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A Practical Guide to Greenwashing for Financial Institutions

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Introduction

Financial institutions face growing exposure for greenwashing. This can arise not only when their public statements on sustainability and responsible business practices are misleading, selective or incomplete, but also when their products and marketing strategies do not align with their public sustainability goals. Sustainability-related communications range from the publication of nonfinancial statements to the referencing of such terms in financial product names. Litigation, enforcement and damage to reputation represent key risks for financial institutions in this respect.

Increasing demands on reporting have made businesses more vulnerable to scrutiny. In this respect, the Network for Greening the Financial System considers that the expansion of regulatory reporting has increased the likelihood of cases being brought directly against financial institutions.[1] In the last year, regulators as far apart as the US and Australia have brought enforcement action for greenwashing, and more will likely follow. Similarly, within the EU, the number of greenwashing allegations involving large firms has risen of late. After the oil and gas sector, financial services is the second most affected sector of the economy, ahead of food and beverage.[2] Regulatory findings often lead to civil litigation, both because they attract attention to potentially actionable conduct and because claimants can use adverse regulatory decisions to help establish liability in civil proceedings.

This guide considers what is greenwashing, the developing legal landscape and how financial institutions may mitigate the risk of reputational damage.

Reputational

A financial institution that claims to be sustainable but is perceived to have misled customers can face widespread market publicity, causing significant damage to its reputation and loss of market share allowing competitors to gain a competitive edge.

Customer distrust and disengagement

If customers see a lack of authenticity in a firm's sustainability claims, they may become skeptical of such promotions, reducing the flow of capital into financial products, thereby slowing alignment of the economy with net-zero carbon emissions goals.

Legal consequences

Regulatory authorities and nongovernmental organizations are increasingly scrutinizing businesses for potential greenwashing. Financial institutions may face significant fines, which can further impact their reputation and profitability.

Definitions

Although the term greenwashing is now frequently used, there is no authoritative definition; however, some regulations do refer to it in specific contexts. The International Organization of Securities Commission's 2021 "Asset Management Report" describes green-washing as "the practice of misrepresenting sustainability-related practices or the sustainability-related features of investment products." In the EU, the European financial supervisory authorities refer to greenwashing as "a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial service."[3] Consequently, consumers, investors and other market participants may be misled. Examples given include cherry-picking, omission, ambiguity, exaggeration and misleading terms.

Greenwashing claims usually relate to statements about an entity's (or its products') environmental credentials, but they can also be brought in connection with disclosures on other issues, including equality, diversity and inclusion.

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Greenwashing Dynamics | Greenwashing Risk

Operational-level forces

- Gaps and inconsistencies in regulatory framework
- Poor governance, lack of skilled staff
- Limited resources available for systems and controls and compliance
- Limited and poor-quality sustainability data on underlying investments and economic activities
- Inadequate labelling schemes and poor retail investor knowledge

High-level forces

- Increasing demand for "Sustainable" Products and Services
- Incentives to associate products and services with sustainability at risk of exaggeration and selectivity in descriptions etc.
- Reliability of sustainability ratings and data gaps at the corporate level
- Increasing regulatory enforcement focus and NGO appetite to bring claims

Transition finance

Transition finance can facilitate the transition of high emission and hard to abate economic activities toward net zero targets. Particular care, however, is required to avoid allegations of "transition washing" due to the need to have credible transition plans. For example, plans to reduce emissions may be premised on insufficiently substantiated or too bullish expectations around the use of technology.

Greenwashing legal landscape

Legislation and regulatory rules are being developed internationally to address the incidence of greenwashing. Many jurisdictions have a mix of general law and regulation (e.g., unfair commercial practices) applying to all market sectors, general advertising rules and, increasingly, bespoke rules relevant to financial markets and securities. Listed financial institutions may also be subject to potential greenwashing allegations based on market abuse rules. Given the importance of such disclosures to share price, they could potentially be considered to amount to market manipulation. Greenwashing may also constitute a breach of directors' duties, with any damages and litigation costs triggering claims on directors' and officers' insurance.

Besides advertising standards authorities and nongovernmental organizations, financial supervisors are active in this space.

Europe

In the UK, the financial conduct regulator is introducing a general anti-greenwashing rule. This forms part of a package of proposed measures governing sustainability disclosures and investment labels for funds. Authorized financial institutions will need to ensure that any reference to sustainability characteristics in financial products and services is fair, clear and not misleading. In continental Europe, the EU is in the vanguard of sustainability regulation, but disclosure obligations themselves can sometimes create greenwashing risk. Under the Sustainable Finance Disclosure Regulation (SFDR), financial institutions including asset managers must disclose both entity and product-level information. Uncertainty over the interpretation of Article 9-labeled funds under the SFDR, however, has in the recent past led to confusion and the subsequent downgrading of many funds to "less green" Article 8 labels. The European Commission has asked the three European financial supervisory authorities, as part of their work programs, to (i) understand and monitor greenwashing more closely, (ii) evaluate the implementation and supervision of sustainable finance policies and (iii) assess the necessary supervisory and enforcement response. Reflecting the seriousness attached to greenwashing, the European Securities and Markets Authority has published a briefing on the phenomena, its impact on investor confidence and the importance of addressing the issue.

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Protection against unfair practices

In January 2024, the European Parliament adopted a Proposal for a Directive empowering consumers for the green transition. The Directive aims to prohibit certain ESG-related practices as per-se inadmissible, e.g., displaying a sustainability label which is not based on a certification scheme or not established by public authorities, or claims that a product has a positive environmental impact when such a claim is based on carbon offsetting.

North America

The approach in the US can best be described as regulation by enforcement. This reflects the activity of its regulatory agencies and high levels of litigation, including class actions. Reliance is being placed on existing general-purpose disclosure rules, for example, investment advisers owe a fiduciary duty to their clients to make full and fair disclosure of all material facts; if advisers hold themselves out as adhering to environmental, social and governance principles but fail to do so, US regulators may pursue them, even in the absence of positive disclosure requirements for such matters. There is also a new Securities and Exchange Commission (SEC) "names rule" that requires investment fund names to match 80% of the makeup of their portfolios. Moreover, there are new SEC rules that seek to improve and standardize climate disclosures by public companies to assist investors. With this backdrop, certain states are trying to push disclosure-based laws: for example, California has passed the Climate Corporate Data Accountability Act, which may be the closest the US has come to the EU's Corporate Sustainability Disclosure Regulation.

Asia Pacific

In Asia Pacific, Australian legislation generally prohibits the making of statements that are false or misleading in respect to financial products or services. Additionally, the Corporations Act requires product disclosure statements for financial products (where the product has an investment component) to explain the extent to which labor standards or environmental, social or ethical considerations are considered. Issuers of managed fund products also have conduct obligations that are relevant to greenwashing. Moreover, the Australian Securities and Investments Commission has been active in bringing greenwashing cases. It has also warned entities against creating a "green halo" effect using generic statements. Elsewhere in the region, the Monetary Authority of Singapore has implemented specific disclosure and reporting standards, including guidance for sustainable funds to mitigate greenwashing risks. Like other jurisdictions, where a fund name uses terms such as "sustainable" or "green," this must be reflected in the underlying investment portfolio and strategy.

In Japan, scrutiny of greenwashing is increasing. The Financial Services Agency is developing a regulatory framework in the light of a Cabinet Office order for the disclosure of corporate initiatives on sustainability and corporate governance, mainly covering listed companies. Such companies will be liable for misstatements where outcomes differ from forward-looking information unless they were reasonably based on the information available. There are also guidelines to address greenwashing risks for asset management companies that manage ESG investment trusts. Additionally, a new Code of Conduct for ESG Evaluation and Data Providers aims to improve the transparency and fairness of such evaluations.

International

The International Sustainability Standards Board (IOSCO) has issued sustainability-related financial disclosures standards known as IFRS S1 and IFRS S2. In place of the recommendations of the Task Force on Climate-Related Disclosures, it is intended that these will provide a global framework in developing the use of sustainability-related financial information, including the accurate assessment of sustainability risks and opportunities. This initiative should reduce the scope for ambiguity and inconsistency in standards, thus reducing the risk of greenwashing allegations. IFRS S1 and IFRS S2 are gradually being endorsed by financial supervisors for use in their markets. As the European Securities and Markets Authority has done, IOSCO has published a report for supervisors to help them address greenwashing.[4] This reinforces the importance attached to this risk by the authorities.

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Sustainability ratings

Ratings information on entities and products can help spot sustainability risks that conventional due diligence might not necessarily identify. The dilemma is that ratings are still open to interpretation, being only as good as the methodology and the data employed, and potentially lack independent verification. Third-party ratings may rely on public information, so their outputs will necessarily be subject to data gaps. All this can give rise to potential allegations around greenwashing. Change is coming. Some jurisdictions — the EU, India, Japan, Singapore and the UK — are introducing codes of conduct or regulation for ratings providers to improve transparency, governance and management of conflicts of interest.

How to mitigate the risk of greenwashing

It is no longer viable to remain silent on sustainability and responsible business standards, for example, through the practice of "greenhushing," i.e., playing down or withholding sustainability information. Financial institutions should not make aspirational statements without a granular plan on implementation either. Regulatory and legislative priorities have shifted to force disclosure and to highlight businesses that fail to do so. Any regulatory findings will provide a basis to assert civil liability and spur litigants to pursue standalone claims where regulatory oversight has not yet landed upon businesses failing to meet expectations.

The greater the degree of preparation and litigation readiness on the part of a financial institution, the more likely it will be to resolve disputes at the earliest possible stage. Additionally, this will help in the adoption of a consistent position across jurisdictions that supports an overarching commercial strategy, and the protection of reputation. Exposure to litigation can be preempted to a degree by continuing careful management of sustainability programs' performance and disclosure. Businesses are devoting increasing attention and resources to their performance, reporting and disclosure processes, taking a risk-based view on the systems and controls necessary to secure compliance with sustainability and responsible business standards in operations and reporting. They will also be required to engage effectively where the threat of litigation does crystallize, ensuring appropriate remediation is actioned without aggravating liability and defending case by case, while maintaining a broader view from the impact on licenses to operate to their reputation.

Questions for management to ask to avoid greenwashing

What sustainability and responsible business practices goals and reporting are we subject to whether mandatory or voluntary?

> It is crucial to identify and track all relevant obligations, including on reporting and disclosure — so-called legal risk mapping. This landscape is rapidly changing in many jurisdictions, thus regular monitoring is essential.

If we make disclosures in different markets (e.g., across North America, Asia and Europe), have we reviewed these to make sure there are no inconsistencies or incompatibilities?

> For example, in Europe, where existing regulations are far-reaching, and in other markets, like the US, where disclosure obligations are more generic and likely to be voluntary. For non-EU financial institutions and private equity portfolio companies carrying on business in the EU, be mindful that EU sustainability legislation will be evermore relevant to their operations.

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Questions for management to ask to avoid greenwashing

How realistic are the targets and goals to be implemented, against which the business will be assessed?

> When setting targets and goals, it is better to be realistic than later have to resile from overly ambitious objectives. On the other hand, insufficiently ambitious targets and goals may attract criticism and potentially, in some cases, litigation alleging that management is failing in its stewardship or to uphold commitments with external climate change targets. Consider also whether internal policies are stricter than applicable regulation and whether this might unnecessarily restrict future new business as against competitors. See also the UN Net Zero Report which makes recommendations on how to make net zero commitments.[5]

Have we reviewed our operations and investment practices for their consistency with our broader commitments, aspirational statements and corporate communications?

> Where internal policies and practices are amended, it is recommended, as part of any update, that a review is carried out to check that internal and external communications are aligned to avoid inconsistent public statements.

Have we explained clearly and consistently how terms of art for sustainability and responsible business practices are defined to avoid confusion or misleading stakeholders?

> Where regulation is new and there is ambiguity around the scope of new green "labels," it is sensible to exercise caution. It is also important to understand what any new mandatory legal disclosures require, how any internal voluntary definitions compare against them and to be transparent in this regard.

Have we verified all sustainability and responsible business practices-related claims, including disclosures around strategies, targets and KPIs?

> The quality of due diligence and related processes is vital. Carry out documented, evidence-based reviews of such disclosures and statements. Consider what degree of assurance is available whether as part of an annual audit or otherwise.

If we use third-party verification programs, are we satisfied over their quality and accuracy?

> Ratings products, for instance, are open to interpretation, dependent on their methodology and the data used, and could potentially lack independent verification.

Do we properly resource our internal controls and processes, especially due diligence of transactions with third parties and supply chains?

> Insufficiently resourced controls and poor governance can heighten the risk of greenwashing allegations. Remember also to integrate sustainability risks into existing risk management systems. Regulators may hold managers to account for such failings besides the business itself.

1. Climate-related Litigation: Recent Trends and Developments, NGFS, September 2023.
2. The Financial Impact of Greenwashing Controversies, ESMA TRV Risk Analysis (2023).
3. Ibid.
4. Supervisory Practices to Address Greenwashing, IOSCO Final Report FR12/13, December 2023.
5. Integrity Matters: Net Zero Commitments by Business, Financial Institutions, etc., Report from UN High-Level Expert Group.

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