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ESG – the good, the bad, the ugly

SARAH BIDINGER | LUDOVIC ZACCARON

ESG

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DEAR READER,

Welcome to edition 56 of the Capco Institute Journal of Financial Transformation, produced in partnership with King's Business School and dedicated to the theme of ESG – environmental, social and governance.

We all recognize that transformation towards a green economic system via sustainable finance is needed, welcome and inevitable. Our clients have a crucial role to play here. Acknowledging the scope and complexity of the evolving ESG landscape, we are perfectly positioned to prepare them for the ESG era.

With climate change accelerating and generating physical events on an unprecedented scale, governments and societies are considering measures to mitigate carbon emissions via net zero initiatives. The focus is firmly on greater sustainability and more equitable policies in response to shifting public attitudes. ESG considerations are reshaping investment risks on the one hand, and opening the way for green financing and sustainable technologies and innovations on the other.

This edition of the Journal examines all three pillars – environmental, social, and governance, highlighting efforts by regulators and practitioners to create a unified approach.

Moving forward, compliance with emerging ESG standards will be a critical differentiator for long-term business success. Data will also play a critical role in delivering the transparency and insights required to validate the ESG credentials of businesses, and investment strategies. Advances in areas such as machine learning, artificial intelligence and cloud technologies will be key to establishing a future model of sustainable finance.

This edition draws upon the knowledge and experience of world-class experts from both industry and academia, covering a host of ESG topics and innovations including the value of tracking Return on Sustainability Investment (ROSI) and the importance of moving away from purely external risks to addressing issues that can have positive commercial and societal impacts.

I hope that that the research and analysis within this edition will prove valuable for you as you shape your own ESG strategies, policies, and innovation.

Thank you to all our contributors and thank you for reading.

Lance Levy, **Capco CEO**

ESG – THE GOOD, THE BAD, THE UGLY

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ABSTRACT

If there is one buzzword that current strategic discussions across all industries have in common, it is ESG. Even though sustainable investments initially started as a niche investment class, they are slowly reaching mass adoption. While environmental concerns like climate change previously seemed to be non-urgent, COVID-19 rewrote that narrative, and we are observing a massive disruption in public consciousness. With the wealth transfer taking place, demand for sustainable investments skyrocketing, and regulations and public scrutiny tightening, banks are under immense pressure to steadily fulfill growing demands for ESG products. However, this flight to green is increasingly considered as a cause for concern. The "why" in relation to ESG is undebatable, we now need to focus on the "how" – or rather "how not to". This is where greenwashing comes into focus. Based on recent large-scale scandals, it has become apparent that greenwashing can occur across the full investment value chain. Due to lack of global cooperation and adoption of what is really considered sustainable, greenwashing can be committed intentionally or unintentionally, if there is lack of proper due diligence at product, company, and/or point of sale level. This article provides a framework for greenwashing prevention through the five key pillars of strategy, target operating model (TOM), governance, risk management, and data and reporting. Ultimately, key guidelines are provided to help financial institutions avoid the greenwashing trap, no matter where they are on their individual ESG journeys – be they laggards or frontrunners.

1. INTRODUCTION

If there is one acronym shaping strategic discussions across industries like no other, it is ESG. Sustainability moved from street protests of climate activists to the boardroom and is considered one of the main growth opportunities of the 21st century. Given the immense pressure of the investor revolution, banks are rushing to ensure sustainable product supply is satisfying demand so as to not leave any money on the table. At the most extreme, asset managers are repurposing existing assets by simply changing product names. The ESG bubble has grown so rapidly that it is hard to ascertain whether all the institutions that market themselves as sustainable investors have invested sufficient effort to ensure a genuine ESG transition, and to guarantee that portfolios are really ESG friendly.

Sceptics are also making sure that their voices are heard, with many suggesting that ESG labels are in many instances nothing more than the paper straw of investing, which is served inside a plastic cup. Are ESG investment vehicles really what they claim to be or are they simply a marketing tool to repackage existing assets and sell them at a green premium? A number of hedge fund managers are of the view that they are overpriced, with some short-selling shares they believe are wrongfully inflated by ESG promises. Whenever there is information asymmetry, greenwashing can easily occur – at product, company, or point-of-sale level. This translates into the following statistics:

- More than 70 percent of executives lack confidence in their organization's own ESG reporting.[1]

[1] https://bit.ly/3Skdxkz

- 42 percent of the green claims are "exaggerated, false, or deceptive", according to the European Commission.[2]
- Even though 95 percent of European corporate lending comes from banks that claim to be committed to the Paris Agreement, less than 10 percent of companies have Paris-aligned targets defined (European Commission).

A globally accepted, stringent framework and audit for non-financial statements is still missing and ESG rating processes are mostly a black box. ESG performance is not black or white and should be evaluated on a sustainability continuum. This did not go unnoticed by the regulators and a number of newsworthy investigations are taking place, with some impacting internationally renowned fund management brands. As a result, overselling green claims is no longer considered within the grey zones of a creative marketing strategy, but a crime, which may also be penalized on a personal level.

This article provides guidance on what banks can do to ensure that they can effectively integrate ESG within their corporate strategy, translate ESG strategy into operational processes and controls, and review 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. MANAGING THE ESG TRANSITION

What can banks do to not commit greenwashing, intentionally or by falling into the greenwashing trap of their investment targets, regain investor trust, and ensure they are really having the impact that they are promising and aiming to achieve?

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. Furthermore, national interpretations regarding soft or hard laws still vary, with hard laws being legally binding and soft laws not.

With the E.U. being at the forefront of initiatives and action plans, emerging regulations have primarily targeted disclosures (e.g., NFRD[3] and SFDR[4]) and climate risk (E.U. Climate Transition and TCFD[5]), with certain regulations directly trying to challenge greenwashing through, for example, the E.U. Taxonomy Regulation and the E.U. Ecolabel for Financial Products.

The launch of the SFDR also introduces the disclosure concept of Principal Adverse Impacts (PAIs) into the E.U. regulatory landscape, which are negative externalities resulting from investments on sustainability factors. There are also two different categories of sustainable financial products that are defined and differentiated (Article 8 and 9 products).

The E.U. recently announced that there will also be requirements for sustainability reporting audits, which means that banks' sustainability reporting will receive even more attention.

While these regulations are all helpful, as long as ESG disclosures remain voluntary, and not integrated globally into hard law, the risk remains that companies will cherry pick what they want to report and omit what they don't want the public to know. Consequently, banks should expect increasing regulatory demands and proactively define bank-wide standards that adhere to the most stringent ESG regulations globally.

3. INTEGRATING ESG INTO THE STRATEGIC MANAGEMENT PROCESS

ESG considerations like climate risk do not 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), the risk of greenwashing can be reduced. There is less intrinsic motivation for bank employees to engage in greenwashing if tampering with the sustainability reporting numbers does not translate into a better bottom line.

"Purpose is the engine of long-term profitability," according to Larry Fink, CEO of BlackRock.[6] For a bank, the starting point is to re-think how purpose and profit can be combined alongside the three Ps – people, planet, and profit. 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, as illustrated in Figure 1.

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[2] https://bit.ly/3Ly4rhN
[3] NFRD: Non-Financial Reporting Directive
[4] SFDR: Sustainable Finance Disclosure Regulation
[5] TCFD: Task Force on climate-related financial disclosures
[6] https://bit.ly/3S4pKtQ

Figure 1: Integrating ESG into strategic management progress

What does this 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 – an integrated approach that would be also credible to shareholders since the core banking services are simultaneously solving a pressing issue in developing countries while generating a profit.

4. TRANSLATE ESG INTO A MODIFIED TARGET OPERATING MODEL

Due to the weaknesses of external ESG ratings, internal processes and procedures receive even more investor attention. To unlock the strategic value of ESG, it cannot be considered a one-off checkbox activity. After ESG has been integrated into the company's strategy and DNA, it needs to be deeply embedded into operational practices that are audited and quality controlled. The bank's target operating model needs to include ESG – on both an enterprise-level and the functional/(fraud) risk management level.

- **People:** ensure that the right people are hired, roles and resources aligned, job descriptions and organizational structure updated, and training adjusted.
- **Processes:** 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.
- **Technology:** utilize advancements in technology and artificial intelligence to create new solutions, innovate processes, and generate material ESG data.

5. INSTITUTIONALIZE ESG INTO THE RISK AND FINANCIAL CRIME GOVERNANCE

Regulatory bodies already 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 of AML, KYC/PEP, payment fraud, merchant fraud, internal fraud, bribery and corruption, application fraud, loan fraud, and cybersecurity need to be enhanced by a dedicated greenwashing team. Likewise, reporting lines are required for standing committees to oversee greenwashing, as well as ad-hoc committees for severe cases and damage control and whistleblowing incidents. In addition, banks should proactively address greenwashing through the classic three lines of defense framework and managerial oversight.

The first line of defense (business owners) needs to detect and raise risks where they emerge and proactively report them to the second line. Consequently, an understanding of all internal ESG policies, controls, and regulations is critical to be able to engage in continuous risk monitoring and self-assessment.

The second line of defense (control functions) defines the bank-wide minimum control requirements and country-specific interpretations of regulations, and with that baseline establishes targets and KPIs that the performance can be benchmarked against. It is also within their level of responsibility to perform a periodic review of the risk governance framework against pre-defined performance targets (front-to-back risk assessment and management of residual risk). Finally, they identify training requirements for the first line.

The third line of defense (internal audit) engages in independent oversight and testing of control activities to ensure comprehensive risk oversight and to provide assurance to senior management. A lookout for greenwashing red flags is critical:

- Vague reporting without clear evidence or actions (goals rather than achievements)
- Achievements that seem too good to be true – use common sense and assess viability
- A significant portion of funding related to access to financing (e.g., government grants for clean energy consumption)
- High overlap between 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
- Lack of critical view regarding shortcomings and points or "path to green".

6. INCORPORATE ESG INTO THE RISK AND FRAUD RISK MANAGEMENT FUNCTION

Whether a bank is more susceptible to actively engage in greenwashing or to become a 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.

6.1 Assessment of risk exposure

The periodic (fraud) risk exposure assessment needs to incorporate greenwashing. Banks need 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 most at risk of greenwashing and treat them with priority.

6.2 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, but not be limited to, the following focus areas:

- **Know your partner:** assess whether adequate due diligence is undertaken 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.
- **Know your employee:** understand key HR practices for permanent and temporary employees (recruitment, onboarding, employee monitoring, exit) and internal incentives/KPIs that would encourage greenwashing.
- **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.
- **Think like a fraudster:** apply the fraud triangle to your organization (opportunity, rationalization, pressure) to understand potential internal weak spots.

A potential checklist of questions would include (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 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 attitude of employees towards sustainability and unethical behavior? Are employees 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 (pressure, opportunity, rationalization) can be used as an insightful tool to assess fraud risk through the likelihood of an individual engaging in a fraudulent act.

6.2.1 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.

6.2.2 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 are investing in ESG products by themselves lack solid sustainable investing expertise.
- **Transparency in ESG reporting:** a lack of external controls and verification from auditors on ESG reporting may not incentivize companies towards full transparency.
- **Numerous ESG rating agencies:** companies can cherry-pick the rating agency that 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, for example, a company that is scoring well on climate risk metrics to one that is trying to enhance labor conditions in developing countries.

6.2.3 RATIONALIZATION

- **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 that 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 that behavior.
- **Marketing as grey zone:** the lines between marketing as a differentiation factor and greenwashing are blurring, so banks might justify their misconduct as “creative marketing strategy”.
- **Fear of job loss:** ESG performance 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.

6.3 Target state definition

To define the future state of (fraud) risk management, greenwashing needs to be factored into prevention, detection, and response processes.

6.3.1 PREVENTION: REDUCTION OF OPPORTUNITIES

To prevent greenwashing, leadership commitment, tone from the top, and adherence to values foster the right ESG culture. The risk appetite statement needs to also include greenwashing and the level of risk the bank is willing to accept. Greenwashing needs to be incorporated into the fraud governance, with dedicated ownership established. Fraud policies, processes, and standard operating procedures should also address greenwashing. Ensure the right people are trained and have an awareness and understanding of new processes/procedures across the three lines of defense and third-party networks.

6.3.2 DETECTION: ESTABLISHMENT OF 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 also specifically include wrongdoing in relation to ESG (greenwashing). Employees in the first line need to be educated on the red flags that they should be on the lookout for and what they should report and to whom.

6.3.3 RESPONSE: DETERMINATION OF APPROPRIATE REMEDIATION ACTIONS

Communicate a zero-tolerance attitude for any misconduct in relation to greenwashing. That also includes the establishment of adequate remediation actions for key greenwashing risks identified. An emergency plan needs to be in place in the marketing/PR department for immediate disclosure of wrongdoing – report any discovered greenwashing misconduct proactively and openly.

6.4 Change management and progress monitoring

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. 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 do not change until people do, and change takes time. 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 will eventually become less relevant.

7. INTEGRATE ESG INTO THE DATA LIFECYCLE

The ESG data industry is said to have become a U.S.$1 billion industry in 2021 (Techmonitor)[7]. 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.

7.1 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[8] and GDPR[9] forced banks to invest in data governance, data ownership, and data quality initiatives. An extension of past data governance initiatives with non-financial (ESG) data needs to be on top of the chief data officer's agenda. Data owners and stewards need to be nominated from both business and IT to determine an approved source for material ESG data, sign off on data quality, and establish a common data glossary, enterprise-wide.

7.2 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 have even incorporated this within remote working and are measuring homeworkers' carbon footprint anonymously through an app on the end user's device.

7.3 ESG performance metrics

Based on the strategic direction, suitable key performance indicators (KPIs) need to be determined that fulfill the triple bottom line (profit, people, and planet) – 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 a 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. Also, in Europe, investments in weapons have been assessed through a different lens since the start of the war in Ukraine.

7.4 External reporting/marketing

So far, banks' sustainability efforts have targeted 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 the TCFD 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 in establishing this linkage. Clear rules need to be established and communicated concerning which investment strategies and practices an organization considers as sustainable and which not, with clear internal definitions of ESG products. If, for example, a best-in-class strategy is followed, the investor needs to be properly educated that this could result in investments in the so-called sin industries like tobacco, gambling, etc. Those need to be made readily available to all stakeholders and in a language that is precise and understandable.

Given the rapid transformation of sustainable investments, from a niche investment class to mainstream retail products heading towards mass adoption, 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 does not necessarily have the detailed sustainable investing knowledge to understand the difference between investment strategies like, for instance, impact investing, sustainable and responsible investing, best-in-class screening, norms-based screening, ESG integration, or negative exclusionary screening. 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. Furthermore, 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.

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[7] https://bit.ly/3SoYfv1

[8] Basel Committee on Banking Supervision's standard number 239 has established principles for effective risk data aggregation and risk reporting.

[9] General Data Protection Regulation safeguarding personal data and privacy

7.5 Internal communication

Employees need to be addressed in the same common language as all other stakeholders. Whereas external communication should be centralized to ensure a unique and controlled branding and messaging that is not contradictory, 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.

8. CONCLUSION

With all the perceived benefits of ESG investments, corporations and individuals might have an incentive to sugar-coat their internal practices and present themselves as "greener" than they actually are. Change is inevitable for all stakeholders in the financial services industry. The sustainability process is complex and does not 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 are 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 of the truthfulness of labels, ratings, and disclosures. With increasing regulations and pressing deadlines that lack clear implementation guidance and product definitions, greenwashing might continue to increase 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 and 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 reassess the inherent ESG opportunities and greenwashing risks, to then put adequate controls and audits in place. Laggards that are just jumping onto the ESG bandwagon 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 proactively define their future strategy in ESG terms, while ensuring a sound control framework and governance is in place from day one. 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 questionable activities, such as socialwashing, bluewashing, pinkwashing, etc. are just around the corner.

However, a considerable regulatory aftermath is expected from the latest greenwashing scandals and allegations. Pascal Durand, a member of the E.U. Parliament, recently stated: "From now on, having a clean human rights record will be just as important as having a clean balance sheet." Consequently, front runners will be those financial institutions that are a step ahead.

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