WHITE PAPER

Preparing for heightened regulatory expectations

A control framework to combat ESG washing in financial institutions

November 2024
By Lorenzo Fantini, Jannik Leiendecker, Benedetta Testino, and Georg Lienke

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Executive Summary

ESG washing extends beyond greenwashing, which focuses on the environmental impact of products and services, to include misleading practices in both the social and governance dimensions. Although relevant action has not yet been mandated by regulators, leading financial institutions have been taking a proactive approach so that they can reduce the risk of misleading statements, declarations, actions, or communications across E, S, and G dimensions. This paper discusses the definition of ESG washing risk, the various factors that affect the risk, and the question of risk ownership in the first and second lines of defense. To manage ESG washing risk in the most effective way possible, financial institutions should implement an ESG washing control framework, covering steps from risk identification to risk monitoring and reporting. GenAI can help to strengthen this control framework.

The need to act with urgency

ESG washing has become a critical concern for financial institutions. This is principally due to three factors: increased regulatory scrutiny; growing investor demand for sustainable investments; and public awareness of environmental, social, and governance (ESG) issues.

During recent years, major financial institutions have been accused of overstating the sustainability of investment products, or making unsubstantiated claims in ESG-related public commitments or communications. ESG washing accusations can prompt investigations by regulators, result in regulatory fines, damage a firm's reputation, and even lead to senior management resignations. All these negative repercussions derive from concerns about the firm's willingness or ability to provide transparent and accurate information on their sustainability practices.

Such cases can undermine trust among customers, investors and the public, and ultimately harm the business performance of an institution. To prevent such a scenario, therefore, the risk of ESG washing must be managed proactively. This white paper focuses on the control framework and processes that can effectively mitigate ESG washing risk.

ESG washing – The background

There has been a marked increase in ESG washing allegations over recent years, posing a broad range of risks to financial institutions.

Increase of alleged incidents of misleading communication on ESG-related topics

One recent quantitative analysis by the European Banking Authority (EBA) reveals the proliferation of reported cases of alleged misleading communication on ESG issues. There were 2,119 such cases across the geographical regions covered in 2023, up by 21% from the previous year, and more than seven times higher than in 2012. The number of cases increased in 2023 by 26% in the European Union (EU), 6% in non-EU Europe, and 52% across Asia and remaining regions.[1]

1. Not including US; EBA: Greenwashing monitoring and supervision (2024), p. 12.

Impact on range of existing risk types

Unlike other risk types, such as credit or market risk, where the impact is more confined to specific areas, ESG washing cuts across risk types, and therefore introduces vulnerabilities to financial institutions that are both interconnected and far-reaching. Indeed, in our experience, ESG washing has an impact on three major types of risk:

Reputational risk: Banks, insurers, and asset managers that fail to meet mandatory ESG requirements, or fall short of voluntary commitments, may suffer a loss of trust among investors, customers, and the public. Any such decline in trust may be difficult to rebuild, and can therefore have long-term consequences for an institution's brand and market position. This risk is heightened by intensifying public and stakeholder scrutiny of corporate sustainability practices.

Business risk: When investors believe that a financial institution is misleading others on its ESG commitments, they could decide to sell their shares, leading to stock price decline. Moreover, ESG washing may result in a reduction in business volume, as customers prioritizing sustainability might choose to take their business elsewhere if they doubt the sincerity of the company's ESG commitment.

Regulatory risk: Financial institutions are at growing risk of regulatory enforcement for promoting financial products that do not meet ESG standards. For example, EU national regulators have the power to suspend European green bonds or investment funds under Articles 8 and 9 of the Sustainable Finance Disclosure Regulation (SFDR), if they suspect that proceeds are not invested in line with EU taxonomy requirements.

Ultimately, financial institutions raise their exposure to ESG washing risk when they do not reach sustainability targets or voluntary commitments. Devising reasonable sustainability plans and then delivering on set targets are therefore crucial for economic success.

Overview of regulatory requirements

The European Supervisory Authorities (ESAs) have set out clear expectations for the prevention of greenwashing, emphasizing that it can occur across environmental (E), social (S), and governance (G) dimensions. They require financial institutions to define sound risk management processes, including appropriate controls to identify, prevent, and manage risks, and to integrate these controls into existing risk management systems. Indeed, ESAs view internal controls as a vital element in ensuring the accuracy of ESG claims and commitments.[2] Outside the EU, regulators such as the Swiss Financial Market Supervisory Authority (FINMA) and the UK's Financial Conduct Authority (FCA) have also taken up the topic and have advanced similar requirements.[3]

We have identified two main challenges for financial institutions as they seek to confront ESG washing.

2. EBA: Greenwashing monitoring and supervision (2024); ESMA: Final report on greenwashing (2024); EIOPA: Advice to the European Commission on greenwashing risks and the supervision of sustainable finance policies (2024).
3. FINMA Guidance 05/2021 (Preventing and combating greenwashing); FCA Finalised Guidance FG24/3 (Finalised non-handbook guidance on the anti-greenwashing rule).

Challenge 1: Defining and framing ESG washing risk

It is crucial that financial institutions devise ESG washing definitions appropriate for their business model, and properly assess the underlying risk.

Some regulators still focus on environmental dimension

According to the ESAs, greenwashing risk involves sustainability-related statements, declarations, actions, or communications that do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or a financial service across E, S, and G dimensions. Other regulators have put forward slightly nuanced, but essentially comparable, definitions, often still retaining an emphasis on the environmental aspect:

- Swiss FINMA: Risk that investors and clients are consciously or unconsciously misled about the environmental characteristics of financial products and services.[4]

- UK FCA Risk that financial institutions make environmental claims about their products and services that are exaggerated, misleading, or unsubstantiated.[5]

- Australian Securities and Investments Commission: Risk of misrepresenting the extent to which a financial product or investment strategy is environmentally friendly, sustainable, or ethical.[6]

Market practice

Our experience is that leading financial institutions have established comprehensive ESG washing definitions across E, S, and G dimensions. However, some still opt for a narrower focus on the environmental context, with corresponding greenwashing definitions. Meanwhile, some institutions have not yet established distinct ESG definitions at all. Instead, they merely refer to definitions by regulators, or have included the topic in rules on suitability or on mis-selling and client conduct.

What ESG washing risk encompasses

ESG washing involves the issuance of misleading environmental, social, or governance claims—whether intentionally or unintentionally—about the actual or prospective performance of an entity, its products, or its services.

ESG washing can materialize in several ways, such as when:

- A financial institution exaggerates the environmental benefits of a product (for example, by claiming a product is "100% sustainable" without providing any substantiating evidence);

- An institution omits critical information that would reveal a more accurate picture of its social impact (for example, failing to disclose diversity and inclusion challenges);

- An institution falsely advertises its governance practices (such as by claiming strong ethical standards while simultaneously engaging in business practices with questionable counterparties).

4. FINMA Supervisory Note 05/2021 (p. 2).
5. FCA Finalised Guidance FG24/3 (p. 3).
6. Information Sheet 271.

Parameters for framing ESG washing risk

ESG washing comes in different forms, and the contributing factors, regulatory implications, and the stakeholders involved can be multiple and diverse. To frame the underlying issues properly, and devise holistic solutions, financial institutions need to consider the following background and act accordingly:

Understanding the distinction between regulatory and voluntary triggers: The statements, declarations, or communications that can be subject to ESG washing allegations are made by financial institutions in response either to regulatory requirements or because of voluntary commitments. Even though the potential reputational damage will be similar in both scenarios, the risk of regulatory sanction (and the need to manage that risk) is much more significant for a breach of mandatory requirements.

Paying attention to E, S, and G dimensions: ESG washing can occur in an environmental, social, and governance context, depending on whether the relevant misleading claims exaggerate a company's environmental initiatives, its social impact, or its governance practices. However, as we have seen, there can often be a disproportionate focus on environmental claims, overshadowing the social and governance dimensions and leading to potentially unbalanced sustainability narratives.

Covering all transmission channels: Due to the rapidly evolving expectations of regulators, financial institutions need to understand their exposure to ESG washing risk at the product, service, and entity level. The different transmission mechanisms for each of these three levels, and the corresponding prevention measures, must be clearly determined between the relevant stakeholders.

Maintaining consistency across the organization: Depending on the ESG washing allegations against a bank, insurer, or asset manager, different business segments, owners, teams, and processes will enter the spotlight. Financial institutions must act consistently across the organization in assessing accusations and deciding on follow-up measures.

Exhibit - Overview of potential ESG washing triggers for financial institutions

Level	Parameters	ESG washing trigger	
		Regulatory	**Voluntary**
Product & services	Type	• Sustainable investment products • Financial advice & discretionary portfolio mgt. • Green & sustainability-linked loans • Green mortgages • Green bonds & securitizations	• Marketing and advertising for products and services
	Regulatory mitigant	• SFDR • EU Taxonomy • EuGB regulation	• n/a
	Transmission channel	• Prospectuses • Product & marketing communication • Legal documentation	• Marketing material • Website, social media
	Business owner	• Asset management • Private banking • Lending, underwriting, origination	• Marketing • Communication • HR
	Dimension	• E, S	• E, S
Entity	Type	• ESG disclosures	• Commitments to net-zero • Diversity & inclusion • Good governance
	Regulatory mitigant	• CSRD/ ESRS • EU Taxonomy (Art. 8)	• n/a
	Transmission channel	• Non-financial statement (in annual financial statement)	• External communication • Corporate disclosures • ...
	Business owner	• Finance • Sustainability	• Board/senior management • Sustainability • Communication
	Dimension	• E, S, G	• E, S, G

Challenge 2: Establishing ownership of ESG washing risk

Effective management of ESG washing risk requires clearly defined responsibilities and accountability across the first and second lines of defense.

WHAT WE OBSERVE IN THE MARKET

Financial institutions exhibit different degrees of maturity when it comes to establishing ownership of ESG washing risk.

In some institutions, rules have been proactively established and aligned between business owners and control functions. In other institutions, however, processes are not as sharply defined and alignment is lacking.

In the first line of defense, some institutions have established a central, coordinating role for management of ESG topics. In these institutions, compliance with regulatory ESG requirements and internal standards is typically managed by business owners that oversee product origination, marketing, preparation of sustainability disclosures, and communication of sustainability commitments. However, in other institutions, ownership for ESG washing risk is unclear in the first line of defense, and mitigation measures can be incomplete and fragmented.

In the second line of defense, ESG washing risk oversight is typically coordinated either by a central team within the risk function (Operational Risk, Non-Financial Risk, or a dedicated ESG risk team), or by a combination of different functions working together (mostly the risk, compliance and sustainability functions). Such coordination usually involves looking after the institution's ESG risk framework, mapping ESG risk drivers to risk types, and overseeing implementation by other second-line-of-defense functions.

In some other institutions, risk oversight is split between the risk function (which focuses more on the E dimension) and the compliance function (typically for the S and G dimensions). In still others, the oversight is divided according to the specific risk—the risk and compliance functions each look after those ESG risks that are related to the existing risk types in their oversight.

The risk function sometimes has a stronger focus on voluntary claims (for example, net zero), with an eye on the feasibility and measurability of forward-looking targets. The compliance function is often more focused on regulation-based claims (such as SFDR or EU taxonomy).

What we deem essential

As ESG washing risks should be merged into existing risk management structures and processes, a crucial first step is to integrate them within the current three-lines-of-defense model. There needs to be heightened risk awareness in the first line, taking ownership of ESG washing risks and actively managing them. In the second line of defense, the risk function is generally in the best position to assume a coordinating role for the whole spectrum of ESG washing risks, given its expertise on both financial and non-financial risks. The compliance function, in turn, is typically responsible for handling the impact of ESG washing factors on the non-financial risks it oversees.

However, new topics and processes that do not fall neatly into existing categories have arisen (such as the task of meeting voluntary commitments), while challenges are also emerging in the management of co-owned risks. Roles and responsibilities must therefore be delineated clearly and then periodically reviewed.

Proposed solution: ESG washing control framework

An ESG washing risk management framework can be built upon the traditional risk management processes applied to other risk types, covering steps from risk identification to risk monitoring and reporting. The framework would therefore operate in the following way.

At regular intervals, second-level control functions scan public sustainability claims (for the purpose of risk identification) made by the institution across various sources. These statements are then prioritized according to the anticipated risk exposure for the institution (risk measurement). The effectiveness of first-level controls and procedures in mitigating these ESG washing risks is then assessed (risk management), and new monitoring controls are introduced as necessary (risk monitoring) to address potential ESG-washing accusations. Once controls are executed and discussed with the relevant business owners, the findings are aggregated and reported to the appropriate internal committees (risk reporting).

Risk identification

This step involves scanning official corporate sources such as annual reports, press releases, website publications, and social media posts to identify public sustainability claims by the institution. These claims may be commitments or communications related to sustainability, including regulatory-driven disclosures (for products classified under SFDR Articles 8 or 9, for example) or product-related disclosures (such as for green bonds). Sustainability claims may reside at the entity, business process (for example, involving investments), or product level, and could be triggered by either regulatory or voluntary commitments. Any identified claims are mapped according to the relevant attributes (source, scope, level, and trigger) to help decide on the subsequent risk measurement steps.

Risk measurement

Once the sustainability claims have been identified, second-level control functions then prioritize them according to the extent of the potential risk exposure. The risk-based prioritization identifies claims that are more visible (such as regulatory disclosures), subject to heightened scrutiny (environmental claims being more so than social claims), or at greater risk of public criticism (from, for example, influential non-governmental organizations (NGOs)). Claims that are considered more vulnerable to accusations of ESG washing may require further second-level control scrutiny.

Risk management

From the perspective of second-level control functions, risk management assesses the effectiveness of first-level controls and procedures that mitigate the ESG washing risk for prioritized claims. In many cases, sustainability claims have already been supported by first-level processes and controls established for other managerial or regulatory reasons, but which also serve as a first line of defense against ESG washing risk. These first-level controls and procedures test the feasibility of ESG commitments, and may involve methodologies, data quality checks, procedural authorizations, and scenario analysis or stress testing.

Risk monitoring

New second-level controls are only introduced when existing first-level controls are deemed insufficient in mitigating ESG washing risk. These second-level controls are designed with specific objectives, type descriptions (for example, sample-based testing), and a proposed frequency (such as one-time, event-driven, or semi-annual), as well as supporting documentation requirements (such as data, methodologies) that need to be provided by the relevant business owners. They should follow the following principles:

– Additional value: They should offer a supplementary perspective to existing control processes and methodologies. For example, they could identify anomalous information that challenges the robustness of public claims, or they could test the success rate of internal procedures.

– Forward-looking: They should monitor actual performance against publicly pledged targets and therefore anticipate potential accusations of ESG washing. Monitoring may involve the stress-testing of assumptions by using independent methodologies, or by making use of alternative data sources.

– Data-driven: They should utilize internal data analysis to verify the accuracy of sustainability claims. For example, this could involve conducting SFDR fund look-through analysis to confirm that classification rules are applied correctly, or reviewing investment portfolios to ensure that exclusions (such as coal-related investments) are enforced without exception.

If a control evaluation establishes that existing controls are inadequate, remediation actions are then recommended to the central leadership and to local business functions. These recommended actions must be formalized in writing, assigned an owner and due date, and reported to the relevant committees.

Risk reporting

On a regular basis, control functions present a consolidated report to the relevant committees, outlining the residual ESG risk exposure for the institution. This process should align with other group-wide control functions.

AI use cases for the ESG washing risk management framework

As ESG washing risk management is routine, intensive, and constantly evolving, the above control framework would certainly benefit from generative AI (GenAI). For example, GenAI could be used in the following areas:

– Risk identification: Web scraping can accelerate data collection from corporate websites, social media posts, press releases, and other public sources to maintain an up-to-date list of sustainability claims.

– Risk measurement: GenAI can assist in assigning risk prioritization scores based on public information, such as recent litigation cases or market sentiment. This technique would improve over time through learning-by-doing.

– Risk monitoring: Natural language processing (NLP) could be used to analyze bond prospectuses, investment mandate agreements, and product disclosures. In this way, compliance with internal rules could be verified and independent reports generated. Similarly, look-through analysis can be largely automated through data routines.

Making the first strides toward a control framework

How can financial institutions start building an ESG washing control framework? They should consider the following initial actions:

- Consider the factors specific to the entity that shape the control framework, such as its level of corporate complexity, its compliance culture, its financial and technological resources, and its maturity of data governance.

- Determine the scope and ambition level for future controls, taking into consideration the potential ESG washing risk on a product, service, and entity level.

- Establish governance and ownership for the control framework, and select the business owners and second-level control functions to be involved.

- Identify existing control processes that can be used as a starting point for ESG washing controls, such as those relating to new product approval, marketing and communications, and to corporate disclosures.

By taking these measures, financial institutions can create momentum toward an overarching system that mitigates ESG washing risk.

About the Authors

Lorenzo Fantini is a Managing Director and Partner in our BCG Office in Milan and global leader of ESG Risk & Compliance.

Jannik Leiendecker is a Partner & Associate Director in our BCG Office in Munich and Co-Leader of BCG's Center for Sustainability Policy & Regulation.

Benedetta Testino is an Associate Director in our BCG Office in Milan.

Georg Lienke is an Associate Director in our BCG Office in Frankfurt.

For Further Contact

If you would like to discuss this report, please contact the authors.

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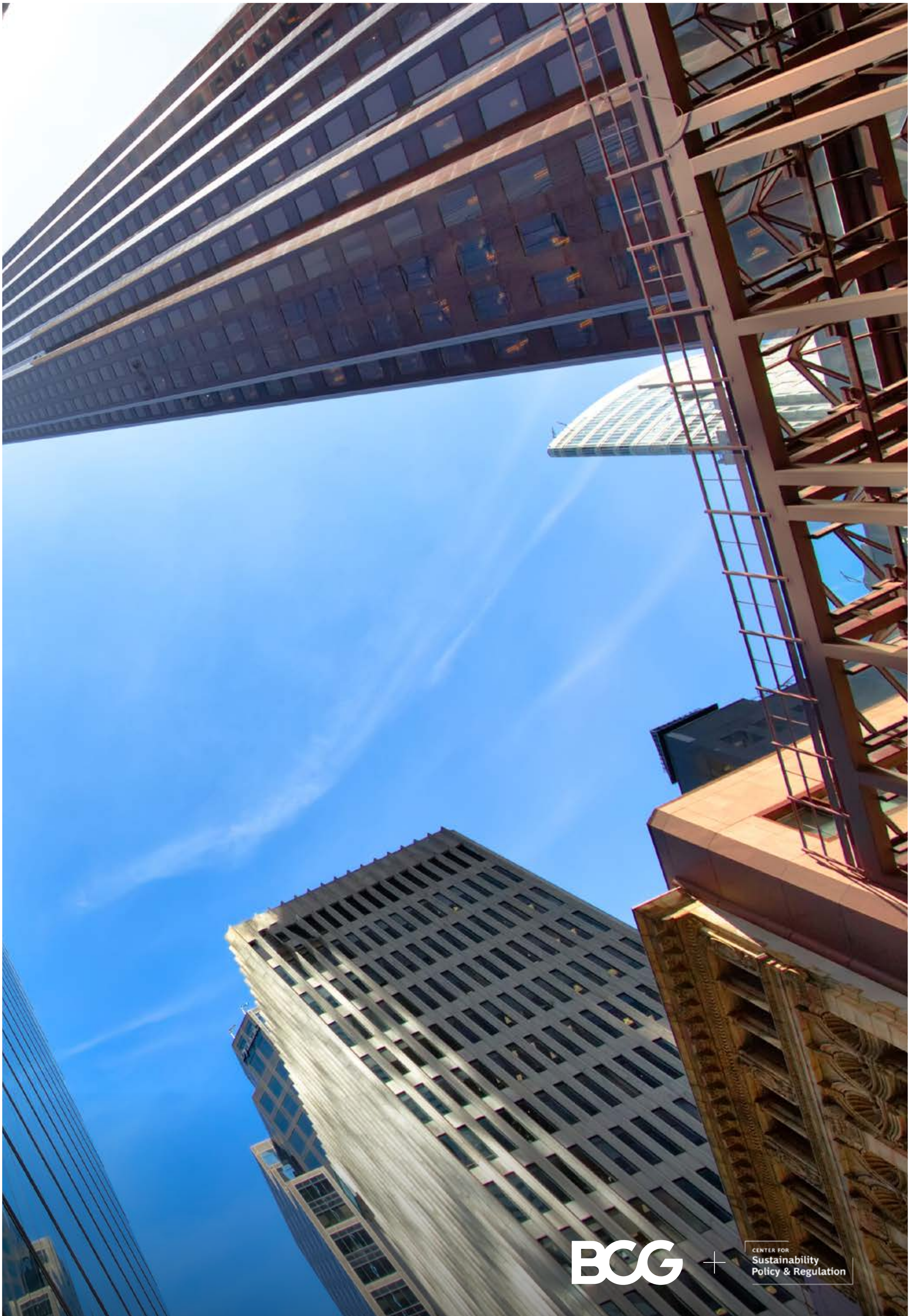
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