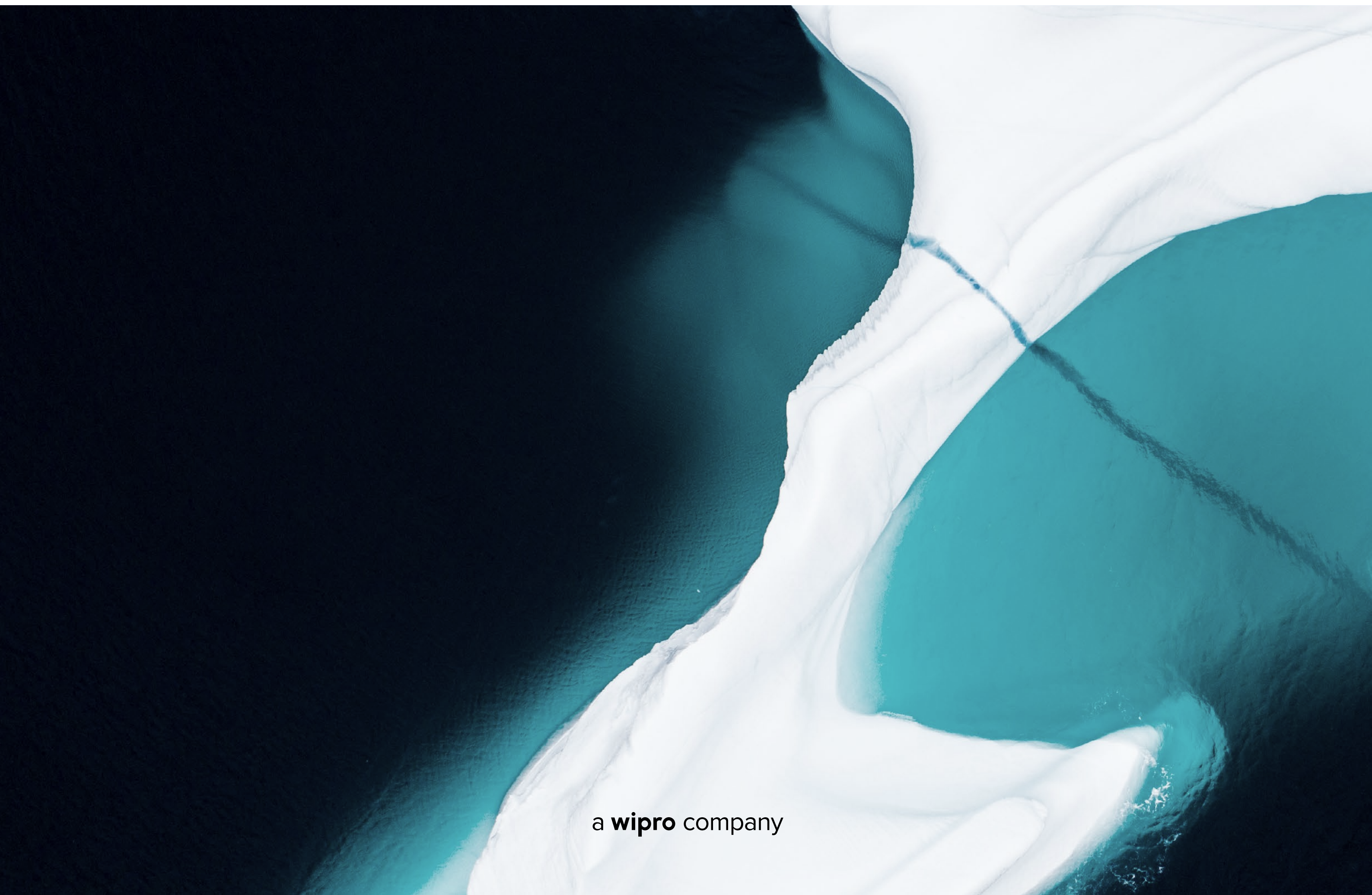
CAPCO

CLIMATE CONDUCT & FINANCIAL SERVICES

TOMORROW'S MIS-SELLING SCANDAL?



INTRODUCTION

In recent years growth in products marketed on the basis of their strong environmental, social and governance credentials has exploded. According to the Association of the Luxembourg Fund Industry (ALFI), which represents Europe's biggest fund market, more than half the money that flowed into European funds in 2020 went into sustainable products[1], totalling €1.4 trillion. Globally, ESG assets are expected to exceed US$53 trillion by 2025, representing more than a third of the US$140.5 trillion in projected total assets under management[2].

Due to the increasing awareness of the risks – and opportunities – presented by climate change, pressure from investors for responsible investments is growing at a steady rate and ESG has come to dominate the agenda at board level meetings and on investor calls. Consequentially, more and more financial institutions are increasingly either selling directly or partnering with third parties to offer green products to customers – a trend that is generally welcomed in the context of climate change mitigation.

A recent survey by iResearch[3] reported that 63% of 550 global financial service professionals surveyed said their products are green friendly; and 64% said their upcoming products have been designed to be socially, environmentally, and economically friendly. However, what comes with this 'gold rush' of new green products, this clamour to seize upon a new opportunity, is the potential to misrepresent the true underlying nature of these green products.

Consequently, the potential risk of mis-selling cannot be understated as firms look to enhance perceptions of their environmental credentials and products. One can draw parallels with the UK's payment protection industry scandal as a cautionary tale, and a marked nervousness is already becoming apparent within the financial services industry. In a recent survey from market researcher Cicero[4], almost all financial advisers (97 of 100) polled were 'very' or 'fairly' concerned about the potential for allegations of mis-selling" of ESG-badged investments.

Accusations of mis-selling outside of the financial sector are also growing rapidly[5], with episodes such as the Dieselgate scandal making headlines, and regulatory bodies are increasingly aware of the need to mitigate against so called 'greenwashing' of products and services. These regulators are now moving towards legislation to make existing initiatives and frameworks binding to mitigate these risks for both firms and consumers. Frameworks such as the Taskforce on Climate-related Financial Disclosures (TCFD) highlight the need to identify transition liability risks, but firms should be aware of the potential harm from mis-selling at both company and sector-wide levels.

1. https://www.bloomberg.com/news/articles/2021-06-15/european-esg-funds-hit-record-1-4-trillion-in-assets-last-year
2. https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/
3. https://www.iresearchservices.com/sustainability-in-financial-services-why-the-future-is-now
4. https://www.ft.com/content/2d3f7683-65a6-3171-8cbb-66ff5ab34405
5. https://www.truthinadvertising.org/six-companies-accused-greenwashing/

CONSIDERING CLIMATE CONDUCT

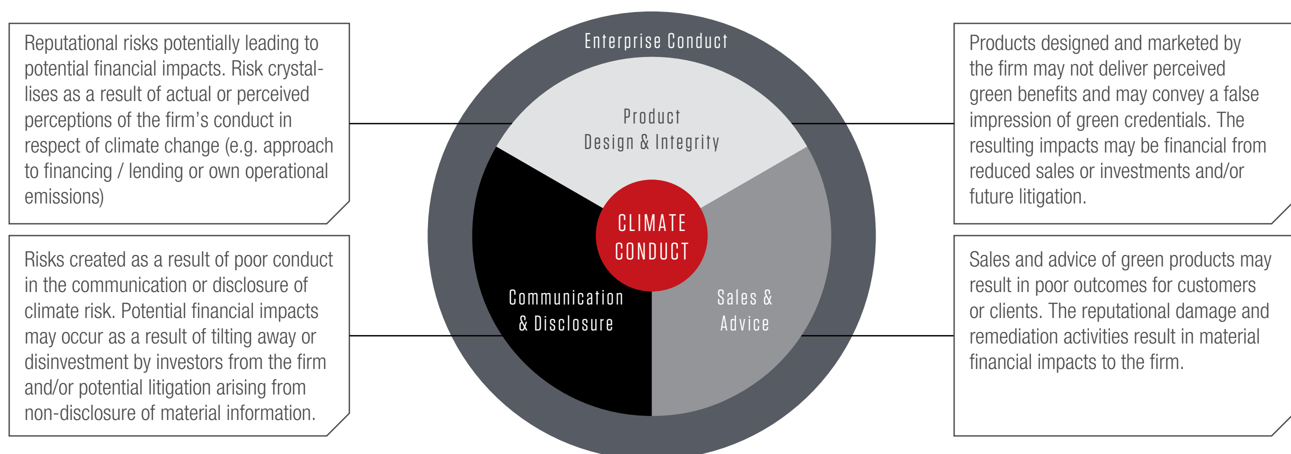
Conduct has been high on the UK regulatory agenda since the July 2006 introduction[6] of Treating Customers Fairly (TCF) by the Financial Conduct Authority's (FCA) predecessor, the Financial Services Authority (FSA). The intense scrutiny on banks' wider conduct since the financial crisis in 2008 has seen a doubling down by the regulator on its commitment to wholesale cultural improvements. As part of the focus on cultural improvements, annual data on conduct fines is published by the FCA on their website in a "name and shame" exercise[7]. Similar changes have also been driven forward in jurisdictions outside of the UK, most recently in Australia and New Zealand following the findings of their recent Royal Commission[8].

On top of these 'headline' conduct activities, there is a more subtle but still powerful conduct imperative running beneath the surface of the financial services sector. Across the industry its clear to see that cultural enhancements are becoming ever more deeply ingrained throughout organisations, for instance:

- A broader focus on customers obtaining the right outcomes for their unique individual circumstances.
- Explicit guidance around market abuse and annual attestations required by employees that they are adhering to requirements.
- A greater focus on personal and transactional conflicts of interest – for instance, through the disclosure of personal account dealings.
- An increased focus on who firms do business with, including indirect interactions, commonly referred to as "non-client counterparties".

The gap that currently exists is around whether firms have considered their 'climate conduct' to be as important as other parts of their culture. The diagram below covers four key areas of climate conduct:

Firms may be exposed to climate conduct risks because of the actions of individuals or the organisation. Below we look at each of our four key areas in turn. Firms face reputational, financial, and regulatory repercussions where they fall short in their climate conduct.

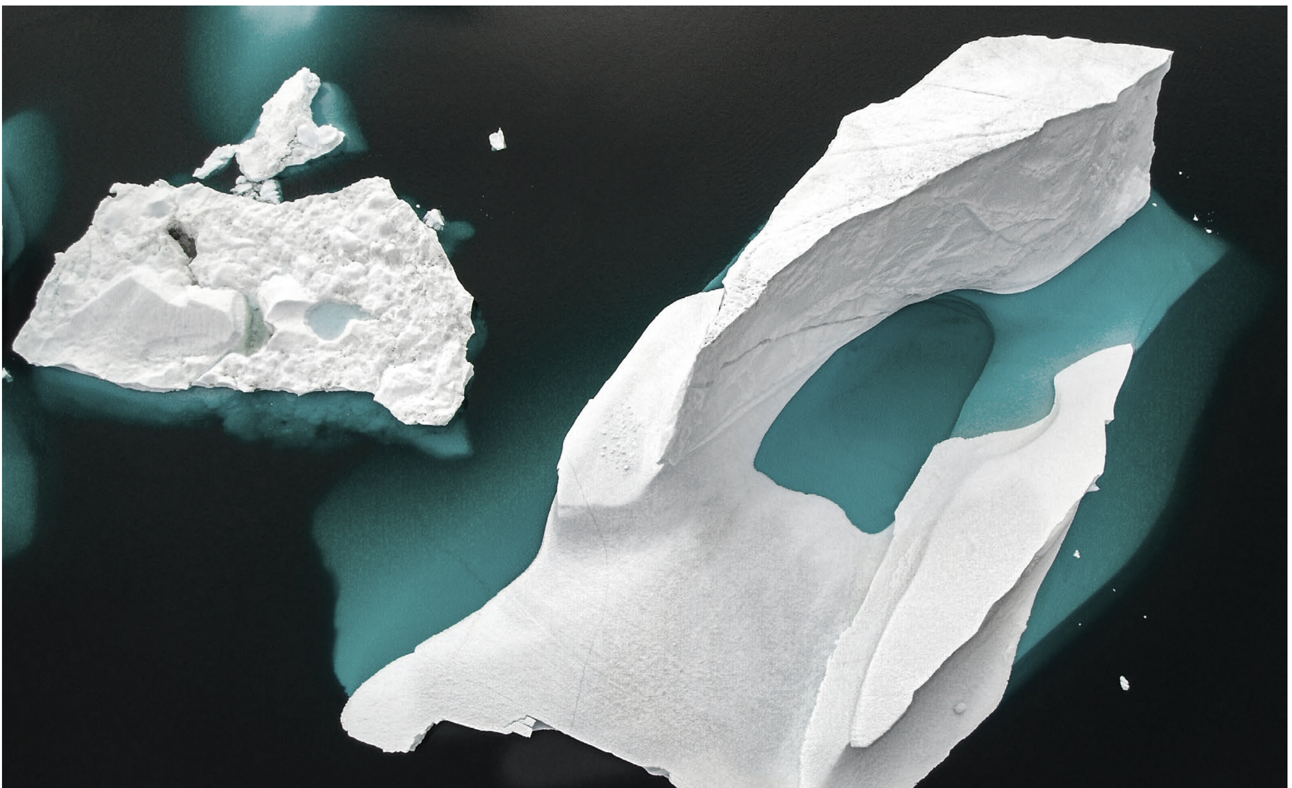


6. https://www.fca.org.uk/publication/archive/fsa-tcf-towards.pdf
7. https://www.fca.org.uk/news/news-stories/2020-fines
8. https://financialservices.royalcommission.gov.au/Pages/default.html

ENTERPRISE CLIMATE CONDUCT

Now more than ever, firms face unprecedented challenge and scrutiny over the way they operate and who they lend to, with the implication that 'wrongdoers' and 'laggards' run the risk that customers and investors will vote with their feet and wallets. Over recent years, several challenger banks have entered the market, each with a unique selling point: amongst these challengers are so-called 'socially conscious' banks (such as B-Corps, certified Sunrise Banks[9], and Aspiration[10] in the United States) predominantly focused on green financing and fighting climate change.

Especially among the younger generation, who are more likely to be environmentally conscious and more likely to change provider if dissatisfied, those firms financing high emissions companies or failing to adapt their own operations to minimize carbon impact can expect a loss of their customer base to these greener operators. A recent Morgan Stanley report[11] highlighted that 84% of millennials cite investing with a focus on ESG impact as a central goal. Those companies that fail to adapt or respond face financial impacts to growth and potentially liquidity as new sales and customer or investor deposits are potentially reduced.



9. https://sunrisebanks.com/
10. https://www.aspiration.com/
11. https://www.morganstanley.com/sustainableinvesting/pdf/Sustainable_Signals.pdf

MARKETING PRODUCTS

Growth in green products has accelerated significantly, with firms offering more and more different options across a range of product suites, both retail and investment. On the retail side, banks have launched green mortgages, electric vehicle loans, green savings accounts, asset-backed rooftop solar loans, and green current accounts all having become available to customers recently. On the investment side, a plethora of green funds exist for people seeking a sustainable selection, along with bonds and covered bonds for institutional investment.

The third quarter of 2020 saw a record US$76.5bn raised[12] from 170 new green issuances, driven by sovereign wealth funds, multi-laterals and banks. However, with this rush to 'green-up' firms' product suites comes accusations of greenwashing, and an increased risk of compliance failures as green benefits sold to customers or investors cannot be credibly evidenced. The reputational and financial impacts arising from potential litigation in this area should not be underestimated.

In November 2020, the UK's Competition and Markets Authority (CMA) began an investigation into whether 'eco-friendly' claims made in respect to products and services could be misleading consumers and breaching consumer protection law[13]. They recently closed a consultation on their draft guidance[14], which aims to advise businesses on the best way to communicate their green credentials. The CMA expect to publish the final guidance in September 2021. The CMA's direction of travel will tell us a lot about the overall scope for regulatory action in this space, and their advice hinges around the following principles:

- Claims must be truthful and accurate.
- Claims must be clear and unambiguous.
- Claims must not omit or hide important relevant information.
- Comparisons must be fair and meaningful.
- Claims must consider the full life cycle of the product.
- Claims must be substantiated.

The FCA have drawn their own line in the sand via Feedback Statement 19/6, citing the need for transparency and trust when designing and marketing sustainable products. Their Trust in the market for ESG/sustainable investments consumer research paper is due imminently and will follow close on the heels of their Authorised ESG & Sustainable Investment Funds Guiding Principles.

The Guiding Principles note it is essential that products "marketed with a sustainability and ESG focus" must ensure that assertions made about goals are "reasonable and substantiated". The FCA also commented that, in receiving applications for new ESG and sustainable investment funds, "a number of these have been poorly drafted and have fallen below [our] expectations. They often contain claims that do not bear scrutiny".

Compliance departments must get on top of this new wave of guidance and retrospectively assess their existing and proposed product suites to ensure that strategies, benefits, and goals meet these criteria and can be validated and substantiated.

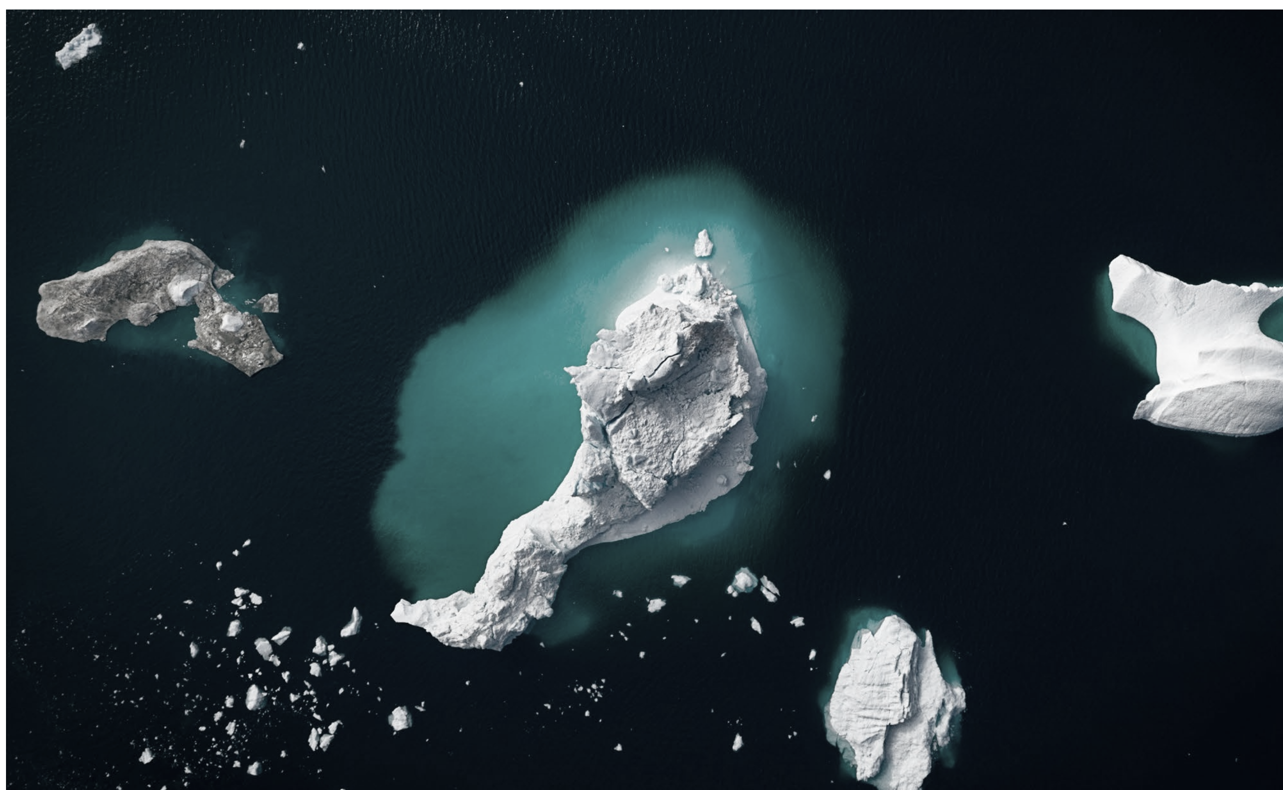
12. https://www.refinitiv.com/perspectives/market-insights/sustainable-finance-market-continues-2020-growth/
13. https://www.gov.uk/government/news/cma-to-examine-if-eco-friendly-claims-are-misleading
14. https://assets.publishing.service.gov.uk/media/60a66a9cd3bf7f73893a8e1f/Draft_guidance_on_environmental_claims_on_goods_and_services-.pdf

SELLING AND ADVISING ON PRODUCTS TO CUSTOMERS AND CLIENTS

If you offer a green product, how many staff in your front-line sales and advice teams can you comfortably say are qualified to discuss the associated benefits and risks to a customer? Like PPI and many other products previously mis-sold, green products are expected to present a particularly risky proposition due to transitional risks of climate change. Products sold one day may quickly see their green credentials superseded due new innovations, resulting in customers trapped in expensive long-term commitments that offer poor value to them.

Firms should challenge their sales processes around green products – asking whether:

- Customer outcomes have been appropriately calibrated to capture green outcomes.
- Green product recommendations can only be provided by suitably skilled persons.
- Training programs have been developed and embedded that allow sales staff appropriate capabilities to offer green products.
- Training programs are frequently reviewed and updated to offer timely refreshers in a fast-moving environment.
- Employees are appropriately incentivized (noting inappropriate sales metrics in PPI) to sell green financing and investor products to clients.
- Appropriate quality assurance and risk-based sampling is being used on what is a new addition to firms' product suites.



ONGOING COMMUNICATION & DISCLOSURE

Product level

The FCA's recent paper introducing climate-related financial disclosure rules and guidance for asset managers, life insurers, and FCA-regulated pension providers, showed a direction of travel towards more granular product and portfolio level information, rather than entity level as was formerly the case. As frameworks develop, data is gathered and firms mature, we expect this to become even more granular over time. The FCA's recent Dear Chair letter to Authorised Fund Managers stated the importance of "clear and accurate ongoing disclosures to consumers".

Customers and clients will want to understand green performance and credentials of their own products held on an ongoing basis. At a customer-level, the FCA recently commented that "firms must ensure their communications are 'clear, fair and not misleading'. What we do not expect to see is firms exaggerating their products' green credentials". Firms failing to identify the necessary data and accurately disclose to this level run the risk in future of being left behind, leaving them to rely heavily on their own assumptions which are more likely to be challenged legally should they prove inaccurate. Based on the clarity of regulatory messaging, firms should be under no illusion of expectations in this area.

Company-wide level

In recent months, environmental group Extinction Rebellion (which has an explicit goal of net zero emissions by 2025) has been targeting and damaging head offices of banks that it considers to be neglecting their climate responsibilities . These actions were arguably in part fuelled by the readily accessible data that is published on the amount of fossil fuel financing that banks contribute to, either via direct lending or in advisory capacities .

Firms will come under increasing scrutiny for the quality, transparency, and granularity of their climate-related disclosures, both at an entity and customer/investor level. Turning first to entity-level disclosures, at a recent event, Frank Elderson, a Board member of the European Central Bank commented on bank regulatory self-assessments:

"Our overall initial snapshot is rather disappointing. None of the banks under our supervision meet all our expectations. All banks have several blind spots and may already be exposed to material climate risks. They are all still a long way off meeting the supervisory expectations we have laid out for them. And, all banks need to catch up, as their climate risk undertakings will eventually influence their supervisory requirements."

This stark message aligns to Capco's own assessment of bank disclosures. Our recent benchmarking exercise of 33 banks globally highlighted mixed standards across all areas of disclosure. As more and more firms make commitments towards achieving Paris-aligned goals through science-based targets, so does the potential for future questions to be asked around accountability and legitimacy of these claims.

15. https://www.fca.org.uk/publications/consultation-papers/cp-21-17-climate-related-disclosures-asset-managers-life-insurers-regulated-pensions
16. https://www.fca.org.uk/publication/correspondence/dear-chair-letter-authorised-esg-sustainable-investment-funds.pdf
17. https://www.fca.org.uk/news/speeches/building-trust-sustainable-investments
18. https://www.bbc.co.uk/news/uk-england-london-56843329
19. https://www.ran.org/wp-content/uploads/2020/03/Banking_on_Climate_Change__2020_vF.pdf
20. https://www.bis.org/review/r210616b.htm
21. https://info-de.capco.com/climate-change

RISKS AND PITFALLS

A history of mis-selling relating to ESG and climate credentials already exists. We have highlighted two case studies where misrepresentations of green credentials and benefits have been prominent.

Case Study 1 - Diesel-gate emissions scandal as a marker

Background

In September 2015, the US EPA (Environmental Protection Agency) identified irregularities in the emissions profiles of a number of VW based diesel vehicle platforms. Subsequent testing between real world driving emissions and the laboratory test figures differed wildly and the ensuing investigation identified a 'defeat device' in the software. The actual mechanics and methods have not been fully publicly disclosed, but a very sophisticated and orchestrated deception was afoot. In essence, the vehicle would 'know' when it was being tested due to inputs (or lack of) such as no steering, no brakes and certain air and throttle position; under these circumstances it would default to a much lower power and emissions setting that would create an artificial view of the particulates and gas content for the test. Under certain conditions the Nitrogen Oxide pollutants were 40 times higher under real use conditions than are permitted under US regulation.

With similar parallels to the influx of green products from financial services, the VW group saw a huge commercial opportunity to market its small diesel platforms as eco-friendly to the US. When combined with a significant sales campaign, focussed on green credentials, it generated a wave of new car sales based on erroneous environmental claims. The EPA identified 482,000 cars in the US alone, with VW identifying a further 11 million vehicles subsequently as the case caught global attention, with 8 million in Europe.

The ensuing legal battles, claims and pay outs started with VW setting aside a significant figure of around €6 billion in 2015/2016, by 2020 this has risen to €31.3 billion globally. If this is not a cautionary tale of mis-selling, then the money that may have facilitated it should be. Statements obtained from the European Investment Bank by journalists implicate a loan facility of €400 million that was likely used as part of drive train efficiency. In an early 2016 press conference the banks president Werner Hoyer admitted that a facility provided by the EIB could well be implicated in the defeat technology and subsequently 'put on hold' any new facilities whilst investigating further.

Applying the lesson to climate conduct

The implications for a financial services firm, when either creating a new green products suite or indeed the onwards use of its funding in green initiatives, must be considered from a risk perspective as a war on two fronts. Although there is a significant generational opportunity both to affect change and drive commercial and shareholder value, it is not without risk and must be very carefully navigated to not end up in the same 'provisions' boat as VW.

Our recent benchmarking exercise of 33 banks globally highlighted mixed standards across all areas of disclosure. As more and more firms make commitments towards achieving Paris-aligned goals through science-based targets, so does the potential for future questions to be asked around accountability and legitimacy of these claims.

22. https://www.bbc.co.uk/news/business-34712435
23. https://www.bbc.co.uk/news/business-34324772
24. https://www.reuters.com/article/us-volkswagen-results-diesel-idUSKBN2141JB
25. https://bankwatch.org/blog/updated-new-documents-on-european-investment-bank-loans-to-volkswagen
26. https://www.euractiv.com/section/transport/news/dieselgate-eib-freezes-new-loans-to-volkswagen/

Case Study 2 - UK Green Deal mis-selling scandal

Background

The UK's Green Deal was hailed as the "biggest home improvement programme since the Second World War" when it was launched by the UK Government in 2013. It promised homeowners solar panels, insulation and new boilers, with no up-front cost. Customers would need to take out a loan, but they were assured that the repayments would be no higher than the savings they would make on their energy bills.

Problems started to emerge when it was discovered that the claim was based on a typical household's energy usage, and many homeowners who used less than this 'average' have ended up with higher bills. On top of this, the loans were tied to the property, rather than the individual, which meant homeowners could potentially struggle to sell their house in the future. Faults also emerged in the quality of fittings conducted by approved installers.

The multi-million-pound scheme was dropped by the UK Government after just two years following low uptake and was described by MPs as a "complete fiasco". The scheme has left a legacy of thousands of households encumbered with high-interest loans that they will potentially be paying off for decades to come. Mis-selling claims are now underway and are being handled by the Department for Business, Energy & Industrial Strategy (BEIS) and Ombudsman or, if elevated to appeal, the Secretary of State.

Applying the lesson to climate conduct

In Scotland, the firm Home Energy and Lifestyle Management Ltd (Helms), which was an approved installer, faced criticism for its selling tactics, with Citizens Advice Scotland producing a report in 2018 detailing the unorthodox methods reported by customers. Tactics included telling vulnerable and elderly people they were getting the work done for free and using high-pressure tactics to get them to sign up. One customer was signed up for a 25-year loan aged 82, meaning it would only be paid off when the customer was 107.

The Green Deal shares many of the same mis-selling traits as PPI and should be heeded by firms when identifying green product types, partnerships, and sales approach and channels. At a time where the UK government is proposing replacing gas boilers by electricity-driven heat pumps as part of its Green Plan, the potential scale for mis-selling dwarfs that of the Green Deal. As firms move to offering their own products, or partner with third parties to supply these, there is increased risk of mis-selling, including failing to appropriately assess suitability, applicability, and affordability. Ensuring conduct frameworks remain dynamic to the new and existing risks posed by green and ESG-linked products is paramount.

22. https://www.bbc.co.uk/news/business-34712435
23. https://www.bbc.co.uk/news/business-34324772
24. https://www.reuters.com/article/us-volkswagen-results-diesel-idUSKBN2141JB
25. https://bankwatch.org/blog/updated-new-documents-on-european-investment-bank-loans-to-volkswagen
26. https://www.euractiv.com/section/transport/news/dieselgate-eib-freezes-new-loans-to-volkswagen/

WHAT SHOULD FIRMS BE DOING

- **Embed climate risks and opportunities at the highest level** – Firms should be spotlighting ESG and climate risk and opportunities at the highest level. More and more firms are building in climate change as a principal risk with its own dedicated risk management function, board and executive level representation. Consideration must be given as an ongoing material strategic agenda point, moving away from it being a subset of a different business area such as Finance or Corporate Affairs.

- **Taking a holistic view** – Firms must ensure potential conduct risks posed by climate change are recognised and factored into their strategy and risk management frameworks. In the past two months, Capco has reviewed 63 separate disclosures covering climate risk management, and only a handful consider climate conduct as a material first or second order risk for the firm.

- **Working through product lifecycles** – Firms should be using risk assessments around green products and considering their full lifecycle, including interaction with third parties. Based on market trends, many firms are likely to partner and potentially outsource some elements of specialist product sales to third parties and must ensure their standards, risk management and controls are equivalent to the firm's own, and the firm can perform some degree of ESG sales audit and quality assurance.

- **Approach the data challenge** – With the acquisition of accurate date being widely recognised as a keystone in the implementation of a wider ESG strategy, the need for robust and scientific data when making environmental claims should also be considered. Firms should look to increase capacity to complete full life-cycle assessments of their products, ensuring that they are able to make valid and substantiated claims about their products. Movements in the development of global taxonomies will help to standardise and provide clearer ESG labelling guidelines. These classify which economic activities are seen as 'green', and firms should be aware of region-specific regulations from governments and supranational organisations to help mitigate the potential for greenwashing.

- **Keeping pace with disclosure developments** – With current disclosure frameworks constantly and swiftly evolving, firms must constantly revisit and review their own frameworks on a timely basis, less risk being left behind or failing to meet new standards of disclosure (e.g. Taskforce for Nature Related Financial Disclosures – more to be covered in our upcoming focus paper). Firms with the broadest awareness and consideration of disclosure will be able to find the greatest synergies and overlap, which will aid the reduction of unnecessary duplication and back-and-forth conversations with customers, clients, and suppliers. With COP26 getting ever closer, the pressure for action is intensifying[27] and it seems more and more likely that frameworks will become mandatory.

27. https://www.cityam.com/mps-call-for-greenwashing-ban-in-financial-services/?utm_source=newsletter&utm_medium=email&utm_campaign=Midday+newsletter+Nov+2020

SUMMARY

The complex subject of conduct in combination with climate change – arguably one of the widest ranging thematic issues of our time – presents an anxiety-inducing and risk-strewn proposition. When navigating this potential minefield, caution and process must be the watchwords at all levels of the firm when delivering robust and defendable frameworks to manage ESG products and services. Without this approach, it will be all too easy for firms to over-egg their 'green pudding' and as Dieselgate attests, 'where there's blame, there's a claim'.

The danger of mis-selling green products and misrepresenting the positive ESG or climate credentials of a product may deliver short-term gains, but could also lead to significant value destruction in the longer run. Climate compliant and friendly products are without doubt the next 'gold rush', given they represent a moral and commercially attractive proposition that can benefit, to a greater or lesser degree, the entire global population. If the lessons of previous mis-selling mishaps are learned, then this could be the defining opportunity for the next generation of financial services' customers, firms, employees and executives. If not, it has the potential to damage not only individual firms' balance sheets and reputations, but also broader efforts to make sustainable finance a reality – and ultimately the very future of our planet.

HOW CAPCO CAN HELP

Capco has developed a comprehensive, holistic approach to assessing and enhancing conduct risk agendas. We can provide services such as:

- Current State Diagnostics – Capco analyses the 'as-is' state of your organisation whilst benchmarking against the industry and regulatory expectations, in order to highlight gaps relative to your peer groups and their aspirations, and how you measure up to 'best in class' practices.
- Design Roadmap – Capco draws upon our industry advisory experience to build realistic delivery plans with clear ownership, accountability and success criteria established
- Conduct Change Delivery – Conduct is a complex area within which to deliver change, due to constantly changing requirements and ongoing scrutiny. Capco's experience and strong track record in delivery of conduct change across financial services can help you implement a streamlined and robust conduct risk framework.

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ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy specializing in driving digital transformation in the financial services industry. With a growing client portfolio comprising of over 100 global organizations, Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to deliver end-to-end data-driven solutions and fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its Innovation Labs and award-winning Be Yourself At Work culture and diverse talent.

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