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Best Practice for Detecting & Mitigating Greenwashing in EE-ESG financial products for SMEs

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TranspArEEnS

Mainstreaming Transparent Assessment of Energy Efficiency in Environmental Social Governance Ratings

Contents

Executive Summary.......... 4

1. Introduction 5

2. Supporting & substantiating claims: The TranspArEEnS Infrastructure as a robust rating system7

3. Labelling Financial Products & Instruments: Ensuring Quality & Transparency 9

   3.1 Definition & eligibility criteria 9

   3.2 Transparent Disclosure & Communication 9

   3.3 Robust Governance 10

   3.4 Regular Review 10

4. Other considerations 11

5. Conclusion 12

6. Bibliography 12

Executive Summary

The rapid and interconnected development of the Sustainable Finance agenda in recent years and the subsequent proliferation in sustainable finance products and instruments has inevitably led to a heightened risk of greenwashing and subsequent measures from the EU institutions among others to mitigate this risk.

With SME financing in mind, as per the scope of the TranspArEEnS Project, and focusing on the specific example of (EE-ESG) European Secured Notes (ESN), our research, analysis and experience from other domains, indicates that a combination of a robust rating system, namely that designed and delivered under the TranspArEEns Project, together with a labelling initiative, based on an appropriate definition and eligibility criteria, transparent disclosure and communication, robust governance and regular review, drawing on existing best practice in the covered bond space, is an extremely effective market-led way of supporting the detection and mitigation of greenwashing. As indicated in the introduction to this Report, this approach is also fully aligned with the expectations of the European Supervisory Authorities.

1. Introduction

For the last several years the role of private finance in financing the climate transition has been recognised as paramount in a context where 1.5 trillion euros per year is needed to meet the EU's climate targets for 2050[1]. As pressure has increased on banks to step up and channel finance to sustainable investments, driven in large part by a complex, interconnected and rapidly evolving regulatory and supervisory framework, so has the subsequent supply of sustainable finance products and instruments. With this rapid proliferation of products and instruments comes a risk of greenwashing.

Currently, there is no formal or official definition of greenwashing although, in the area of financial services, the European Supervisory Authorities propose a common high-level understanding as follows: *"a practice whereby sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services. This practice may be misleading to consumers, investors, or other market participants."*[2]

The consequences of greenwashing are multiple: the practice, whether intentional or not, can undermine trust and confidence in an organisation, damaging reputation and potentially giving rise to financial risks (including litigation and sanctions), whilst defeating the overall objective of enhancing the sustainability of an organisation's activities and products, and subsequently also undermining sustainable finance policies and therefore the climate transition. It furthermore represents a risk to individual and systemic financial stability. For example, greenwashing prevents a proper assessment of EE and ESG risk linked to banks' and insurance companies' exposures, potentially resulting in an underestimation of capital requirements under CRR III and Solvency II respectively, thereby undermining sound risk management linked to EE and ESG products and jeopardising the individual and systemic stability mentioned above. Moreover, the practice could prevent the proper disclosure of their degree of alignment with the EU Taxonomy, negatively affecting asset prices and financial stability, and potentially necessitating intervention by central banks and financial regulators. Overall uncertainty can erode investor confidence, hampering the flow of EE investment.

Since 2018 in particular, the European Commission has developed and published a comprehensive, interconnected set of measures and initiatives designed to both integrate sustainability considerations into the EU's financial policy framework and channel investment in support of the EU Green Deal, whilst mitigating the risks of greenwashing. The result is a set of tools and standards, namely the EU Taxonomy, the EU Green Bond Standard and a Regulation on ESG ratings, alongside a suite of disclosure requirements based on the EU Taxonomy, including the Corporate Sustainability Reporting Directive (CSRD), the Sustainable Finance Disclosures Regulation (SFDR) and binding pillar 3 ESG disclosures, complemented by specific legislation focused on combatting 'greenwashing', including the Green Claims Directive. These regulatory requirements are coupled with increasingly detailed supervisory expectations around the management of climate-related and environmental risks.

[1] EU needs trillions of investment for 2050 climate target - research | Reuters
[2] EBA progress report on greewnwashing.pdf (europa.eu)

These legislative requirements and supervisory expectations are requiring financial institutions to embed sustainability into their business models and strategies, necessitating far-reaching measures from these institutions to understand the implications of the regulatory and supervisory landscape related to sustainable finance and the EU Green Deal for their business activities, identify the steps needed to secure compliance and alignment and accelerate implementation and operationalisation.

It is perhaps worth highlighting at this point that the urgency of the climate transition and the subsequent push from the regulatory and supervisory agenda are also necessitating a careful balance between the ambition that is expected and required in order to meet the climate targets and the challenges financial institutions face of practical implementation and transformation. Indeed, against a background of imperfect information, data gaps and shortages, a rapidly evolving regulatory and supervisory framework and lack of clarity or guidance around interpretation and implementation of the requirements, the risk of 'getting it wrong', by making premature claims or over-promising, no matter how well-intentioned the actions might be, or by interpreting regulatory requirements, such as the EU Taxonomy's Technical Screening Criteria, too broadly, is a real one, and could give rise to the reputational and financial damages highlighted above. At the same time, however, reluctance or hesitation in committing to making progress in relation to ESG objectives or an excessively strict interpretation of regulatory requirements, as a result of concerns about greenwashing, could result in paralysis and subsequent reputational damage. These are themes which are explored by Deloitte in an interesting article entitled *"Greenwashing in Financial Services: Tip for Avoiding Common Pitfalls"*.[3]

At the heart of the TranspArEEnS Project are efforts to improve access to long-term finance for energy efficiency projects, with a focus on the EU's SMEs as the engine of the real economy and therefore as fundamental to achieving the climate transition. In the specific case of SME financing and EE-ESG ESN and based on the analysis, tools and experience gained through the TranspArEEnS Project and other closely associated initiatives, most notably the Covered Bond Label, we have been able to identify certain fundamental ingredients, with a focus on robust rating methodologies and clear and transparent disclosure and communication, which can guide not only financial institutions in avoiding the risk of greenwashing but also other market participants, including investors, rating agencies and supervisory authorities, in detecting potentially dubious claims. The result is consistency and comparability through transparency, enhanced market confidence and genuine transformational progress.

Significantly, the European Supervisory Authorities put forward a series of recommendations which are entirely aligned with the fundamental ingredients we have identified and which have been in place in the covered bond space for several years:

[3] https://www2.deloitte.com/nl/nl/pages/financial-services/articles/greenwashing-in-financial-services.html

"To mitigate greenwashing risks, market participants across the SIVC have to live up to their responsibility to make substantiated claims and communicate on sustainability in a balanced manner. Comprehensibility of sustainability disclosures to retail investors needs to be improved, including by establishing a reliable and well-designed labelling scheme for financial products. Finally, the regulatory framework needs to gain in maturity, key concepts need to be clarified and sustainability impact or engagement better integrated."[4]

What follows therefore is a description of these ingredients, starting with the TranspArEEnS infrastructure as an integral part of the EE-ESN instrument and drawing on best practice examples from the EEM and covered bond space to guide future developments:

2. Supporting & substantiating claims: The TranspArEEnS Infrastructure as a robust rating system

Some of the key obstacles identified by the TranspArEEnS Project to the smooth development of the sustainable finance market are the lack of standardised disclosure on EE investments and poor understanding of EE risk in ESG ratings, which could give rise to greenwashing. Indeed, a lack of target variables for assigning ESG ratings (in particular with regard to the E dimension), poor and non-standardised information about the use of proceeds of the projects that compose investor portfolios (e.g. bank loans) does not allow for the assessment of the alignment of Projects with the EU Taxonomy and other benchmarks.

With these concerns in mind, the TranspArEEns infrastructure provides for a standardised framework for the gathering of quantitative and qualitative information on the EE and ESG dimensions, risk and performance of firms, including SMEs[5], in different sectors (buildings, industry, transport, for example). This information will be sourced by way of a standardised survey which consists of 60+ general questions on EE and ESG addressed to all SMEs comprised in the definition of the EU recommendation 2003/361[6] (Turnover lower than €50 million), individual companies and partnerships excluded, while a set of more specific questions is addressed to SMEs operating in the Construction and Manufacturing sectors. Finally, the questionnaire as a whole is standardised in line with EU Guidelines, International Standards and Certifications. This data is subsequently be stored in a large-scale firm-level database, alongside other relevant information, including EE performance for SMEs and listed firms in the energy and utility sector, building data, EE scores based on the energy labels of the products they produce and SME' financial performance. The levers used to assess SMEs' EE credentials as part of the 'E' in ESG include renewables (use of renewable energy), green buildings (green certification and EE), policy & innovation (presence of policies & IPR), consumption (energy intensity of the activity).

By way of Artificial intelligence and Big Data techniques, the data collected via the standardised survey and stored in the firm-level database is subsequently be used to generate EE-ESG ratings. These deliver

[4] EBA progress report on greewnwashing.pdf (europa.eu)
[5] Considered to be those with a turnover of <50m EUR.
[6] eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32003H0361

a robust understanding of SMEs' EE and ESG credentials and therefore enhance banks' understanding of the extent to which these ESG credentials influence SMEs creditworthiness and the subsequent performance of exposures to these firms over time. The TranspArEEns EE-ESG rating model is based on the philosophy of the MORE (Multi Objective Rating Evaluation) model, a creditworthiness model developed by Modefinance[7] to assess the level of distress of industrial companies using data included in their financial statements by means of a risk class. What drives the model is the assessment of the creditworthiness of a company based on an evaluation of its overall equilibrium in terms of financial stability. The result is an evaluation of the balance sheet and income statement of the company, from which the model calculates the probability of default and the creditworthiness of the company. The MORE model is already widely used in rating of investments (including EE ones) for financing to SMEs, with the addition of a qualitative score component, taking account of a firm's size, industry, location, creditworthiness and economic and financial history.

By way of its quali-quantitative framework intended to improve the standardised collection and analysis of firms' EE and ESG information aligned with the EU Taxonomy and other relevant benchmarks and its standardised EE-ESG rating, the TranspArEEnS Infrastructure offers a valuable tool for banks and investors when integrated into financial products and instruments linked to SME financing. Indeed, the infrastructure supports banks and investors in understanding the EE-ESG credentials of SMEs, either in the context of loan origination or in respect of existing SME loan portfolios, and therefore assessing and analysing alignment with sustainability criteria and incorporating these considerations in lending and investment decisions with confidence.

During the course of the TranspArEEnS Project, particular focus has been placed on the development of a long-term capital markets based funding instrument, European Secured Notes (ESN), as a way of supporting SME lending and enhancing the flow of (EE) financing to SMEs, mindful of the critical role they will play in the Renovation Wave and therefore the climate transition. This focus coincides with ongoing work by the EMF-ECBC[8] to design and develop a conventional ESN product and a recent call for advice to the EBA from the European Commission on the possibility of ESN legislation, in the context of the Review of the Covered Bond Directive.[9]

Against this background, the TranspArEEnS infrastructure, when integrated into the ESN instrument and combined with efforts to maximise transparency and robustness in disclosure and communication, providing for a quality benchmark, delivers a robust mechanism to detect and prevent greenwashing, as will be explored further in the next section.

[7] https://www.modefinance.com/en

[8] European Secured Note (ESN) - ECBC (hypo.org)

[9] https://eba.europa.eu/sites/default/files/document_library/About%20Us/Missions%20and%20tasks/Call%20for%20Advice/2023/Performance%20and%20review%20of%20the%20EU%20covered%20bond%20framework/1061369/CfA%20to%20the%20EBA%20on%20the%20performance%20and%20review%20of%20the%20EU%20covered%20bond%20framework.pdf

3. Labelling Financial Products & Instruments: Ensuring Quality & Transparency

Best practice in the covered space and specifically the Covered Bond Label[10], provides important evidence of the value of a market led initiative focused on quality and transparency, which delivers trust and confidence in the asset class on the part of investors and regulatory and supervisory authorities. This best practice has since inspired the Energy Efficient Mortgage Label as a quality and transparency benchmark in relation to energy efficient mortgages and unsecured consumer loans. At the heart of the Covered Bond Label initiative are certain key features which can be applied in the EE-ESG ESN space: an appropriate definition and clear eligibility criteria, transparent data disclosure, robust governance and regular and structural review:

3.1 Definition & eligibility criteria

In a TranspArEEnS Report describing the business case for and specific characteristics of an EE-ESG ESN[11], we put forward a **working definition** for the instrument and explore specific **eligibility criteria**, drawing on best practice in the covered bond space:

"A dual recourse instrument issued by a Financial Institution secured on eligible assets, applying proven technology from the covered bond market to create robust, transparent and high credit quality securities with a high degree of pan-Union standardisation. Criteria for asset eligibility to include loans to small and medium sized enterprises with a high minimum TranspArEEnS rating and other credit and economic criteria analogous to those applied in the covered bond market."

While both the definition and the eligibility criteria, which are detailed in the Report mentioned above, would require further discussion to secure operationalisation, the analysis conducted provides valuable guidance and an important basis for elaboration in the coming weeks and months in the context of the EMF-ECBC's ongoing work and the EBA's response to the Call for Advice from the European Commission.

3.2 Transparent Disclosure & Communication

At the heart of the Covered Bond Label is the **Harmonised Transparency Template (HTT)** which, since its debut in 2017, is now used to report the underlying cover pool assets of over 75% of the covered bonds outstanding globally and, since 2020, includes a specific ESG section. Indeed, the strength and success of the Covered Bond Label lies in the HTT which provides for transparent and harmonised data for market participants and is recognised by investors, rating agencies, regulatory and supervisory authorities as a gold standard for data disclosure. It almost goes without saying that the transparency, harmonisation and comparability afforded by the HTT is a very valuable tool for the detection and

[10] https://coveredbondlabel.com/

[11] Technical Report on EE relevant ESN business case

mitigation of greenwashing. The HTT was the inspiration for the EEM Labels Harmonised Disclosure Template (HDT) and Harmonised Reporting Template (HRT).

This best practice from the covered bond space is discussed in more detail in a TranspArEEnS Report focused on the analysis of market needs in relation to EE-ESG covered bonds. Clearly, the HTT provides an important blueprint for (EE-ESG) ESN which is currently being elaborated by the EMF-ECBC in collaboration with the investor community in order to capture the relevant data points necessary to assess the credentials, including the EE-ESG credentials, of SME loans in ESN cover pools.

3.3 Robust Governance

Another core feature of the Covered Bond Label which will be fundamental in underpinning an (EE-ESG) ESN Label and supporting overall efforts to mitigate greenwashing is a **robust governance** structure. The Covered Bond Label Committee is at the heart of the Covered Bond Label governance structure and is essentially charged with the critical functions of guiding and supervising the management of the Label Convention that enshrines the covered bond definition, the labelling process, with a focus on the process of self-certification, the internal processes for the granting and withdrawing of the Label, and the revision process of the Harmonised Disclosure Template (see below for more details).

Importantly, the **Label Committee**, together with an **Advisory Council** made up of other relevant market participants including investors, rating agencies and regulatory and supervisory authorities, also ensures alignment between the Covered Bond Label and the EU's policy objectives and EU Taxonomy in order to ensure that issuers are able to meet the proposed criteria and avoid market confusion, fragmentation and inconsistencies.

The governance structure is underpinned by the **Label Secretariat** which is responsible for: (1) the formal administration of the Label, including compliance with legal requirements and financial administration, and (2) day-to-day management of the Label. This includes responding to application queries and activating applications, providing ongoing support to Labelled Institutions including on the completion of the HDT, organising meetings of the Market Committee and Advisory Council, facilitating exchanges with relevant market stakeholders, and managing marketing and communication activities around the Label.

The Covered Bond Label governance structure inspired the **EEM Label**[12] governance structure and will serve as an important guide for the underlying structure of a future (EE-ESG) ESN Label.

3.4 Regular Review

Central to the quality assurance afforded by the Covered Bond Label are two very important processes which are at the forefront of efforts to ensure accurate and robust disclosure:

[12] https://www.energy-efficient-mortgage-label.org/

- ***Annual review***

The first of these is an annual review exercise linked to the HTT which is managed by the Label Committee in consultation with the Advisory Council and based on market feedback. This review process delivers regular feedback to issuers on market participants' needs from a data perspective, both in general and specifically related to ESG considerations, and experience of the Covered Bond Label and HTT. It also ensures incremental 'raising of the bar' of the Label's eligibility criteria to create a dynamic process that allows the market to continue to align around the common quality benchmark, ensuring constant enhancement of the Label over time.

- ***Peer Review***

The second of these is a kind of 'peer review' according to which market participants using the HTT, whether these be investors, rating agencies or regulatory and supervisory authorities, flag inconsistencies or possible errors in the HTT to the Label Secretariat. These are then escalated to the issuer in question for clarification and/or correction. This is once again a key, inherent process which ensures quality standards, improves disclosure and provides for overall credibility.

As for the other core characteristics of the Covered Bond Label, these processes of regular and ongoing review will be fundamental to protecting against greenwashing in the (EE-ESG) ESN space.

4. Other considerations

It is worth highlighting that beyond concrete mechanisms that can be put in place to support banks in substantiating ESG claims and reducing the risk of accusations of greenwashing in the (EE-ESG) ESN space and beyond, the useful article by Deloitte[13] mentioned above points to some additional, more general tips to support banks in their endeavours in this area:

- Firstly, the importance of 'doing' and 'learning by doing' rather than holding back out of fear of making a mistake. In this context, the importance of involving all departments, from audit to legal, in the activities is highlighted as key.
- Secondly, working with peers across the sector to develop best practice and agree common understanding is seen as vital. As should be clear from the previous section, this second tip is at the very heart and success of the Covered Bond Label which exemplifies the spirit of collaboration and cooperation.
- Finally and linked to the first tip, banks will have to accept that there will always be some risk in making ESG claims and establish what they consider to be acceptable levels of risk. Once again, the involvement of other departments, for example internal audit, is highlighted as invaluable.

[13] Greenwashing in Financial Services | Deloitte Netherlands

5. Conclusion

As indicated in the introduction to this Report, the rapid and interconnected development of the Sustainable Finance agenda in recent years and the subsequent proliferation in sustainable finance products and instruments has inevitably led to a heightened risk of greenwashing, whether intentional or not, and subsequent tools and measures from the EU institutions to mitigate this risk. Indeed, as we have shown here and as is widely recognised, the consequences of greenwashing are multiple and potentially very serious.

What has emerged from our research on the topic of greenwashing is the importance of balancing 'doing' and 'learning by doing' in the Sustainable Finance space with the fear and risk of 'getting it wrong'. Clearly, hesitation in committing to ESG objectives or playing down solid progress, also known as 'green-hushing', will seriously undermine the pursuit of the EU's net zero goals.

Long-standing market experience in the Covered Bond space, as outlined in this Report, points to the value of industry-led initiatives with certain key features which offer a coordinated and integrated approach to benchmarking and disclosure with an emphasis on quality and transparency, which in turn provides financial institutions with the confidence to 'do' and confers trust in the asset class on the part of investors and regulatory and supervisory authorities.

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