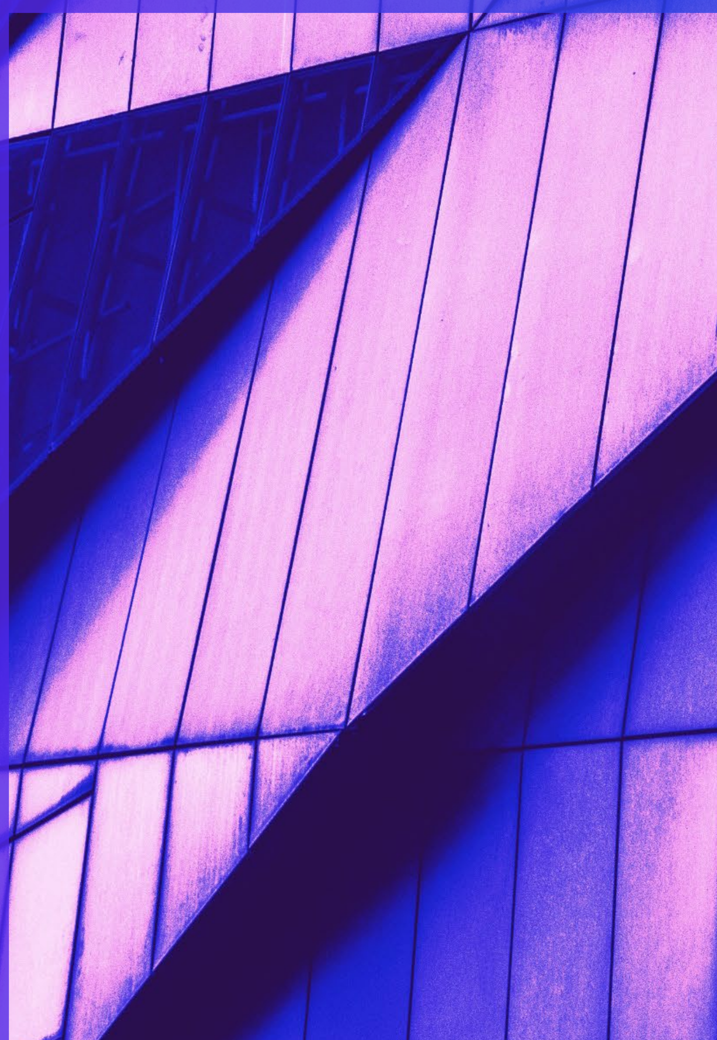
Avoiding the Greenwash Peril

Best practices for the asset management sector



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Foreword

When Climate meets Credit
Greenwashing, as a concept, can be viewed in the context of past misleading activities leading to shocks in the capital markets such as the real estate crash in 2008. Against the backdrop of immense demand for packaged mortgage products, the often conflicted relationship of ratings agencies and those that packaged mortgage products incentivised credit risk misrepresentation. The result of this dynamic led to a significant miscalculation of the actual risks that investors were taking on, whereby a AAA rated investment product, *the same credit rating of the U.S. Government*, contained pronounced exposure to poorly rated, subprime mortgages. As the market collapsed, bringing down the global economy, we all became acutely aware of what it meant to "wash" a financial product.

By 2023, the growing demand for sustainability-related offerings, coupled with the rapidly evolving regulatory landscape, has created a conducive environment for greenwashing.

What is Greenwashing?
Greenwashing can be defined as misleading or unsubstantiated claims about sustainability performance made by a business or investment fund regarding their products or activities. It is important to note that the term greenwashing includes claims relating to all aspects of the ESG spectrum (i.e., environmental, social and governance). Ultimately, greenwashing undermines trust in the market and can lead to the misallocation of capital intended for sustainable investments and the risk the investor is taking by deploying capital in a financial product that is not fully understood.

Counterbalanced against this is the term *Greenhushing* which refers to a company's refusal to publicise anything, or very little, about the sustainability of its products or services for fear of being open to criticism i.e. facing pushback from stakeholders who view their efforts as not ambitious enough or from investors who believe ESG efforts undermine returns or run counter to prevailing values. *Greenhushing* consequently can make corporate climate targets harder to scrutinise by investors, leading to less ambitious targets being set and limitations on knowledge sharing and collaboration in industry.

These sometimes abusive marketing practices, where the sustainability benefits of a product, service or a strategy, are misrepresented, could threaten the resilience of the financial markets as occurred in 2008.

In this paper we consider common errors that can, at the very least, have the appearance of a greenwashing activity. This is not an exhaustive list of potential greenwashing practices, however, we have considered those practical pitfalls that are most common, which even the best intending investment managers will need to actively avoid.

Why?

Greenwashing often occurs where competing interests intersect. The commercial impetus of an investment management firm to drive AUM, and in turn revenue, can conflict with ESG strategy or even be influenced by demand for ESG. For example, in pursuit of investment, the firm might overinflate "Sustainable AUM" to appear as a leader in the space.

A recent study from carbon consultancy South Pole reports that 25% of surveyed UK-based heavy-emitting companies are 'going green, then going dark', in other words are setting targets but still refusing to publicise them completely

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Although Europe has led the charge, regulators across jurisdictions are seeking to protect financial markets against the potential damage of greenwashing.

How SFDR Seeks to Lessen Greenwashing

The Sustainable Finance Disclosure Regulation (SFDR) aims at preventing greenwashing and ensuring data comparability through enhanced standardised transparency on sustainability within the financial markets.

It is designed to drive convergence in how funds describe themselves with respect to sustainability and in turn reduce confusion in the market, making greenwashing more difficult.

SFDR requires that fund managers provide information about the ESG risks and negative impacts of their investment on society and the planet across mandatory ESG indicators, known as Principal Adverse Impact (PAI) indicators, under certain circumstances where the regulated entity is not permitted to an exemption from reporting PAIs.

SFDR is intended to raise the bar for investment products, particularly those seeking to promote ESG characteristics and objectives, by setting a strict minimum-disclosure standard.

Key Mechanisms

- Precontractual disclosures set out the investment policy as it relates to ESG
- Disclosure of Materiality in ESG; Article 6 (Brown), Article 8 (Light Green) & Article 9 (Dark Green)
- Article 8 & 9 Funds required, under certain circumstances, to report on 14 ESG metrics and 2 optional metrics; known as Principle Adverse Impact (PAI) Data

How UK SDR Seeks to Lessen Greenwashing

The UK Sustainability Disclosure Requirements (SDR) aim to encompass the full breadth of sustainability disclosures for financial services and companies into a single, integrated framework. In doing so, the SDR aims to increase transparency around the sustainability credentials of investment products.

Specifically the SDR will include disclosures against the UK's 'green taxonomy', the Task Force on Climate-related Financial Disclosures (TCFD) and subject to consultation, reporting under the IFRS Foundations' International Sustainability Standards Board (ISSB).

Furthermore, from 2023 firms will also need to disclose on a mandatory basis their climate transition plans and these will need to align with the UK's 2050 net-zero objective.

In addition to the overall SDR requirements, the Financial Conduct Authority (FCA) has published a Consultation Paper which proposes new measures under the SDR, including; a sustainable investment labelling regime for investment products, new sustainability-related disclosure requirements and a general 'anti-greenwashing' rule.

Key Mechanisms

- Sustainable investment labels to help investors distinguish between products based on their sustainability characteristics ('sustainable focus', 'sustainable improvers' and 'sustainable impact')
- Consumer facing product-level disclosures about the investment strategy of the product and relevant sustainability performance metrics
- 'Anti-greenwashing' express rule that reiterates requirements for all regulated firms that sustainability claims must be fair, clear and not misleading
- Pre-contractual disclosures set out the investment policy as it relates to ESG from 2024

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We have set out below some common greenwashing pitfalls, paired with examples of best practice mitigants. Many of these examples have been successfully pursued by regulators. In some cases, the resulting remediation and penalties resulted in multi-million dollar judgements.

1. Temporal Greenwashing

Although one of the key aims of SFDR is to prevent greenwashing, it still allows room for firms to report misleading and inaccurate representations of their portfolios.

Specifically, investment managers can rebalance their portfolios prior to the reporting dates and as such 'drop' investments which are not ESG aligned.

Subsequently, the portfolio will appear more sustainable than it is, positioning it in a more sustainable light. To avoid this form of greenwashing it is recommended that portfolio positioning is captured on a higher frequency than is required by the regulation.

Best Practice

- **Robust Internal Controls:** Create separation of control oversight;
  - Separate officer to monitor portfolio
  - Implement pre-trade ESG clearance programs
- **Track Portfolio Holdings:** Frequently download/backup portfolio holdings to create a record.
- **Document Investment Rationale:** For every investment decision;
  - include written thesis or view of the ESG considerations for the investment
  - consider PAI data points in the investment thesis and record expectations

2. Data Cherry Picking

Data collection and disclosure under the SFDR will prove challenging due to the lack of availability of non-financial ESG data. It is therefore unlikely that firms will be able to collect 100% of ESG data from one provider and consequently multiple data providers will be required to satisfy the SFDR reporting requirements.

This creates room for portfolio managers to pick and choose data from different providers as to present their investment most favourably.

Where firms are collecting data from multiple vendors, there needs to be consistent structures in place and consistent application of policy when selecting one metric over another. The firm will need to be able to provide clear justifications for data and metric selection in line with the SFDR requirements.

Best Practice

- **Data Due Diligence:** Fully understand the methodology and limitations (*e.g. coverage*) of third party data providers.
- **Written Data Policy:** Record the data procurement process and establish KPI's that when violated require review.
- **Consistent Policy:** When multiple data providers are engaged, ensure consistency in application of data across multiple funds consistently.
- **Question Data Sources:** Frequently check data versus other data providers and implement reasonability checks.
- **Do Not Depend on Ratings:** Ratings represent an opportunity for ambiguity. Understand the methodology for creating a rating and require notice for any change in methodology.

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3. Portfolio Management Bias

Portfolio management bias has its greatest applicability to investment strategies that are dependent on an index.

This is common in passive investment approaches whereby a third party index provider will create a basket of securities based on certain criteria.

The calculation of jurisdiction, sectors, industries and weightings for each constituent can sometimes be misunderstood by the fund manager and lead to a mismatch in naming conventions versus the actual underlying investments.

For example, a fund might represent sustainability in marketing materials and name, but have exposure to fossil fuels if the index is transitory in nature.

In an effort to not have the appearance of greenwashing, a number of passive funds have downgraded from Article 9 to 8, in part, for this reason.

Best Practice

- **Investment Dependencies:** Fully understand and document rationale associated with the use of external investment management mechanisms (*e.g. reference indexes*)
- **Vendor Alignment:** Ensure that third party vendors, such as investment sub-advisors, are required to provide ESG related information.
- **Embed Compliance:** Tailor an ESG compliance programme that fits specific investment strategies. For example, pre-trade clearance for public equity strategies or required assurance of portfolio companies for private equity investments.
- **Marketing Oversight:** Require an ESG review prior to authorised use of marketing material;
  - Ensure consistency with regulatory reporting.
  - Require audit trail of firm metrics (*e.g. Sustainable AUM)*
  - Require plain language disclosures for all metrics and qualitative elements

4. Lack or Deficit in Policy

Written and implemented policy is the cornerstone of anti-greenwashing.

Policy starts with agreement of leadership and documentation. Similar to a compliance manual, and ESG manual should set out the basic policy specific to that investment strategy.

In the European context, regulators are keen on the concept of “show me, don’t tell me.” Those that have written policy have a better chance of concluding such a review unscathed.

Best Practice

- **ESG Regulatory Manual:** Documentation of all considerations, methodology, limitations, remediation approach, policy and regulatory register associated with regulation on every jurisdiction of distribution.
- **Management Commitment:** Senior staff should have remuneration attached, in some part, to ESG compliance and policy.
- **Expert Oversight**: Upskill or hire senior staff for ESG expertise.
  - If the investment vehicle is a regulated fund structure, add at least one board member with ESG expertise that can be applied in an oversight function.
  - Engage third party vendors for ESG assurance.

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5. Overstated AUM

As the demand for ESG investment products increases, investors are struggling to find attractive and adequate ESG investment opportunities, leaving room for unintentional greenwashing. In some instances, firms will overstate ESG AUM as a result of miscalculation of funds' defining variables.

For example, let's assume that a firm with $500mm in AUM has $50mm is in a fund called Sustainable Transition that only considers companies which will benefit by a transition from fossil fuels to renewable energy, representing a component of the ESG agenda. It is possible that these assets might be counted by an ill-informed staff member to be ESG assets when the investment objective does not take Social or Governance factors into account. As a result of an error, the firm would unintentionally represent exaggerated levels of ESG assets under management.

Best Practice

- **Policy Driven**: Ensure firm policy for AUM calculation;
  - takes into account the specific categorisations; based on the investment process' consideration of E, S & G factors.
  - policy describes calculation methodology
  - AUM matches regulatory disclosure
- **Calculation Oversight**: Compliance officers should review all externally distributed material to ensure policy is being adhered to.
- **Detailed Disclosure**: Create plain language disclosure that fully describes
  - the calculation methodology
  - what the firm defines the AUM label as
  - what ESG-related theme the AUM does and does not include
  - any investment restrictions or permitted investments associated with the AUM

ESG assets are on a pace to constitute 21.5% of total global Assets under Management (AUM) in less than 5 years.

6. Naming Conventions

Historically, product managers and other distribution professionals seek fund names which catch the interest of investors through the use of buzzwords relating to a market or investment trend. With ESG funds under significant demand, this form of greenwashing has become particularly prevalent.

The current deficit in industry standards against which to measure the sustainability performance of a fund makes it hard for investors to understand exactly how sustainable their investments are.

Funds claiming to be 'sustainable', 'green' or 'ESG' in nature may prove to have no significantly lower carbon intensity than regular funds. Thus funds claiming to be sustainable, without material evidence, may ultimately mislead investors.

Best Practice

- **Require Rationale:** In the product launch process, require staff to provide the rationale for the fund name. Most notably, compliance officers should ensure;
  - no inference is being made
  - that the name matches the investment strategy
  - the name does not violate regulation in each jurisdiction of distribution
- **Set Expectations:** Clearly state the intentions and investment strategy in plain language.
- **Data Proof**: If a fund claims to be "green", for example, then the observed data related to environmental metrics should be relatively better metrics than "non-green" peers.

Getting ahead of greenwash

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The future of greenwashing

Drawing from tough lessons learned in 2008, regulators in Europe are accelerating their scrutiny of the potential threat of greenwashing on the resilience of the financial markets.

1. ESAs launch joint Call for Evidence on greenwashing

Three European Supervisory Authorities (EBA, EIOPA and ESMA – collectively "ESAs") published a Call for Evidence on greenwashing on November 15th, 2022. The call seeks to gather input from stakeholders on how to understand the key features, drivers and risks associated with greenwashing and to collect examples of potential greenwashing practices. Obtaining a more granular understanding of greenwashing will help inform policy makers and ultimately help foster the reliability of sustainability-related claims. All interested parties are welcome to contribute to the survey, including financial institutions under the remit of the three ESAs and other stakeholders ranging from retail investors and consumers' associations to NGOs and academia. Respondents were asked to submit their responses by 10 January 2023.

2. ESMA's call for Naming Regulation

ESMA is seeking input on draft guidelines on the use of ESG or sustainability-related terms in fund's names. ESMA is particularly seeking stakeholders' feedback on the introduction of quantitative thresholds for the minimum proportion of investments sufficient to support the ESG or sustainability-related terms in funds' names. The objective is to ensure that investors are protected against unsubstantiated or exaggerated sustainability claims whilst providing asset managers with clear and measurable criteria to assess names of funds. The consultation period closes on 20 February 2023 with a view to finalise the guidance afterwards.

3. Investors Holding Managers Accountable

Active ownership is when shareholders engage in a company they have invested in to influence the company's leadership, strategy and actions. It is a method often used in responsible investing and has taken on ever greater significance as environmental, social and governance themes feature more prominently in investing. Active ownership includes proxy voting, engagement, filing shareholder resolutions and other forms of influence that investors can use as financial stakeholders.

Shareholder voting is the most common way for shareholders to influence a company's operations, corporate governance and social responsibilities. Thus, a key feature of any active ownership strategy is the asset manager's proxy-voting policy, which sets principles for the way in which asset managers vote on behalf of their clients at shareholder meetings.

Recent data from Morningstar on U.S proxy voting, shows that the number of E&S shareholder resolutions that were opposed by company boards increased by 42% year over year. Subsequently, asset managers are responding by providing more detailed and specific policies on which E&S proposals they would support. This is intended to lead to more transparency for investors.

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How KPMG Sustainable Futures Can Help

KPMG Sustainable Futures is a dedicated cross-functional team of experts who help corporate, finance and public sector clients plan and execute programmes addressing ESG topics, decarbonisation and long-term value creation.

The team brings together a wide range of disciplines including sustainability practitioners, economists, engineers, corporate strategists, accountants, credit risk experts and financiers to help clients navigate the complex and fast evolving climate change and sustainability agenda.

Services

Gap Analysis

- Full firm review and analysis
- External analysis
- Peer analysis
- Risk identification and register

ESG Integration

- Investment process retooling
- Marketing material integration
- ESG Data due diligence, implementation and optimisation

Regulatory Handbook

- Policy, methodology & supervisory mechanisms
- Third party data procurement
- Regulatory Register for investment managers and their investors

SFDR Advisory

- ESG Readiness Assessment
- House/Fund level strategy
- Product governance
- Product launch
- Commercial Peer analysis

ESG Training

- Upskilling current staff
- Quarterly new staff training
- Bespoke training specific to firm policy, asset class and jurisdiction

ESG Reporting

- Reporting process and oversight
- SFDR Periodic Reporting
- Annual Firm CSR/ESG Report
- ESG Factsheets by Fund

ESG Assurance

- KPMG led workshops for external stakeholders
- Agreed Upon Procedure (AUP) private reports
- External assurance opinions

Compliance by Design

- Governance design and implementation
- Product policy and sustainability risk analysis
- Risk management framework
- Disclosures and transparency

Leadership

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