors in the real economy, alongside principles for designing credible transition plans to enhance accountability (developed in collaboration with international organisations).
2. Foster transparency on the methodologies used by market participants to gather and process ESG information, provide ESG data and ratings, conduct external reviews and develop sustainability benchmarks. Transparency would aid understanding and use of ESG scores, ratings and benchmarks.
    a. establish a register of external verifiers authorized by the European authorities in order to ensure that they meet the requirements for verifying entities regarding greenwashing matters with a correct management of potential conflict of interests.
3. Mobilise resources to improve investor education, providing market participants and especially retail investors with the tools to identify opportunities aligned with their interests and articulate better their sustainability preferences. ESAs and market regulators have a role to play in "educating" and disseminating information on robust standards and global frameworks to ensure that stakeholders have well-founded opinions.

Finally, while we note that the scope of the ESAs' mandates relate to misrepresentation in the financial sector, it is important to recognise that, in many cases, financial institutions are likely to be the recipients of misleading statements or data. Measures should therefore not be limited to the financial sector but should also be addressed throughout the real economy. Addressing greenwashing risks in the real economy would significantly reduce the prospects of greenwashing in the financial sector.

ESMA section

As stated previously, the drivers of greenwashing are multifaceted and better understanding them is critical to addressing the issue.

F.1. Which of the elements listed below, do you consider to be the main driver(s) of greenwashing risks? Please provide a short explanation of your answer: [multiple answers allowed]

a) New / innovative ESG products in rapidly evolving ESG markets

b) Entry of new participants such as issuers of ESG products, ESG rating or data providers, etc.

c) Lack of ESG expertise and skills of market participants

d) A rapidly evolving regulatory framework

e) Differing interpretations of the regulatory framework

f) Desire to exaggerate the sustainability profile at entity/product or service level

g) Competition (wanting to be better than a comparable issuer/product)

h) Lack of reliable data

i) Mismatch between retail investors' expectations and market participants' ability to deliver real-world impact

j) Financial literacy

k) Other, please specify

In our recent report ESG and the Role of Compliance[9], we identified a number of challenges which can give rise to greenwashing risk. These include a lack of clarity and changing definitions or expectations of what is classed as sustainable, reliance on clients, businesses, ESG ratings and data providers and second party opinion providers, and a lack of clarity in regulatory expectations and requirements.

F.2. As stated before, this CfE uses the term greenwashing broadly, covering sustainability-related claims relating to all aspects of the ESG spectrum. While the sustainable finance legislation gives more prominence to environmental aspects, we would like to understand which aspects of the ESG spectrum may be more prone to greenwashing risks, at this stage? Please rate the three aspects below from 1 to 5 (where 1 = very low occurrence ; 2 = low occurrence ; 3 = medium occurrence ; 4 = high occurrence ; 5 = very high occurrence [multiple choice]

a) Environmental aspects b) Social aspects c) Governance aspects

As there has been greater emphasis on climate aspects and less so on other environmental or social aspects in, for example, taxonomies and corporate disclosures, there can be less developed data available. This opens up to different possible interpretations of sustainability claims and, in turn, both legitimate or unsubstantiated greenwashing allegations, particularly in cases where there could be a conflict between environmental and

[9] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME_ESGCompliance_2022_05.pdf

social objectives (e.g., investment in mass transit infrastructure with social benefits, brought by alleviating congestion and improving quality of life, considered alongside its inherent GHG emissions). The impact of misrepresentation on market development is of particular concern for social impact investment, where the investment flows are very limited compared to what is actually needed. However, for this sort of investment, the difficulty in defining specific criteria for misrepresentation is particularly prominent, as an overly stringent framework may, in light of the difficulty in setting objective measures of social impacts, restrict the growth of the market. AFME recently published a report with EY which amongst other things highlights a number of challenges with scaling finance in support of nature and biodiversity objectives including a lack of agreed metrics and comparable data.[10]

2. Consideration of greenwashing risks by financial market participants and issuers

It appears that some industry players already perceive greenwashing as a source of potential risks for their own development and performance and have started to take action with the view to mitigate such risks. The following section seeks to collect insights on how financial market participants and issuers perceive greenwashing and take action to address the issue at their level.

F.7. Does your organisation perceive greenwashing as a potential source of risk? a) Yes, and we have started developing a structured approach to tackling the issue b) Yes, but we have not yet developed a structured approach to the issue c) No d) Other, if so specify

F.7.1. If you answered a) or b) to Q7: what category of related risks do you anticipate could result from greenwashing issues? [multiple answers allowed] a) Financial risks b) Reputational risks c) Legal risks d) Other, if so specify:

- regulatory risk
- commercial risk

F.7.2. If you answered a) or b) to Q7: what types of potential negative impacts do you anticipate as a result of greenwashing issues?

F.7.3. If you answered a) to Q7: What safeguards / risks mitigants have you (or are you planning to) put in place to address greenwashing risks?

AFME members have developed and put in place a range of measures to mitigate greenwashing risks, including, for example, the following:

- Central governance on sustainability
- ESG commitments tracking at Group level
- Third party opinions on internal Sustainable / Green Finance Frameworks
- New Product Approval (NPA) process for ESG related products
- Independent validation of Sustainable Finance labelled financing performed by central SME function
- KPI Tracking for Sustainability-linked solutions
- Marketing materials reviewed by Sustainability function
- Monitoring of transactions with clients from high-emission sectors for net-zero pathway alignment
- Regular Environmental and Social due diligence for selected clients

[10] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME_Biodiversity2022-3.pdf

- Use of external ESG data and review of external ESG data providers

F.8. Do you know of any industry initiative that could be instrumental in tackling greenwashing?

Market standards for green bonds and green loans provide a framework which helps tackle greenwashing.

F.9. Which do you think are the market mechanisms that can help mitigate greenwashing risks (e.g. reputational issues) and how do you believe supervisors can help in this respect?

The increasing focus of investors and other stakeholders on sustainability claims provides an important market mechanism in dissuading greenwashing. This should become more efficient as the availability and comparability of sustainability information improves and other areas of regulation are implemented such as the EU Green Bond Standard, Taxonomy and financial sector disclosures and forthcoming focus on ESG ratings. It is important that a clear framework is provided for the market to work effectively and to avoid claims which are not grounded in evidence.

F.10. What could policymakers and regulators do more to alleviate greenwashing risks?

We make the following recommendations to address concerns around the misrepresentation of sustainability claims:

1. Review the coherence of the existing regulatory framework, in the EU and internationally, and address areas of uncertainty, inconsistency or lack of appropriate sequencing that could increase greenwashing risk. We recommend enhancing the legal clarity of existing measures, monitoring their implementation, and offering targeted guidance to financial market participants, for example:
    a. Address implementation challenges and data gaps and consider the findings of this call for evidence as part of the input into a review of the EU Sustainable Finance regulatory framework, also taking account of the Platform on Sustainable Finance's work on the usability and coherence of the EU Taxonomy and the broader regulatory framework;
    b. Help investors and consumers understand the objectives (and limitations) of product-level disclosures, for instance by clarifying that the inclusion of sustainability-related information in product templates to meet the disclosure requirements in Article 8 SFDR does not entail the classification of a fund into a sustainable category;
    c. Provide further guidance on sustainable investment (including on sustainable derivatives and sustainability-linked bonds and loans) in the EU framework, based on existing industry initiatives and best practices, and facilitate the distribution of sustainable investment products by ensuring that the guidelines on sustainability aspects of the MiFID II suitability requirements help retail investors set realistic expectations and make more informed sustainable investment decisions.
    d. Address the sequencing challenges for disclosures, which create greenwashing risks due to lack of underlying data required for mandatory reporting requirements. Provide appropriate safe harbour provisions in mandatory disclosures where data gaps exist and ensure that disclosures for the financial sector are appropriately sequenced to apply only after the relevant data is available from the non-financial sector.
    e. Foster coordination internationally, to address the risks of regulatory fragmentation across different jurisdictions which increase the risks for greenwashing allegations for international firms. Harmonisation of EU regulation with future initiatives in other jurisdictions (e.g., FCA

Sustainability Disclosure Requirements and investment labels, including naming and anti-greenwashing rules) is desirable.

2. Complete and support the implementation of the new rules in the EU sustainable finance framework which will provide its science-based foundations (EU Taxonomy Regulation), narrow down ESG data gaps (CSRD), and foster confidence and integrity in the market (EU Green Bond Standard).
3. Address the lack of a transition finance framework by evaluating the feasibility of setting out measurable, science-based transition milestones for specific sectors in the real economy, alongside principles for designing credible transition plans to enhance accountability (developed in collaboration with international organisations and standards). Regulators should prioritise further work to develop an effective transition finance framework, underpinned by guidelines on the design of credible and measurable transition plans for corporates and financial institutions:
    a. Develop harmonized and proportionate framework for transition plans that enable banks to assess the credibility of companies' transition plans. Credible transition plans with sufficient details are a key enabler for transition finance, reducing the risk of greenwashing.
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    We also recommend that policymakers review their current legislative and regulatory frameworks with a "transition finance" lens to identify opportunities to facilitate transition finance and ensure that it is appropriately provided for and not disincentivised in the regulatory framework.
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5. Mobilise resources to improve investor education, providing market participants and especially retail investors with the tools to identify opportunities aligned with their interests and articulate better their sustainability preferences. ESAs and market regulators have a role to play in "educating" and disseminating information on robust standards and global frameworks to ensure that stakeholders have well-founded opinions.
6. Mobilise resources and implement initiatives to assist and support financial institutions to enhance understanding, develop and strengthen skills and know-how of their workforce in order to deal with the complexity and new requirements of the European legislative framework.

The ESAs should consider the necessary balance between protecting consumers of financial products and the need to protect financial institutions (and other companies) from unsubstantiated greenwashing allegations. Such allegations tend to receive more attention than the reporting made by firms on the methodologies, data sources and any limitations for embedding sustainability considerations into risk management, sustainable investing, target setting, and scenario analysis, leading to risks to markets and reputational risks for institutions which can be difficult to be repaired.

Finally, while we note that the scope of the ESAs' mandate relates to greenwashing in the financial sector, it is important to recognise that greenwashing is not limited to the financial sector but should also be addressed throughout the real economy. Addressing greenwashing risks in the real economy would significantly reduce the prospects of greenwashing in the financial sector.

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.