CAPCO

THE DARK SIDE OF ESG

CONTENTS

1. ESG – THE GOOD, THE BAD, THE UGLY

If there is one acronym that is shaping strategic discussions of corporates across industries like no other, it is ESG. It has become apparent that the topic moved from climate activists' street protests to the board room and top of business leaders' agendas around the world. As banks provide the fuel for the economy, they are expected to act as the main facilitator for a more sustainable future. While there has been significant media attention on the substantial value of ESG, there are always two sides of the coin and the inherent risks of this "flight to green" should not be ignored. As AuM (Assets under Management) of ESG investments keep on growing at ever increasing rates, having surpassed 1/3 of total global AuM[1], voices of sceptics are rising at the same speed. Are ESG investments really what they claim to be, or are they simply a marketing tool to repackage existing assets and sell them at a green premium? But let's start at the beginning – where is this rapid green movement that is a cause of concern coming from?

1.1 All eyes on ESG post-pandemic

ESG is considered as one of the main growth opportunities of the 21st century. In the past two years, marketing around ESG was all about the "why": While environmental concerns like climate change previously seemed to be non-urgent, Covid-19 rewrote that narrative. Parallels were drawn between the unforeseen risks of a pandemic and sustainability considerations like climate change (low probability/high impact): The new "Black Swan" will be green. Lockdowns and restrictions that have paused life around the world triggered an awareness period and acted like a wakeup call for mankind. Additionally, Covid-19 specifically shifted the attention to the "S" in ESG: Social issues like public/ mental health or labor rights came to the forefront due to virus control measures and social distancing/remote working practices. The pandemic touched upon all aspects of life and made people reconsider their daily choices like never before, fueling fundamental ESG paradigms, e.g.:

- **Materialism:** Store closings forced people to re-think their spending patterns and re-assess why and how they spend their money.

- **Food consumption:** As Covid-19 most probably originates from an animal food market in China, conscientiousness on food consumption is rising, with meat and dairy substitutes spiking.

- **Physical & mental health:** Due to Covid-19, health became a priority again, and specifically mental health came out of the hidden.

- **Conscious travel:** Enforced travel banks and restrictions are likely to change the travel lifestyle also post-Covid. In terms of business travel, virtual meetings are becoming mainstream. For short-distance travel, demand for sharing platforms keeps on increasing.

Also, it became generally understood and accepted that ESG investments offer superior returns[2] and better risk management[3] - the common misconception of a performance penalty for sustainable funds was successfully negated by industry experts and received enormous media uplift:

PERFORMANCE

- 88% of sustainable funds outperform their non-sustainable counterparts
- Within industries (automobiles, financial services, etc.), companies with better ESG profiles enjoy a "sustainability premium" and outperform their peers
- High ESG-rated companies generate abnormal returns and higher dividend payments

RISK MANAGEMENT

- Sustainable funds have greater survivorship rates than non-ESG investment vehicles
- ESG is considered a significant driver of different risk types like credit risk, market risk, operational risk, and insurance risk and high ESG rated companies show less risk exposure (systematic and idiosyncratic risk)

1. Black Swans are metaphoric for unexpected, hard to predict events resulting in extreme consequences
2. https://www.bloomberg.com/news/articles/2020-05-18/blackrock-joins-allianz-invesco-saying-esg-funds-outperformed
3. https://www.msci.com/documents/1296102/7943776/ESG+Investing+brochure.pdf/bcac11cb-872b-fe75-34b3-2eaca4526237

1. 2 ESG as the paper straw of investing

Given the immense pressure, banks hurry to ensure sustainable product supply is satisfying investor demand to not leave any money on the table. However, many still lack a solid control framework as baseline and are hence sugarcoating their actual ESG achievements. Therefore, ESG has even been labelled as the paper straw of investing, which is served inside a plastic cup: Within the food and beverage industry, corporates were overselling their sustainability considerations just because they switched from plastic to paper straws, while this was only a drop in the ocean.

Is Greenwashing becoming the new virus within banks? According to statistics, yes. Investopedia defines Greenwashing as follows: “the process of conveying a false impression or providing misleading information about how a company’s products are more environmentally sound. Greenwashing is considered an unsubstantiated claim to deceive consumers into believing that a company’s products are environmentally friendly”.

Fraudsters are increasingly targeting the sustainable investment market. Based on an analysis of the European Commission, 42% of the green claims in European companies’ marketing materials are “exaggerated, false or deceptive”[4]. Despite the fact that many firms pretend that climate protection is one of their core values, only a few incorporate the provisions of the most influential climate risk-related disclosure requirements like the Paris Agreement into their daily practices, which the following statistic demonstrates: Even though 95% of European corporate lending comes from banks that claim to be committed to the Paris Agreement[5], less than 10% of European companies actually do have Paris-aligned targets defined[2]. From a retail perspective, especially Millennials begin doubting the green movement and sustainability labels across industries (i.e. the controversial documentaries “Cowspiracy” and “Seaspiracy” questioning the validity of green food labels were getting viral and are among the most watched documentaries on Netflix).

Investors already start short selling shares they believe are wrongfully inflated by ESG promises heavily: Increased regulatory scrutiny regarding nonfinancial disclosures will eventually reduce this information asymmetry in relation to the true ESG performance, and a correction in the share price is anticipated by numerous hedge funds.[6][7] One prominent example is hedge fund guru Crispin Odey who heavily short-sells stocks of clean energy companies he believes are overrated[8]. Also, while the whole financial services industry keeps aggressively exiting the unpopular oil and gas industry lately, Odey Asset Management significantly expanded its position with remarkable outcome: Its European fund gained more than 100%[9]. As market corrections are in sight, ESG in 2022 and beyond should focus on the “how” – or “how not to”.

For banks to build client confidence and not to commit Greenwashing intentionally or accidently, are current controls good enough? The foundation should be a common regulatory framework to assess an organization’s ESG performance and scrutinize sustainability labels and nonfinancial disclosures. From a regulatory perspective, the EU is at the forefront and role model for the sustainable finance regulatory frameworks around the world[10]: Europe aspires to become the first climate-neutral continent by 2050 and to transform the EU economy to ensure environmental and social sustainability. To achieve this, at least EUR 1 trillion of sustainable investments will be mobilized in the upcoming decades, using the financial markets as its intermediary. Specifically, financing sustainable growth will be a key stream of the European Green Deal, as the EU Action Plan activates the legislative backbone of the financial services industry. Numerous additional regulatory projects have followed since, which unfortunately still lack alignment – specifically on a global scale. Within the last months, strong allegations on mis-selling are starting to gain traction, and asset managers need to be prepared for tightened scrutiny and regulatory enforcement in the very near future. Due to the enormous impact of ESG on all bank’s practices, banks that follow a “wait and see”

4. https://ec.europa.eu/commission/presscorner/detail/en/ip_21_269
5. The Paris Agreement is an international treaty on climate change adopted in 2015 at COP 21 in Paris
6. https://www.reuters.com/article/us-global-hedgefunds-sustainable-analysi-idUSKBN1YJ097
7. https://www.ft.com/content/b8c91561-b44c-43cf-9810-7aeff9c377a8
8. https://www.thisismoney.co.uk/money/markets/article-9655693/Crispin-Odeys-hedge-fund-firm-bucks-green-investing-trend.html
9. https://www.washingtonpost.com/business/energy/hedge-funds-are-feasting-on-esgsprofit-leftovers/2021/10/13/9e103e0e-2beb-11ec-b17d-985c186de338_story.html
10. Capco Intelligence: The EU Action Plan: Are Financial Services Firms Aware Of Its Impact On Their Business Model?

approach with focus only on complying with emerging reporting requirements are unlikely to remain competitive.

This paper will illustrate why Greenwashing is one of the most alarming Fraud threats for financial institutions, enriched by practical examples of where in the financial intermediaries' value chain it actually occurs, and which financial products are most at risk of being painted green. Next, Greenwashing is also approached through the eyes of a fraudster and his personal incentives. Finally, it highlights what banks can do to ensure a bulletproof integration of sustainability considerations into the corporate strategy, translation of ESG strategy into operational processes and controls, review of risk management and governance as well as data requirements and marketing considerations to fully embrace ESG and give confidence to investors that their investments are truly sustainable.

2. GREENWASHING IN THE FINANCIAL SERVICES INDUSTRY

One of the first notable records of Greenwashing was in 1986 by the environmentalist Jay Westerveld who accused the hotel industry of masking cost-saving strategies as environmental strategies[11]. While he visited a hotel in Fiji, hotel guests were encouraged to reuse their towels to "help save the environment" while the hotel chain itself was heavily expanding at the expense of the local coral reef.

Across all industries, light forms of Greenwashing have been a prominent marketing strategy to diversify products for decades – from cosmetics tested on animals but labelled vegan, fast fashion produced using child labor branded as sustainable, eco-friendly hotel resorts that exploit natural resources of local communities, food that is flown around the world and producing massive carbon emissions but called organic, sustainable cocoa that is containing palm oil cultivated through immense deforestation and not to forget the car industry and its famous Diesel-gate emissions scandal that was described in a recent Capco's paper[12].

Why is Greenwashing now also becoming a concerning fraud threat to financial institutions? Especially green products are susceptible to "tomorrow's mis-selling scandal". [13]

Whenever there is information asymmetry, Greenwashing can easily occur. In terms of public presentation, marketing materials like fund prospects, websites etc. are turning green. The fact that advertising campaigns of most banks lately highlight pictures of trees, the ocean or renewable energies might still be considered within the grey zone of creative PR and acceptable. However, omission of negative externalities, reporting fictious sustainability achievements and internal fraud is not.

While Greenwashing is no brand-new phenomenon within financial services, it has just recently caught the attention of regulators and the awareness of consumers that it deserves. The paradigm shift of investors is contributing to a reallocation of assets to green causes, with new products evolving daily. At the most extreme, asset managers are repurposing existing assets by simply changing product names and only slightly amending strategies. This approach enables managers to leverage traditional assets and to attract inflows without creating funds from scratch. As a result, financial institutions potentially end up committing Greenwashing (intentionally or unintentionally).

11. Becker-Olsen K., Potucek S. (2013) Greenwashing. In: Idowu S.O., Capaldi N., Zu L., Gupta A.D. (eds) Encyclopedia of Corporate Social Responsibility. Springer, Berlin, Heidelberg. https://doi.org/10.1007/978-3-642-28036-8_104
12. "Climate conduct & Financial Services: Tomorrow's mis-selling scandal?" https://www.capco.com/intelligence/capco-intelligence/climate-conduct-and-financial-services
13. "Climate conduct & Financial Services: Tomorrow's mis-selling scandal?" https://www.capco.com/intelligence/capco-intelligence/climate-conduct-and-financial-services

While organizations that are committing Greenwashing can gain short-term and medium-term benefits of increased sales, they are also taking the risk of facing serious negative consequences like penalties or reputational damage that might have a devastating impact on the share price – apart from the ethical considerations. Financial institutions have the particularity to be a central link in the economy which exposes them to be more often in the victim vs. perpetrator ambiguity than other business sectors. This duality can create an ambiguity for the regulator when it comes to sanctions: Financial institutions identified in a Greenwashing scandal might be tempted to opt for the "greenwashing victim" rather than "greenwashing perpetrator" position as a defense. However, the times were this was sufficient are over.

The financial services industry as such is heavily regulated. Concerning financial performance, external auditors sign off the "true and fair view" of financial statements and ensure their adequate reflection of firm value and performance, enforced by universally accepted accounting principles. For corporate performance in line with ESG criteria, this globally accepted, stringent framework is still missing - ESG ratings are still mostly a black box. This is partially the case since ESG performance is not black or white but should be evaluated on a sustainability continuum - 50 shades of green. The lines between traditional and ESG investments are blurred and oftentimes sustainable financial products issued by banks still lack crystal clear definitions.

	PHILANTHROPY		SOCIAL IMPACT INVESTING		SUSTAINABLE & RESPONSIBLE INVESTING	CONVENTIONAL FINANCIAL INVESTING
	Traditional philanthropy	**Venture philanthropy**	**Social investing**	**Impact investing**	**ESG investing**	**Fully commercial investment**
Focus	Address societal challenges through the provision of grants	Address societal challenges with venture investment approaches	Investment with a focus on social and/ or environmental outcome and some expected financial return	Investment with an intent to have a measurable environmental and/ or social return	Enhance long-term value by using ESG factors to mitigate risks and identify growth opportunities	Limited or no regard for ESG practices
Return Expectation	Social return only	Social return focused	Social return and sub-market financial return	Social return and adequate financial market rate	Financial market return focused on long-term value	Financial market return only

Source: Certificate in ESG Investing Curriculum (CFA Society of the UK, third edition, 2021)

Within an instance, sustainable investments moved from a niche investment class to mainstream retail product heading towards mass adoption. Therefore, the target group is no longer only sustainability experts, but average retail investors. This new class of investors has access to the capital market and is financially literate enough regarding investment classes in general, but doesn't necessarily have the detailed sustainable investing knowledge to understand the difference between buzzwords or investment strategies like e.g. impact investing, green investment, sustainable and responsible investing, best-in-class screening, norms-based screening, ESG integration or negative exclusionary screening. From a product perspective, investors of sustainable fixed income products can quickly get confused by emerging bond types like green bond, blue bond, social bond, gender bond, sustainable-linked bond etc. Hence the end investor, feels good about himself by his perceived sustainable investment choice, even though he has been brainwashed and led to believe he is having a positive impact on society, eventually becoming a victim of Greenwashing – which is at best exaggerated or at worst even harmful.

For example, a common ESG strategy is "best-in-class": Investments involve companies that reach a predefined hurdle based on ESG criteria. Therefore, a tobacco company could be included in a best-in-class ESG fund even though we would not label this as a responsible investment. Along the same lines, applying a "negative screening strategy" can involve stocks from an alcoholic beverage or gambling company, if ESG hurdles are met - which we could never label as "impact investment".

This lack of globally defined sustainable investment definitions leads to the risk that, for example, a pursued exclusion strategy is not able to ensure that the invested funds are used 100% ethically – and instead funding tobacco, alcoholic beverage companies, gambling companies, weapons, fossil fuels and the like. Therefore, each investor (retail investor or intermediary with investment mandate acting on behalf of an end investor) must decide for himself what he considers as sustainable and invest accordingly.

To understand how Greenwashing can affect the end investor, let's examine the stakeholders of the financial intermediation chain in more detail.

2.1 Greenwashing in the financial ecosystem

	Financial Intermediation Chain				
ISSUERS	**Rating providers**	**Indices**	**Asset Managers**	**Inst. Investors**	**END INVESTORS**
Debit and equity issuers that are receiving an ESG rating	Firms that evaluate companies on their ESG performance	Firms that create ESG indices	Firms that construct and market ESG funds	Entities with fiduciary duty that invest on behalf of other individuals	Ultimate owners that bear risks and rewards and might also directly invest themselves

1. **Issuers:** Corporates might wrongly claim to be sustainable by overstating positive sustainability aspirations without revealing negative externalities, or wrongfully receiving sustainability labels – by chance or bribing.

2. **Rating Providers:** Rating providers might incorrectly issue an ESG rating since they have to rely on the self-disclosure by the equity and debt issuers and potentially lack sufficient, high-quality and audited data. This is deteriorated by that fact that companies can choose their ESG rating providers and hence are tempted to select the one that is issuing the most favorable ratings to them. Finally, ESG ratings are still extremely subjective. Based on an MIT study, the correlation of ESG ratings is on average 0.61 – for comparison, credit ratings of Moody's and S&P have a correlation of 0.99.[14]

3. **Indices:** Indices are increasingly used to benchmark the relative performance of actively and passively managed ESG portfolios, and to assess whether portfolio managers have been able to generate superior risk-adjusted returns. ESG indices can be used to give a false representation, if exact inclusion/exclusion criteria are not clear: A sustainability index might follow a best-in-class principle that includes industries like weapon manufacturers and doesn't communicate the investment strategy and concrete targets exhaustively.

4. **Asset Managers:**

   a. Front Office: Banks might fail to properly understand the impact the client wants to make or oversell the "greenness" of certain financial products. This can be done unknowingly or on purpose to meet internal sales targets tied to ESG. In case of discretionary mandates, the asset managers might directly invest in greenwashed financial vehicles without adequate due diligence. Nondiscretionary managers might execute a trade based on wrong perception or lack of knowledge of the investor's impact target.

   b. Middle Office: In the product development departments, banks might structure financial products with unsustainable companies included specifically due to inconsistent and opaque ratings by rating providers.

   c. Back Office: Lack of high-quality time-series data on ESG performance due to e.g. legacy systems and insufficient data governance might lead to investment decisions that are unsatisfactory.

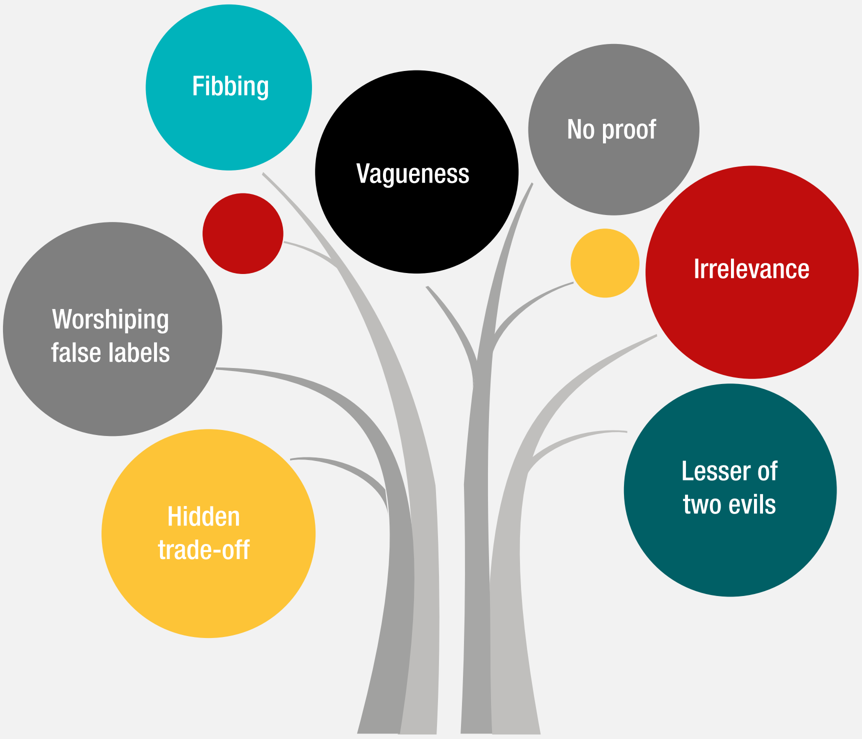
5. **Institutional Investors:** Hedge funds, pension funds etc. might invest on behalf of end investors due to lack of due diligence or engage in shareholder activism to vote for ESG aspects most critical to them that end up being realized at the expense of others.

6. **End Investors:** From a retail perspective, investors that actively invest themselves potentially invest in financial products they don't fully understand, by only trusting names, superficial term sheets, ratings and labels without analyzing the inherent processes and data. Who are the typical ESG end investors? While ESG investments cater to the needs of all investor classes (performance or impact focus), Millennials are emerging as key investor class and represent today's largest generation (MSCI, 2020)[15] and recipient of the greatest intergenerational wealth transfer in history ($30 trillion). They are the generation the most financially literate and today's main retail investors since they do not shy away from investing themselves without the need of outsourcing it to a Relationship Manager. With impact investments as priority, most Millennials are willing to move their brokerage account to gain access to Socially Responsible Investments despite the switching costs. 88% of high-net-worth millennials are actively reviewing the ESG impact of their investment holdings (MSCI, 2020)[16].

14. https://mitsloan.mit.edu/ideas-made-to-matter/why-esg-ratings-vary-so-widely-and-what-you-can-do-about-it
15. https://www.msci.com/documents/1296102/17292317/ThematicIndex-Millenials-cbr-en.pdf/44668168-67fd-88cd-c5f7-855993dce7c4#:~:text=In%202020%2C%20approximately%21.8%20billion,1980s%20to%20the%20mid%2D1990s
16. https://www.msci.com/documents/10199/07e7a7d3-59c3-4d0b-b0b5-029e8fd3974b

2.2 Greenwashing on a financial product level

While Greenwashing can take several forms depending on the type of industry, they usually fall into one of seven types:[17]:



Hidden trade-off: Pretending that a product is sustainable based on only a small set of factors

Worshiping false labels: A product that uses verbal or illustrative marketing to create the expectation that a third-party verification was granted, which is not the case

Fibbing: Advertising certain environmental claims that are not true

Vagueness: A sustainability claim that is extremely vague and therefore subjective and potentially misleading

No proof: ESG claims that cannot be verified through an independent external verification or evidence that is easily accessible

Irrelevance: An environmental claim that is true but doesn't influence the purchasing decision of an environmentally conscious client

Lesser of two evils: An environmental claim that is truthful for a product itself, but neglects potentially devastating negative environmental impacts the industry itself is having

17. https://www.ul.com/insights/sins-greenwashing

Which financial products are most likely to be wrongfully sold as sustainable? The table below provides a non-exhaustive illustration of how the Greenwashing sins could be committed in sustainable financial products.

CATEGORY	SUBCATEGORY	GREENWASHING EXAMPLE	GREENWASHING TYPES
Retail / corporate banking	Green deposit accounts	A retail bank offers its retail or corporate clients a green deposit account, claiming the cash reserves will be invested in "sustainable projects", but the projects' descriptions are unclear or lack verifiable SMART goals (specific, measurable, achievable, realistic and timely)	Vagueness
Retail / corporate banking	Green mortgages	A bank provides a green mortgage to an individual for the construction of a "green" building that will use renewable energies at a discount, but in reality the money will not be used or only partially used for this purpose. This, in turn, can be sold to other investors in the form of CDOs (collateralized debt obligations)	Fibbing
Equities	ESG stocks	A company pretends to have very high ESG standards with the objective to raise as much capital as possible during its IPO. The company struggles to present proof of achieved impact in any of the ESG criteria afterwards	No proof
Equities	ESG stocks	An investor might be seduced into buying shares of a company that is producing disinfectant claiming that they are not using CFC (chlorofluorocarbons - contributor to ozone depletion) when the use of this chemical has been forbidden for years and no products with this ingredient are on the market anymore	Irrelevance
Fixed income	"Green" bonds	A company engaged in traditional energies issues a "green" bond to raise money for a sustainable project based on wind energy that is not pursued	Fibbing
Fixed income	"Blue" bonds	An investor invests in a blue bond raised by a company that is investing in coastal cleaning projects, pretending to be backed by a certification that doesn't exist	Worshiping false labels
Investment funds	ESG ETFs	An asset manager that issues an ESG branded ETF that is based on a small number of concrete ESG compliant companies listed in the holdings	Hidden trade-off
Investment funds	Best-in-class sustainable investment	A retail investor invests in a sustainability index that is following a best-in-class investment strategy. This can include a tobacco company that meets the best ESG criteria in the tobacco industry	Lesser of two evils
Investment funds	ESG mutual funds	A company that applies to be listed in an ESG mutual fund based on supposedly fulfilling ESG criteria that the company cannot provide evidence for	No proof
Alternative investments	Private equity	A family office invests the excess cash of a HNWI client into a startup that is not publicly listed and having loosely defined, superficial, broad goals to fight climate change	Vagueness
Alternative investments	ESG or "green" cryptos	A newly launched cryptocurrency pretends to be the less energy consuming crypto on the market based on few elements	Hidden trade-off

In sum, the more structured or innovative a sustainable product is, the easier it is to fall into the Greenwashing trap due to a lack of transparency of the investment targets' end-to-end operations, specifically combined with a retail investor that is likely to lack knowledge on ESG integration into financial products.

3. HOW TO RESPOND TO GREENWASHING?

The ESG bubble grew so rapidly that it is questionable whether all institutions that market themselves as sustainable investors have put sufficient effort into the groundwork of a solid ESG transition, and to ensure portfolios are really ESG friendly. What should banks do to regain investor trust and ensure they are really having the impact that they are promising?

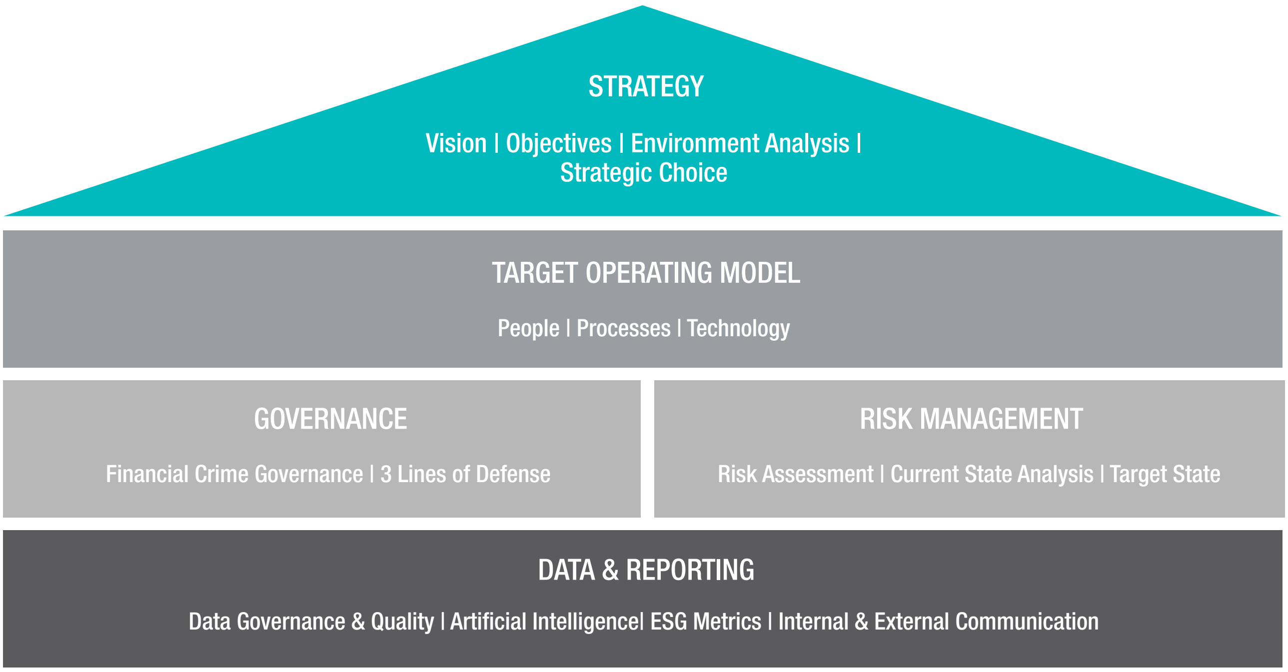
3.1 Tighten and globally harmonize the regulatory landscape

ESG-related regulations that are trying to tackle Greenwashing concerns are increasing and transitioning globally from voluntary recommendations to legally binding legislations. However, there remains a lack of harmonization on global sustainability reporting standards and multiple competing frameworks and methodologies exist. Also, national interpretations as soft or hard law still vary. While hard law is legally binding, soft law is not. With the EU being at the forefront of initiatives and action plans, emerging regulations primarily target disclosures (e.g. NFRD and SFDR[18]) and climate risk (EU Climate Transition and TCFD[19]).

Also, some regulations directly try to challenge Greenwashing through e.g. the EU Taxonomy Regulation and the EU Ecolabel for Financial Products[20]. Finally, the launch of the SFDR introduces the disclosure concept of Principal Adverse Impacts (PAIs) into the EU regulatory environment, which are negative externalities resulting from investments on sustainability factors. Also, two different categories of sustainable financial products are defined and differentiated (Article 8 and 9 products)[21].

While all of these regulations are a step into the right direction, as long as ESG disclosure is still voluntary self-reporting and not integrated globally into hard law, the risk remains that companies only cherry pick what they want to report and omit what they don't want the public to know. Therefore, banks should already anticipate upcoming regulatory demands and proactively define bank-wide standards.

Banks need to ensure that there are no loopholes for Greenwashing through five key pillars as starting point:



18. NFRD: Non-Financial Reporting Directive; SFDR: Sustainable Finance Disclosure Regulation (in force in the EU since March 2021)
19. TCFD: Task Force on Climate-related Financial Disclosures
20. Please see Capco's latest Regulatory Newsletter for a detailed roadmap on all upcoming regulatory requirements coming into force: https://www.capco.com/intelligence/regulatory-horizon
21. https://www.capco.com/Intelligence/Capco-Intelligence/SFDR-Is-The-Financial-Industry-Ready-For-Disclosure

3.2 Integrate ESG into the strategic management process

ESG considerations like climate risk don't only constitute investment risk, but also investment opportunity. If sustainability is a core component of the organizational culture, and if "doing good" is aligned with "doing well" (i.e. superior financial performance), Greenwashing risk can be reduced. There is less intrinsic motivation for bank employees to engage in Greenwashing if tempering with the sustainability reporting numbers doesn't translate into a better bottom line. "Purpose is the engine of long-term profitability" (Larry Fink, CEO of BlackRock)[22]: For a bank, starting point is to re-think how purpose and profit can be combined.

Sustainability efforts need to translate into a "Win-Win" – for the bank and the planet/people by incorporating it into every aspect of the Strategic Management Process:

PURPOSE AND VISION	OBJECTIVES	ENVIRONMENT ANALYSIS	STRATEGIC CHOICE	IMPLEMENTATION	STRATEGIC OUTCOMES

• Re-baseline the company vision and statement of purpose to encompass sustainability
• Re-think how the company can produce solutions to problems of people and planet and in the process produce profits
	• Perform a materiality assessment to identify company-specific ESG issues that directly impact firm value
	• Incorporate metrics into the company objectives and financial goals
		• Incorporate ESG factors into environment analysis:
		• External: opportunities, threats, PESTLE analysis (political, economic, social, technological, legal, environmental), Five Forces
		• Internal: Assess internal ESG resources and capabilities along the value chain
			• **Business level:** Reconsider the strategic choice (cost leadership vs. differentiation) in line with ESG opportunities and risks
			• **Cost leadership:** Determine how ESG opportunities can be exploited to compete on costs
			• **Differentiation:** Determine ESG opportunities for
			  • Product/service attributes (product features, product complexity, product mix, location, timing)
			  • Relationship with customers (customization, marketing, reputation, service, distribution channel) etc.
			• **Corporate level:** Identify how the bank can gain a competitive advantage in several businesses through ESG opportunities via vertical integration, strategic alliances, diversification, M&A or internationalization activities
				• Implement vision enterprise-wide and front to back, along the customer lifecycle
				• Refine organizational structure, control processes and compensation policy in line with ESG strategy
					• Measure the competitive advantage in line with competitor moves and customer acceptance

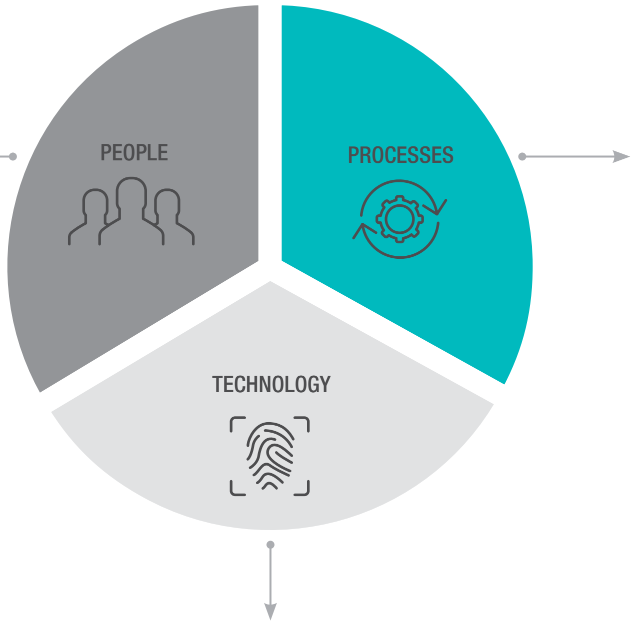
Does our statement of purpose address all stakeholders, not only shareholders?	Are our nonfinancial objectives SMART (specific, measurable, achievable, reasonable and time-bound)?	Which ESG opportunities do we see in the next 1, 2, 5, 10 years? Can we capitalize on existing tangible or intangible assets or easily transform them in a sustainable way?	Is the current strategic direction contradicting to the ESG trend? Business level – Cost Leadership: Is a focus on cost efficiency still viable in the long term? Business level – Differentiation: Does our current product mix unite value and purpose? How can we use ESG to position ourselves in a unique way? How can we integrate ESG for a unique customer service? Are there any unserved niche markets? Corporate level: Which green targets would support our strategy?	Does our organizational structure support ESG? Do we have a robust control environment in place? Are internal KPIs and culture in line with company objectives?	Do we need to adjust our objectives? Do we need to adjust our strategic positioning due to a competitor move?

22. https://www.blackrock.com/hk/en/larry-fink-ceo-letter#:~:text=Ultimately%2C%20purpose%20is%20the%20engine,a%20higher%20cost%20of%20capital.

How does that look like in practical terms? A bank that is trying to expand its market share in payments for example might launch an App that improves financial inclusion and making payments more accessible to the "underbanked" in developing countries. In that case, the integrated approach is obvious and also credible to shareholders since the core banking services are simultaneously solving a pressing issue in third-world countries while generating a profit. Additional examples observed in the retail banking industry lately are credit cards that reward members for their community contributions, green deposit accounts, micro-loans for business owners in developing countries etc.

3.3 Translate ESG into a modified Target Operating Model

Due to the weaknesses of external ESG ratings, processes and procedures gain even more importance and investor attention. To unlock the strategic value of ESG, it cannot be considered a "one-off" checkbox activity but needs to be integrated into the company's strategy and DNA, then deeply embedded into operational practices that are audited and quality controlled. The bank's Target Operating Model needs to incorporate ESG – on both an enterprise-level and the functional / (Fraud) Risk Management level:



Ensure the right people are hired, roles and resources aligned, job descriptions and organizational structure updated and training adjusted

Translate changes in strategic direction to modified operational processes and procedures (front, middle, back office) with a specific consideration for the fraud risk management unit

Utilize advancements in technology and artificial intelligence to create new solutions, innovate processes, and generate material ESG data

3.4 Institutionalize ESG into the risk and Financial Crime governance

Several regulatory bodies understood the importance of reporting on the governance of ESG, e.g. national interpretations of the TCFD demand disclosure of the governance of climate risks and opportunities. The current Financial Crime governance needs to be extended to specifically focus on Greenwashing.

Dedicated reporting lines are required for standing committees to oversee Greenwashing, as well as ad hoc committees for severe cases and damage control. In addition, banks should proactively address Greenwashing through the classical 3 lines of defense framework and managerial oversight:

FINANCIAL CRIME	
AML	BRIBERY & CORRUPTION
KYC / PEP	APPLICATION FRAUD
PAYMENT FRAUD	LOAN FRAUD
MERCHANT FRAUD	CYBERSECURITY
INTERNAL FRAUD	GREENWASHING

01

FIRST LINE BUSINESS OWNERS

- Raise risk concerns where they emerge and report to second line
- Understand and adhere to internal policies, controls and regulations
- Engage in continuous risk monitoring and self-assessment and support with mitigation/remediation

02

SECOND LINE CONTROL FUNCTIONS

- Set up bank-wide minimum control requirements and establish performance targets to actively measure against
- Perform a periodic review of the risk governance framework against pre-defined performance targets (front-to-back risk assessment and management of residual risk)
- Identify training requirements for first line
- Establish standards, policies and guidelines and country-specific addendums

03

THIRD LINE INTERNAL AUDIT

- Engage in independent oversight and testing of control activities
- Ensure comprehensive risk oversight and provide assurance to senior management
- Look out for greenwashing red flags

The following are potential Greenwashing red flags to look out for:

- Vague reporting without clear evidence or action items. If it is too good to be true, it probably is – use common sense
- A significant portion of funding related to access to financing (e.g. government grants for clean energy consumption)
- High overlap of ESG reporting and external rewards (e.g. specific awards or inclusion in indices)
- Weak internal control environment and governance in relation to sustainability in general
- Reporting and marketing with focus on positive stories no critical view regarding shortcomings and points for improvement/ "path to green" and goals rather than achievements

3.5 Incorporate ESG into the Risk and Fraud Risk Management function

No matter if a bank is more susceptible to actively engage in Greenwashing or to become victim of Greenwashing, establishing a Sustainability (Fraud) Risk Management Program is a critical step. Greenwashing needs to be logged as an official risk category and be incorporated into the overall risk framework:

3.5.1 Assessment of risk exposure

The periodic (Fraud) risk exposure assessment needs to incorporate Greenwashing. The bank needs to properly assess its risk exposure (impact/likelihood) based on size/geographic scope, business model, service/product offering and operating model. It is critical to determine which products and processes (front, middle, back) along the value chain are mostly at risk of Greenwashing and treat them with priority.

3.5.2 Current state analysis

Once the key risks have been identified and categorized, potential loopholes for Greenwashing need to be analyzed. An evaluation of the status quo and effectiveness of the bank's Anti-Fraud/Greenwashing control environment should include the following focus areas:

THINK LIKE A FRAUDSTER

Apply the fraud triangle to your organization (opportunity, rationalization, pressure) to understand potential internal weak spots.

KNOW YOUR EMPLOYEE/ PARTNER

Understand key HR practices for permanent and temporary employees (recruitment, onboarding, employee monitoring, exit) and internal incentives/KPIs that would encourage greenwashing.

Assess whether adequate due diligence is followed for all partners, contractors, and service providers like rating agencies.

EVALUATE YOUR M&A TARGET

Which due diligence procedures are currently in place, in addition to the standard financial statement analysis? For all types of inorganic growth (mergers/acquisitions), an in-depth assessment of ESG practices (and greenwashing prevention measures) needs to be incorporated into the decision-making process.

ESTABLISH AN ESG CULTURE

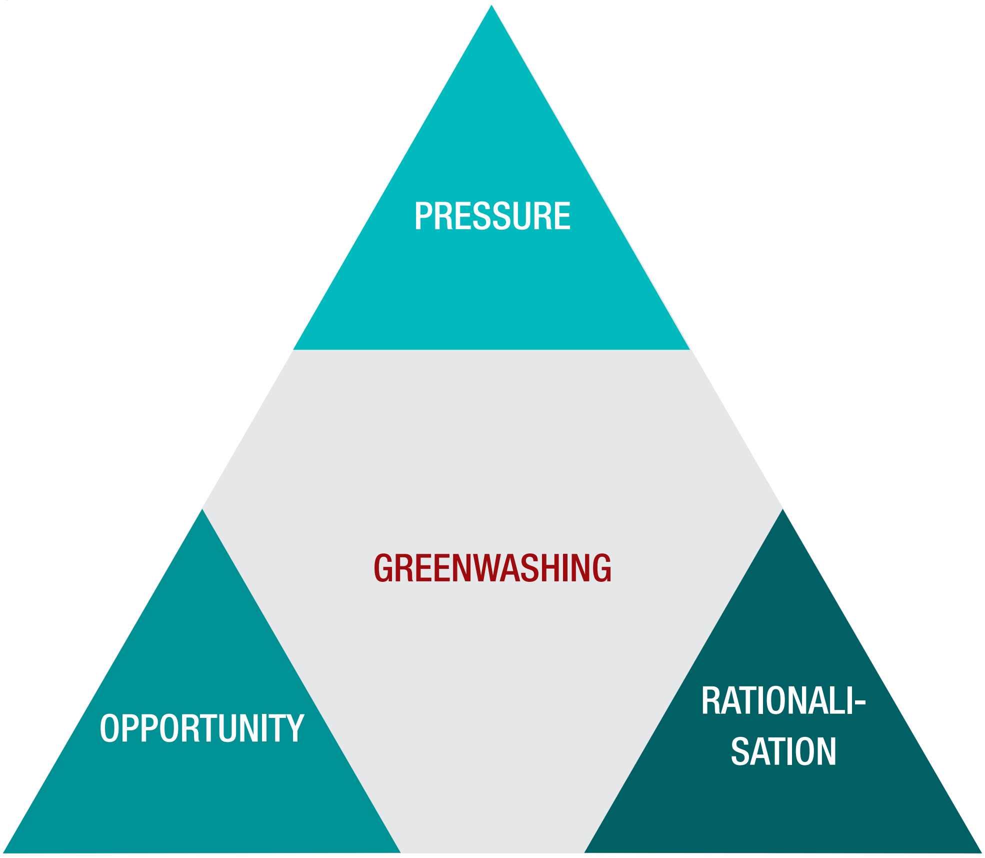
Conduct an ethics survey (culture, fraud attitude, fraud practices awareness, reporting willingness) to understand the average employee sentiment regarding sustainability and internal fraud.

Checklist of questions (non-exhaustive):

- How is ESG and Greenwashing Fraud governed within the bank?
- What are current opportunities for employees to engage in Greenwashing?
- Which controls are currently in place to prevent those? Are these adequate? Are they regularly audited?
- What are potential incentives of individuals/functions to engage in Greenwashing?
- Are there any apparent conflicts of interest that would incentivize employees to engage in Greenwashing? Do KPIs need to be adapted?
- What is the internal culture like? What is the attitude of employees towards sustainability and unethical behavior? Are employees on average willing to report wrongdoing? Are sufficient trainings in place?
- Would there be reasons for specific employees to rationalize a committed Fraud due to their (personal or professional) circumstances?

To actively prevent Greenwashing from happening, banks should put themselves into the shoes of a fraudster. The fraud triangle can be used as an insightful tool to assess fraud risk through the likelihood of an individual engaging in a fraudulent act.

3.5.2.1 Greenwashing through the lenses of a fraudster: The fraud triangle



PRESSURE

- **Shareholder activism:** ESG is gradually becoming a focus of interventions and at the heart of asset managers' investment strategies
- **Product innovation:** Possibility to be considered for screened investment products such as "green bonds"
- **Contributions:** Recovery plans around the world favor sustainable companies in their funding
- **Government procurement:** Public authorities increasingly demand compliance with ESG criteria in their selection process for public contracts
- **Growth requirements:** A strong ESG value proposition is increasingly required of companies to enter new markets or geographies
- **Compliance with regulations:** Regulations around ESG are increasing, specifically with regards to climate risk and disclosure
- **Compensation tied to ESG performance:** Company performance incentives are progressively tied to ESG metrics
- **Talent attraction:** A strong ESG positioning positively impacts a company's ability to attract and retain high quality employees

OPPORTUNITY

- **ESG wave:** ESG is a trend and customers are willing to pay a premium for financial products in line with ESG criteria
- **Lack of global ESG regulations:** Even though ESG regulations exist locally, there is still a lack of globally adopted international standards specifically in relation to the definition of financial products and respective investment strategies
- **Move towards retail investing:** The new generation of retail investors who is investing into ESG products by themselves lacks solid sustainable investing expertise
- **Transparency in ESG reporting:** A lack of external controls and verification from auditors on ESG reporting may not incentivize the companies to full transparency
- **Numerous ESG rating agencies:** Companies can cherry-pick the rating agency which is the most favorable to them, and the correlation between ratings of different agencies is low
- **Subjective nature of ESG ratings:** Difficulty of comparing the ESG rating of e.g. a company that is scoring well on climate risk metrics to one that is trying to enhance labor conditions in developing countries

RATIONALISATION

- **Survival of a business:** Companies with economic difficulties could be tempted to market themselves as ESG compliant in order to obtain financial incentives tied to ESG integration
- **Following ESG leaders:** A financial institution which is a laggard in ESG might be tempted to create false ESG financial products or KPIs to keep up with the leaders in the ESG domain
- **Greenwashing in the financial industry as accepted behavior:** Some companies may think Greenwashing is widespread amongst competitors which persuades them to copy the behavior
- **Marketing as grey zone:** The lines between marketing as differentiation factor and Greenwashing are blurring, so banks might justify their misconduct as "creative marketing strategy"
- **Fear of job loss:** ESG performances are becoming a top priority for companies and can push employees to commit Greenwashing with the fear of losing their job in case the objectives are not reached

3.5.3 Target state definition

Define the future state of (Fraud) Risk Management with consideration of Greenwashing:

GREENWASHING FRAUD RISK MANAGEMENT

PREVENTION: REDUCTION OF OPPORTUNITIES

- ESG culture: Foster the right culture through leadership commitment, adherence to values, tone from the top, code of conduct, etc.
- Risk tolerance/appetite: Establish a risk appetite statement with inclusion of greenwashing, and what level of risk the bank is willing to accept.
- Fraud risk governance: Incorporate greenwashing into the internal fraud governance, with dedicated ownership within the fincrime/fraud taxonomy.
- Policy/control framework: Extend fraud policies, processes and standard operating procedures to address greenwashing.
- Training and communication: Ensure the right people are trained and have an awareness and understanding of new processes/procedures across the three lines of defence and third-party networks.

DETECTION: CONTROL ACTIVITIES

- Financial crime screening data needs to include ESG parameters – rely on data/analytics monitoring tools to detect potential greenwashing activities.
- Controls need to be established for key risk processes identified in the risk assessment, with measures like segregation of duties and 4 eyes principle.
- Reporting channels like whistleblowing need to specifically also include wrongdoing in relation to ESG (greenwashing).
- Employees in the first line need to be educated on red flags to be on lookout for and what they should report and to whom.

RESPONSE: REMEDIATION ACTIONS

- Communicate a zero-tolerance attitude for any misconduct in relation to greenwashing.
- Establish adequate remediation actions for key greenwashing risks identified.
- Have an emergency plan in place in the marketing/PR department for immediate disclosure of wrongdoing.
- Report any discovered greenwashing misconduct proactively and openly.

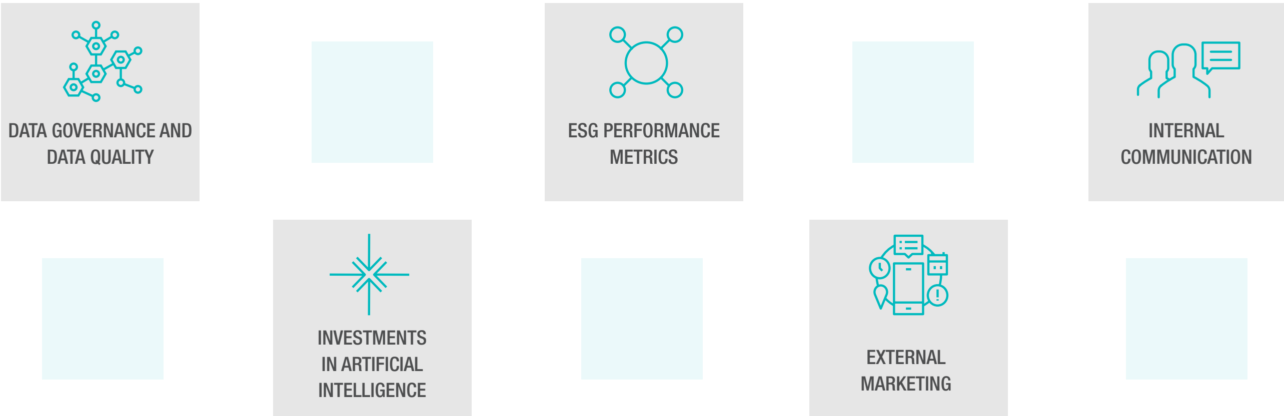
3.5.4 Change management and progress monitoring

Depending on the outcome of the current state analysis, the bank should launch an internal task force and reserve a specific budget/resources to manage the transition towards bulletproof sustainability. Organizations don't change until people do. If employees are intrinsically motivated to act in a way that is aligned with the business strategy which now also includes sustainability, controls and frameworks eventually will become less relevant. The (Fraud) risk management practices (for both internal and external Fraud) need to be constantly aligned with industry trends to prevent and/or detect new, evolving Fraud schemes.

3.6 Integrate ESG into the data lifecycle – from sourcing to reporting

The ESG Data industry is expected to be worth $1bn in 2021 (Techmonitor)[23]- Technology is acting as ESG enabler through improvements in online brokerage platforms, zero commission trades and advancements in the sourcing and provisioning of ESG data itself.

23. https://techmonitor.ai/ai/ai-tackling-lack-of-transparency-esg-investing



3.6.1 Data Governance and Data Quality

To ensure financial reporting data is trustworthy, comparable, reliable, high-quality and safeguarding consumer protection rights, regulations like BCBS 239[24]and GDP[25] forced banks to invest in data governance, data ownership and data quality initiatives. What needs to be on top of the Chief Data Officer's agenda is an extension of past Data Governance initiatives with non-financial (ESG) data. Data owners and stewards need to be nominated on both Business and IT sides to determine an approved source for material ESG data, sign off on data quality and establish a common data glossary enterprise-wide.

3.6.2 Investments in Artificial Intelligence

As the saying goes, you can only manage what you measure. Investors increasingly seek to measure their impact. On top of the sustainability movement, we are also in the middle of a data transformation: With evolving FinTechs, Analytics and AI, it is possible to collect and analyze non-financial data via various sources like weather and satellite imagery or social media posts, and report on resource usage, emissions, workforce composition/diversity, executive pay etc. Some banks incorporated this even into remote working and are measuring homeworkers' carbon footprint anonymously through an App on the end user's device.

3.6.3 ESG performance metrics

Based on the strategic direction, suitable key performance indicators (KPIs) need to be determined that fulfil the triple bottom line: ESG issues that have a material impact on firm value. As social and environmental issues are dynamic in nature and reflect shifting priorities of society, banks need flexible reporting processes and practices that can move quickly. While climate change has been established as long-term key concern, other areas like "diversity" have only recently emerged through viral campaigns like "black lives matter", the "Me Too" debates or the gender pay gap discussions.

3.6.4 External reporting/marketing

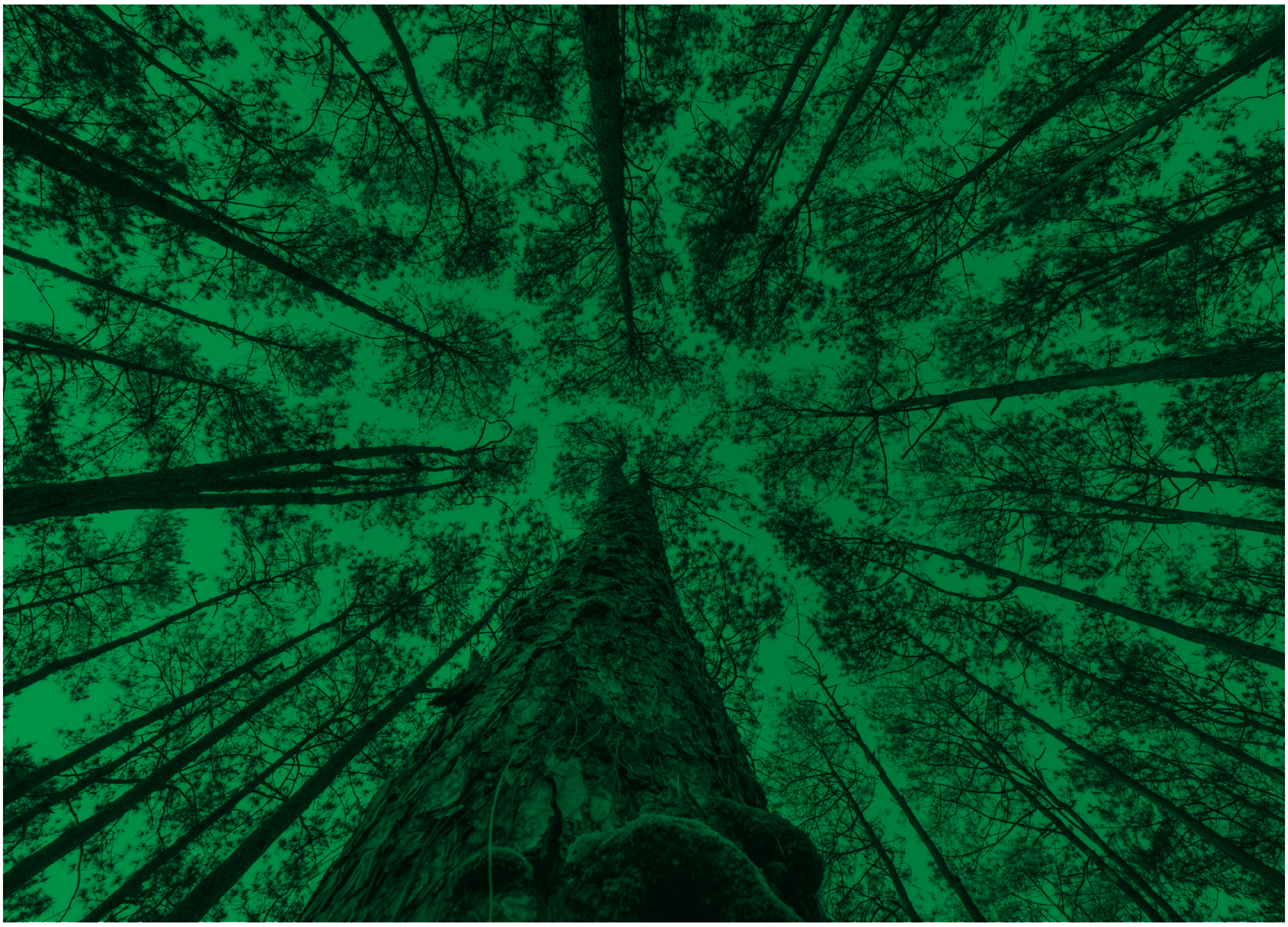
So far, banks' sustainability efforts used to be targeted towards non-profits and policymakers and reported in absolute terms (e.g. number of trees planted, money donated, hours volunteered, etc.). However, impact investors have a different incentive: They want to understand how a corporation is simultaneously fulfilling the triple bottom line of profit, people and planet. Reporting recommendations like from the TCFD[26] already expect disclosure on actual and potential impacts of climate-related risks and opportunities on the strategy. ESG reporting must be targeted to investors that want to see how material ESG issues are integrated into the strategy to obtain a comprehensive overview of firm value - Artificial Intelligence can help establishing this linkage.

24. Basel Committee on Banking supervision's standard number 239 has established principles for effective risk data aggregation and risk reporting.
25. General Data Protection Regulation safeguarding personal data and privacy.
26. TCFD: Task Force on Climate-related Financial Disclosures

Clear rules need to be established concerning which investment strategies and practices an organization considers as sustainable and which not, with clear internal definitions of ESG products. Those need to be made readily available to all stakeholders. The same rules need to be applied consistently, and also communicated through all documents and all kinds of verbal and written communications – marketing material, fact sheets, contracts etc. Also, stakeholders prefer honesty and transparency in achieving sustainability goals. Focus should be on outputs and outcomes instead of intentions and goals. The French luxury brand Chanel for example launched a green bond linked to environmental targets. In case those are not reached, a voluntary penalty will be paid to the bondholders.

3.6.5 Internal communication

Employees need the same common language as all other stakeholders do. Whereas external communication should be centralized to ensure a unique and controlled branding and messaging, internal communication requires a decentralized approach to foster co-creativity and create shared sustainability commitment. Tone from the top, internal newsletters, townhalls and trainings should help employees internalize sustainability values and foster an ESG mindset that discourages Greenwashing.



4. CONCLUSION

With all the perceived benefits of ESG investments, corporations and individuals might have an incentive to sugar-coat their internal practices and report themselves as "greener" than they actually are. Change is inevitable for all stakeholders in the financial services industry. The sustainability process is complex and doesn't offer any shortcuts or quick fixes, especially not for those banks that are still in the early stages. ESG can be a competitive advantage only if financial institutions will be able to "talk the talk" and "walk the walk".

Sustainable Banking is at an inflexion point, driven by consumers who demand sustainable change but are at the same time suspicious on the truthfulness of labels, ratings and disclosures. With increasing regulations and pressing deadlines that lack clear implementation guidance and product definitions, greenwashing might continue rising until bank-wide standards are adapted as well. The way forward is being proactive in embracing sustainability along all described dimensions rather than reactively waiting for emerging regulations. For both ESG leaders and laggards, the risk of Greenwashing deserves growing attention and clear action items for Strategy, Target Operating Model, Governance, Risk Management and Data & Reporting.

The next steps vary depending on the current position on the ESG journey:

- Banks that are already at the forefront of ESG need to take a step back and re-assess the inherent ESG opportunities and Greenwashing risks, to then put adequate controls and audits in place.

- Laggards that are just jumping onto the ESG wave should not follow a "wait and see" approach and reactively comply with regulations, since this is likely to translate into a competitive disadvantage. They need to pro-actively define their future strategy in ESG terms, while ensuring a bulletproof control framework and governance is in place from Day 1 onwards.

We are witnessing a once-in-a-century transition, and now is the time to do it right from the start. While the risks of greenwashing are slowly becoming understood in the financial services industry, emerging misconduct like "socialwashing", "bluewashing", "pinkwashing" etc. is just around the corner.

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