WHITE PAPER

How Asset Managers Can Put the Greenwashing Genie Back in the Lamp

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How Asset Managers Can Put the Greenwashing Genie Back in the Lamp

Investors are more focused than ever on putting their money to work where they can do good. As a result, the number of ESG-focused products being marketed globally has soared. Since 2018, global ESG assets under management (AuM) have expanded from about $5 trillion to nearly $10 trillion, an annual growth rate of about 20%. However, this increase has led to inevitable questions around the veracity of ESG claims. Greenwashing has become an unwelcome industry buzzword and a new category of risk, amid rising pressure on managers to ensure their funds "do what they say on the tin".

Greenwashing is the practice of making misleading or unsubstantiated claims about the sustainability performance of products or activities. In the asset management context, it is commonly associated with investment practices or the descriptions attached to funds. While the majority of managers are meticulous about their choices, some tag funds as ESG but then make unsustainable investments in fossil fuel producers, companies with poor labour practices, or entities associated with issues such as pollution. In some cases, these practices have led to significant reputational damage and regulatory sanction.

With the public, NGO, and regulatory spotlight increasingly on greenwashing, many asset managers are now revisiting their ESG portfolios and looking to validate their approaches, taking into account their legal obligations, common market standards, and internal investment rules. Leading firms are combining a strategic approach with a pragmatic lens designed to lock out greenwashing and establish a failsafe system for future labelling and workflows. The most successful reduce their risk exposures and establish themselves as "change agents" in the transition to a more sustainable economy.

A Shifting Regulatory Landscape

The growth of green investment has led to a sharp rise in regulatory attention and action. In the US, for example, the SEC has issued a draft that aims to prevent misleading marketing claims around naming conventions. The EU's Sustainable Finance Disclosure Regulation (SFDR), which is now in force, classifies investment products either as "light green" (Article 8) or "dark green" (Article 9)—respectively funds that promote environmental or social characteristics or have "sustainable investment" as their objectives. European managers are now preparing for regulatory technical standards that will come into effect in early 2023. The latest draft of the UK's Financial Conduct Authority, meanwhile, sets out Sustainability Disclosure Requirements (SDR) based on three labels; sustainable focus, sustainable improvers (offering some latitude for improvement over time) and sustainable impact.

There are similar initiatives ongoing around the world (see sidebar: Regulatory initiatives to tackle greenwashing in Asia). In Australia, an FSC guidance note sets out common considerations for the investment management industry on assessment of portfolio emissions and setting of net-zero targets, as well as product labelling and reporting. Switzerland's Financial Market Supervisory Authority (Finma) has proposed a requirement that any fund must invest at least 80 percent of their assets in the investments suggested by its name.

Regulatory initiatives to tackle greenwashing in Asia

Guidance from Hong Kong Securities and Futures Commission (SFC) and Hong Kong Stock Exchange (HKEX)

- SFC-authorized unit trusts and mutual funds that incorporate ESG factors as their key investment focus are required to make additional disclosures with effect from 1 January 2022.
- The disclosures mainly pertain to the fund's ESG focus, the respective investment strategy, asset allocation, reference benchmark and periodic performance reporting.
- The HKEX's ESG Guide requires that a listed issuer's board is responsible for effective governance and oversight of ESG matters, as well as assessment and management of material environmental and social risks. They must also disclose environmental and social matters in ESG reports.

Monetary Authority of Singapore (MAS) guidance on retail ESG funds

- The MAS has issued disclosure and reporting guidelines applicable to retail ESG funds which use or include ESG factors as its key investment focus and strategy
- The guidelines cover aspects such as appropriateness of fund names, its investment (ESG) focus, investment strategy, use of reference benchmark and assessment of associated risks
- The requirements become applicable from 1st January 2023

For their part, regulatory authorities must balance the need to stringently define sustainable investments with the need to ensure there is sufficient capital to fund the green transition. Still, this has not prevented them from taking a firm line on enforcement. The US SEC, for example, in May 2022 settled charges against an investment adviser for misstatements and omissions relating to the use of ESG considerations in making investment decisions for certain mutual funds it managed. The regulator alleged that the adviser "lacked written policies and procedures reasonably designed to prevent inaccurate or materially incomplete statement." In another case, an asset manager was required by the SEC to pay a $6 million fine, while at one European asset manager, the firm's CEO resigned following a police raid focused on prospectus fraud.

These kinds of actions are likely to become increasingly common. Indeed, independent research firm Morningstar in a recent study claims that about 20% of investment products within the European Union classified as "sustainable" do not live up to the expectations of an independent quality assurance.

Drivers of Greenwashing

The primary causes of greenwashing are two-fold: First, evolving regulatory guidance is often ambiguous, creating room for interpretation that can come back to haunt investment businesses. The second is that actual investment practices by individual portfolio managers deliberately or accidentally deviate from external marketing claims.

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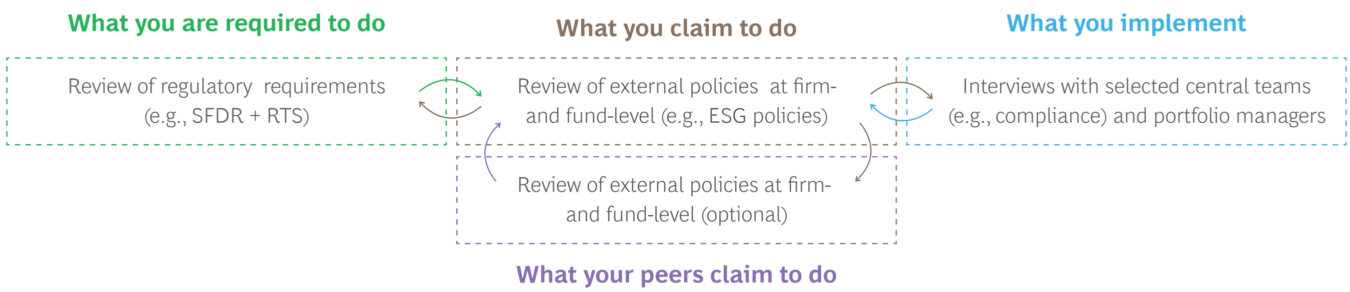
One significant challenge for market participants is that regulators increasingly require them to ensure that regulatory expectations and corresponding internal ESG methodologies are applied through the entire investment process. Often, they fail to clear this demanding hurdle. For example, the simple provision of ESG scores to an individual portfolio manager is not sufficient to be deemed proper consideration by the firm of ESG aspects within the investment process. Indeed, investment firms have a responsibility to adequately train and enable portfolio managers, as well as ensure they have adequate control mechanisms to detect deviations from prescribed investment practices.

A Structured Health Check Approach

To protect against claims of greenwashing, meet regulatory expectations, and ensure that customers have access to reliable information, asset managers, and especially risk oversight functions such as compliance, need to adopt a structured approach to ESG oversight. (See Exhibit 1). A critical element should be an integrity assessment that considers four key perspectives.

- **Regulation:** Identify applicable ESG regulations (in Europe, usually SFDR to start) to determine minimum expectations for ESG investment.
- **Documentation:** Review overarching ESG documents as well as fund-specific materials for a sample of representative funds to identify external marketing claims.
- **Interview:** Undertake detailed interviews with central functions and selected fund managers to better understand the ESG methodology and its consideration in the investment process.
- **Benchmarking:** Select a defined set of peers and analyze their approaches to ESG investment (as outlined in their own marketing materials), for example in relation to explanations of internal thresholds.

Exhibit 1 - Integrity assessment enables rigorous review of ESG practices and claims



Source: BCG

For a meaningful comparison across the different perspectives, firms should create a standardized assessment framework that addresses three key pillars: product development, the investment process, and distribution & advisory.

The outlined approach will allow managers to crystallize an initial view of the alignment of their ESG investment processes with regulatory expectations, peer practices, and internal standards. It should also highlight where there are deficiencies or areas that could be improved in the short-term or require longer-term enhancements.

From our experience, the above approach has highlighted several common challenges across the industry that require more structural changes:

- Asset managers are running the risk of treating ESG aspects inconsistently across funds due to: a) a continuation of legacy investment approaches, and b) vague guidance from the central ESG investment team that allows for interpretation by individual portfolio managers. In response, asset managers are asked to further streamline their approach to "sustainable investment", including establishing a coherent definition for the fund classification process.

- Governance structures do not necessarily ensure full assignment of responsibilities to oversee greenwashing risks, leading to potential control deficiencies. We recommend a thorough review of the 3 Lines-of-Defense (LoD) model to specify the mandate for risk oversight functions and 2nd LoD responsibility for greenwashing risk. This will require an enhanced control framework that goes beyond purely rule-based controls.

- Some asset managers fail to provide sufficient details on their ESG investment approaches (especially where further interpretation of regulatory guidance is required). Still, this shortcoming can usually be addressed through more detailed documentation, alongside additional "proof points" to demonstrate the validity of the chosen investment approach.

To protect against claims of greenwashing, meet regulatory expectations, and ensure that customers have access to reliable information, asset managers, and especially risk oversight functions such as compliance, need to adopt a structured approach to ESG oversight

Exhibit 2 - Standardized framework to review regulation, external claims & interviews

Category	Dimension	Definition
Product Development	Name/Label	The name of a fund or the 'label' used incl. potential reference to investment objective (e.g., ESG, Green, etc.)
	% ESG AUM	% Assets of a fund invested in products addressing ESG factors
	ESG characteristics	The type of ESG risks, sustainable investment share, taxonomy alignment and/or Principal Adverse Impacts considered by the fund. If applicable, the type of ESG factors addressed and the objective it aims to achieve (incl. description of how the stated objectives will be achieved)
	Benchmark	The use of a reference benchmark to attain the ESG characteristics promoted by the financial product
Investment Process	Research	Provision of ESG information needed for investment decisions (e.g., ESG Ratings, internal models etc.)
	Exclusions	Outline of exclusion strategy/list of a fund based on ESG criteria
	Security selection	Valuation of securities using inputs from ESG research and working within the parameters of investment strategy
	Portfolio construction	Construction of portfolios based on ESG research and valuation inputs (e.g., deciding weighting of ecurities to build a portfolio based on risk and return considerations)
	Active ownership	Definition of engagement approach (incl. exercising voting rights, engagement with issuers, collaboration with other investors etc.) and deployment at investment level
	Monitoring & reporting	On-going monitoring of ESG and other performance indicators on a fund level
Distribution & advisory	Distribution & advisory	Provisioning of distribution and advisory services in order to promote sale of ESG funds (incl. positioning of ESG in external documentation)

Source: BCG

Next Steps

Faced with both rising demand for ESG products and increased awareness of greenwashing, asset managers are presented with both an opportunity to attract more demand and a risk that they fail to live up to expectations. The key to maximizing the opportunity and minimizing the risk will be first to take a strategic approach to building a dedicated oversight process.

In all cases, it will be imperative to gather stakeholders from around the organization, including risk/compliance, sustainable investment and legal, so that all relevant parties have a seat at the table. It then would make sense to select a representative sample of funds (usually across different asset classes with sufficient AuM share) and the affected portfolio managers. From there, the manager can conduct a standardized ESG Compliance Health Check over about four to eight weeks, and start to build a product, process, and distribution framework that drives growth and protects the long-term interests of the business.

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