MINERVA BRIEFING

GREENWASHING

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1. INTRODUCTION

Greenwashing is an issue of increasing concern for investors, with false or misleading claims about the environmental benefits of a product or service impeding their ability to accurately understand their own portfolios.[i]

The rapidly growing evidence of greenwashing has potential to affect investor confidence in green or sustainable products, with significant implications for a rapidly growing market.[ii] During 2020, environmental, social, and governance-focused (ESG) funds available to European investors saw GBP200 billion net inflows.[iii] This was almost double the figure of 2019 despite the ongoing COVID-19 pandemic.

Indeed, many asset managers have realised that in a post-pandemic and climate change-aware world, ESG credentials attract investment. As investors flock toward ESG opportunities, they are likewise realising that not all ESG funds are made equal. So, how can you spot greenwashing in the market, how are new ESG regulations going to affect greenwashing, and what can you do to avoid it all together?

This Minerva Briefing on Greenwashing gives asset owners the key details they need to understand and address greenwashing concerns.

Key Summary

- The rapidly growing evidence of greenwashing has potential to affect investor confidence in green or sustainable products, with significant implications for a rapidly growing market.
- However, the boom has been accompanied by a stark increase in greenwashing, which is the practice of making false or misleading claims about the environmental benefits of a product or service.
- As investors around the world shift toward a more environmentally conscious approach to their investment decisions, firms that are not proponents of environmentally or climate-friendly practices in their business model stand to be left behind.
- Standardisation is coming to the ESG investing space, making it easier to identify the many symptoms of greenwashing and remove it where appropriate.

2. WHAT IS GREENWASHING?

The recent uplift in ESG investing and sustainability standards setting has swept up investors from all backgrounds. Judging by the headlines it seems that everyone is turning towards ESG funds to boost their green credentials. However, the shift has been accompanied by a stark increase in concern over what has become called “greenwashing”.

In simple terms, greenwashing is the practice of making false or misleading claims about the environmental, ESG or sustainability benefits of a product or service.[i]

What does this look like in practice? Well, one study by The Economist found that the world’s 20 biggest ESG funds each hold an average of 17 investments in fossil fuels, prompting questions over the legitimacy of ESG claims.[iv] So, what is driving these misleading claims? Are they misleading, are they signs of a market in transition, or is there misunderstanding about investment process?

2.1 WHY GREENWASH?

As investors around the world shift toward a more environmentally conscious approach to their investment decisions, firms that are not proponents of environmentally or climate-friendly practices in their business model stand to be left behind.[v] The demand for such firms to go green is so strong that several firms are guilty of putting the cart before the horse, making unsubstantiated claims for environmentally and socially sustainable credentials before they have made any meaningful change to their business practices.

> **“The more that fund managers see this as a growth opportunity, the more funds we’ll see in this space”**
>
> Mike Appleby,
> Liontrust Authority[vi]

A second major cause of greenwashing is the boost that firms, or indeed asset managers see an opportunity to boost their brand image when whey make green claims about a product or fund. This does not necessarily mean that greenwashing is done with malicious intent, in fact many fund managers may simply be trying to meet the needs of investors that each give a different meaning to the idea of sustainable investment.

Much like copyright regulates and prevents the creation of copy-cat products when a popular new product is released, the market for green products including ESG funds is still a relatively new one in need of better regulation to combat the copy-cats.

2.2 HOW CAN YOU IDENTIFY GREENWASHING?

Identifying greenwashing is by no means a simple task. Thankfully, greenwashing is also a long-documented problem in many sectors, and in 2009, the TerraChoice Environmental Marketing created a list of seven ‘sins’ that indicate the possibility of greenwashing. Although the research that TerraChoice conducted was focused on the retail-sector, their framework is useful to apply to the institutional products offered by asset managers and index providers. This list of sins gives any investor a good way to approach investment options with eyes wide open to spot greenwashing.

The seven sins of greenwashing [i]	
Hidden trade-offs	Environmental claims that emphasise certain benefits at the possible expense of other environmental factors. For example, the electric car manufacturer Tesla is a popular investment for many ESG portfolios, however lithium mining for the manufacture of electric car batteries is known to cause environmental and social issues.
Lack of proof	Environmental claims that are not backed up by factual evidence or third-party certification. ESG funds without third-party certification or evidence of their ESG credentials is a common issue for UK investors. However, developments are under way, with the Financial Conduct Authority (FCA) publishing a letter addressed to authorised fund managers on improving quality and clarity.
Vagueness	Environmental claims that lack specificity and may be deemed as meaningless. For example, if a company claims it is 'sustainably run', it is not necessarily 'sustainable'. For example, the 2021 voting season saw a relatively successful campaign against fossil fuel companies that are making net zero commitments but not evidencing them in their annual reports.
False labels	False environmental certifications invented to mislead customers. These are not very common in the world of investing, but it is certainly true that not all ESG labels are equal. Some funds may invest in controversial products with sustainable labels that are not reliably verified.
Irrelevance	Claims of environmental benefits that are unrelated to the environmental impact of a product. For example, if an ESG fund composed of companies in the energy sector claimed to be certified as sustainably organic. In the case of synthetic funds, investments may be based on a climate aware large cap fund but lack any specific commitment to investing in climate aware companies.
Lesser of two evils	Environmental claims made about a product or service that has no environmental benefit to begin with. For example, many ESG funds may include fossil fuel companies despite their emissions. This may be due to the company's environmental commitments or because the fund manager engages the company to push it toward greener practices.
Fibbing	Environmental claims that are false. This has occurred in past examples such as the Volkswagen emissions scandal.

3. TACKLING GREENWASHING

Addressing the many forms of greenwashing outlined above is a challenge, but in tackling greenwashing it is not only important to consider what you are invested in, but how you act as a steward of your investments. The best place to start is to understand what requirements both you as an investor or asset owner and the many asset managers or investment service providers you work with must adhere to.

The rapidly evolving nature of ESG investing makes it vulnerable to misunderstanding. For example, the ongoing debate over different ESG indexes claiming to measure for the 'ESG efficacy' of companies when in fact they are measuring different variables. That said, there is no 'one size fits all' approach to sustainable investing, so the final decision on how to tackle greenwashing is up to you.

Although this briefing does not intend to provide an in-depth explanation of everything you need to do to boost your stewardship, it may be used as a roadmap for which resources or regulations you can look to for guidance in overcoming greenwashing and greening your investments.

> **"Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society."**
>
> **The Financial Reporting Council**

3.1 TCFD

The Financial Stability Board established the TCFD to develop recommendations for more effective climate-related disclosures that could promote more informed investment, credit, and insurance underwriting decisions and, in turn, enable stakeholders to better understand the concentrations of carbon-related assets in the financial sector and the financial system's exposures to climate-related risks. The Task Force consists of 31 members from across the G20, representing both preparers and users of financial disclosures.

In 2017, the TCFD released climate-related financial disclosure recommendations designed to help companies provide better information to support informed capital allocation. Their disclosure recommendations are structured around four thematic areas that represent core elements of how organizations operate: governance, strategy, risk management, and metrics and targets.

The TCFD primarily works with companies to implement the recommendations and promote advancements in the availability and quality of climate-related disclosure. As of 2020, the number of

organizations expressing support for the TCFD reached over 1,500 globally, including over 1,340 companies with a market capitalization of $12.6 trillion and financial institutions responsible for assets of $150 trillion. Investors have been assisted in implementing the recommendations of the TCFD through the help of the World Business Council for Sustainable Development, the Institute for International Finance, the United Nations Environment Programme Finance Initiative, and other organizations.

The TCFD recommendations helps to tackle greenwashing by acting as a globally agreed set of standards for companies and investors alike to adhere to. They also help prevent greenwashing by recommending that asset managers scrutinise the quality of climate-related data reported by companies. The data may be not reported at all, not explicitly reported by substituted with a near estimate following agreed methods, reported but not independently verified, or reported and fully verified by an independent party.

Another important international framework for asset owners looking to tackling greenwashing is the Paris Aligned Investment Initiative from the International Investors Group on Climate Change. The group publishes a freely available ‘Net Zero Investment Framework’ that guides investors to make commitments and set targets in line with global net zero emissions by 2050. Members of the IIGCC who sign up to the PAII gain access to ongoing research and recommendations into creating net zero portfolios.

3.2 SFDR & THE EU TAXONOMY

The EU Taxonomy Regulation was published in the Official Journal of the European Union on 22 June 2020 and entered into force on 12 July 2020. It is a classification system, establishing a list of environmentally sustainable economic activities. The EU taxonomy is an important enabler to scale up sustainable investment and to implement the European Green Deal.

By providing appropriate definitions to companies, investors, and policymakers on which economic activities can be considered environmentally sustainable, it is expected to create security for investors, protect private investors from greenwashing, help companies to plan the transition, mitigate market fragmentation and eventually help shift investments to where they are most needed.

Alongside the EU Taxonomy, the Sustainable Finance Disclosure Regulation (SFDR) provides a series of sustainability-related disclosures which must be made in the documentation of a financial product and on an asset managers website.[vi] Having come into force in March 2021, the SFDR requires firms to transparently communicate the sustainability risks in their investment processes and disclose all the details of sustainability features advertised within their financial products.[vii]

Although the SFDR is an EU initiative, it undoubtedly affects asset owners and managers in the UK. Not only must UK asset managers or anyone else who distributes financial products into the EU comply, but also the UK government is currently working on new regulations that will mirror the requirements of the SFDR.

The UK’s recently announced Sustainability Disclosure Regulation regime will be a broad framework for disclosures, combining disclosures against TCFD, the green taxonomy and SFDR, and operate as a single regime for industry. Likewise, the UK’s Green Technical Advisory Group, which is advising

government on the delivery of its own green taxonomy will provide its own advice to the UK Treasury by the end of September.

3.3 UK STEWARDSHIP CODE AND FCA

In October 2019 the UK's Financial Reporting Council published an update to the Stewardship Code for the first time since its original publication in 2010. The new revision requires signatory asset owners, asset managers, and service providers to explain how they have exercised stewardship in relation to a far broader range of asset classes. It also calls for better integration of ESG and climate change considerations into stewardship processes, as well as their audit, making it a good starting point for any UK-based asset owners looking to tackle greenwashing.

Adding to the momentum of the new stewardship code, the UK's Financial Conduct Authority (FCA) has published a business plan for 2021 and 2022 announcing the rollout of economy-wide rules aligned with the TCFD recommendations. The FCA also warned against complacency by investors, encouraging full compliance with the UK Stewardship code, which itself helps prevent greenwashing by requiring asset managers to 'apply and explain'. This reduces their ability to claim ESG credentials without providing evidence.

There are also many new rules aimed at investors and fund managers alike that intend to regulate the growing space of green investing and combat greenwashing. In July 2021. the FCA published a letter addressed to set out a list of 'guiding principles' in a July 2021 letter directly addressed to fund managers. The letter made clear that all parties in the UK ESG investing space will be required to meet regulations closely matching the European Commission's SFDR in the near future.

4. NEXT STEPS

Tackling greenwashing is by no means a simple task. That said, standardisation is coming to the ESG investing space, making it easier to identify the many symptoms of greenwashing and remove it where appropriate. The tools, guidelines and regulations identified within this briefing are just a starting point for asset owners looking to step up their stewardship and become responsible investors.

4.1 SUSTAINABILITY GOVERNANCE RATINGS

Being a steward over your investments means looking beyond the environmental claims made by an ESG fund or corporate report to see whether the day-to-day governance of a company is linked back to environmental sustainability through Paris-alignment. Minerva's Sustainability Governance Rating tool enables investors to assess climate strategy governance. It is aligned with key international climate frameworks including The Taskforce on Climate-related Financial Disclosures (TCFD), the Transition Pathway Initiative (TPI), the UN Sustainable Development Goals, and the EU Taxonomy.

Our governance and remuneration data sheds a light on the internal workings of companies in your portfolio, to answer questions like 'is pay tied to ESG commitments?' and 'is a fund really owning-up to its responsible investing commitment?' With over 20 years of experience, the Minerva Sustainability Governance Rating offers institutional investors a thorough, relevant, and cost-effective solution to meeting the evolving regulatory and investment landscape.

4.2 TCFD CONSULTATION

Minerva also offers a TCFD consultation service to help investors identify climate change risks and opportunities and meet regulatory requirements. Together with our strategic partner Solactive we are ready to help investors implement benchmarks suitable to their investment strategy, starting by looking at the four areas outlined within the TCFD.

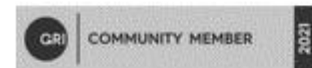
Our services are aligned with many of the frameworks and regulatory bodies outlined in this briefing, including the SDGs, the TCFD, the GRI, and TPI.

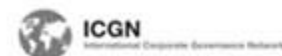
To find out more, say hello@minerva.info.

About Minerva

Minerva helps investors and other stakeholders to overcome data disclosure complexity with robust, objective research and voting policy tools. Users can quickly and easily identify departures from good practice based on their own individual preferences, local market requirements or apply a universal good practice standard across all markets.

For more information, please email hello@minerva.info or call + 44 (0)1376 503500





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ENDNOTES

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