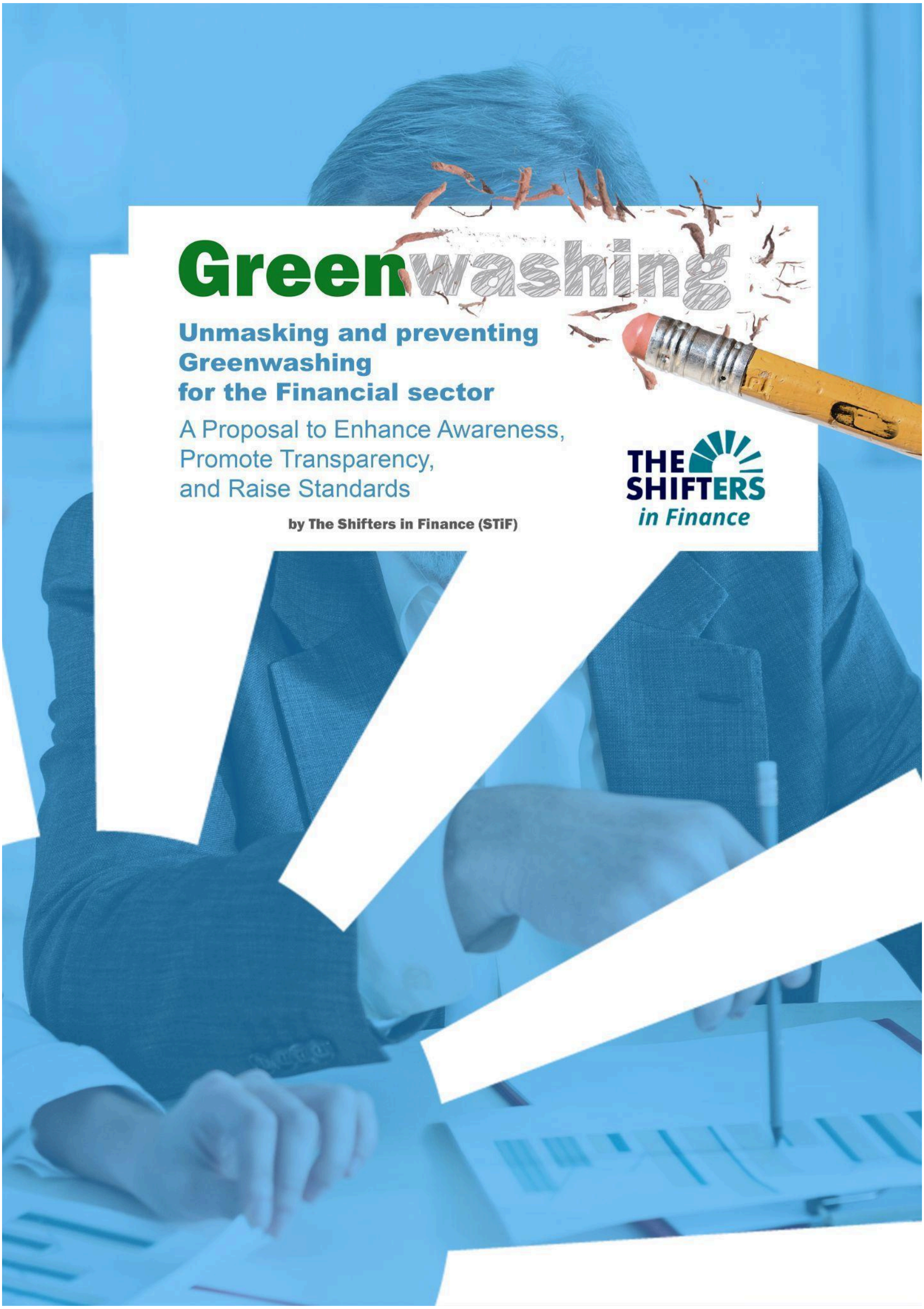

Greenwashing

Unmasking and preventing Greenwashing for the Financial sector

A Proposal to Enhance Awareness, Promote Transparency, and Raise Standards

by The Shifters in Finance (STiF)

THE SHIFTERS in Finance

Introduction

This document was written by "The Shifters in finance", following their response to the "*ESAs Call for evidence on better understanding greenwashing*". "The Shifters in Finance" is a specialist workgroup of the think-tank The Shifters. This document is a self-standing report based on the aforementioned Call for evidence. It deals mainly with "sustainable finance", which can be understood as financial services, products or activities which claim to support environmental, social and governance (ESG) matters in investment decisions to promote more sustainable activities and projects. The purpose of this report is not to provide a comprehensive definition of Sustainability or Greenwashing. Rather, it aims to shed light on questionable practices of greenwashing within the financial sector. Whenever possible, we provide examples to illustrate our findings. Based on our analysis, we offer recommendations, mainly for regulatory frameworks, to help combat greenwashing and promote genuine sustainability in the financial sector.

The Shifters is a group of experts specializing in climate and energy issues. Accordingly, this report primarily focuses on climate change and carbon emissions. It also considers equally important environmental factors (including biodiversity), as well as social and governance issues, when they appear relevant.

This report seeks to recommend improvements but mostly to encourage ongoing developments to be implemented with the highest ambition for an effective fight against greenwashing. Given the evolving European regulatory framework on sustainability issues within the financial sector, as well as on the disclosure of extra-financial performance, the Shifters in Finance seek to share a vision that advocates for a robust regulatory framework while maintaining ambitious sustainability goals. We believe this is particularly relevant in light of recent discussions on regulatory simplifications at the European level, notably through Omnibus.

While this report does not claim to be exhaustive or fully up to date on the current state of the sustainable finance framework in place, we choose to publish it, with the hope that its roots and spirit genuinely serve as a lasting support in the battle against greenwashing.

The following are examples of greenwashing patterns:

- **Green Crowding**: hiding in a group to avoid scrutiny and progress at the pace of the slowest.
- **Green Lighting**: spotlighting a green feature to distract from other environmentally damaging activities.
- **Green Shifting**: blaming consumers for environmental issues instead of taking responsibility.
- **Green Labeling**: misleadingly labeling a product or activity as green or sustainable.
- **Green Rinsing**: regularly changing ESG targets before achieving them to appear proactive.

Some critics have emerged regarding the fight against greenwashing and these definitions are sometimes used to highlight "the extremes" and "unjustified" expectations of the fight against greenwashing. This fight is sometimes perceived as a means to constantly shame companies, preventing them from taking action if they are too ambitious, too cautious, too restrained, or if they attribute responsibility to consumers for their delayed transition. Aggressive fight against greenwashing is then pointed out as the reason leading to a lose-lose narrative where companies are hesitant to admit that the transition is difficult and are reluctant to share what has worked or not for them.

We therefore thought it might be worth highlighting that in our opinion:

Fighting against green lighting doesn't mean preventing companies from promoting their green products, but rather ensuring transparency in their overall sustainability strategy. We need to identify what they are doing beyond their green products and what remains to be done.

Fighting against green shifting doesn't mean companies should not share responsibilities, but rather that they should incentivize consumers and develop solutions to help them shift to more sustainable habits. Changing habits is never easy, but companies have a responsibility to support their customers.

Fighting against green rinsing doesn't mean discouraging companies from setting ambitious targets, but rather promoting transparency in their progress and failures. We need to identify the best transition pathways and tailored solutions to enable companies to meet the 1.5- or 2-degree science-based targets. Sharing feedback and promoting transparency will help rebuild public trust.

Unlike greenwashing, there is also the concept of green hushing, where companies intentionally downplay or withhold information about their sustainability efforts to avoid backlash. Fighting against green hushing doesn't mean forcing companies to boast about every small sustainability action, but rather encouraging them to openly share their full climate strategies, including the gaps and challenges. When companies stay silent about their ambitions or progress, it becomes harder to assess the credibility of their commitments and to build collective momentum towards systemic change. Transparency is not about perfection, but about accountability, and collaboration. By shedding light on both successes and shortcomings, companies can foster more constructive dialogue, accelerate learning across sectors, and contribute to a more honest and effective transition.

Our overall perspective is that the fight against greenwashing is not intended to limit companies in their commitment-making, but rather to ensure that their commitments make sense, to create transparency on the impacts induced by all of their activities and to identify the root causes of their issues, in order to then facilitate consistent and ambitious transition-related commitments. This will create incentives for peers, consumers, and governments to shift towards a more sustainable world. We measure the need to support companies in their transitioning efforts, but we are of the view that we can only do so if we understand their transition risks and challenges.

We believe that fighting greenwashing must not be limited to a debate on terminology and communication. Planetary boundaries are being crossed one after the other. Positive feedback loops[1] leave us no time to stave off global warming, water cycle disturbances, biodiversity's collapse, and their consequences on life and human societies (refer IPBES[2] and IPCC reports[3]). Facing these challenges requires our full concentrated effort. Financial systems must play their part as they have a key structuring role in human societies, whether it be through public or private initiatives.

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[1] A 'positive feedback loop' shall mean the acceleration of climate change and biodiversity loss. In contrast, a 'negative feedback loop' shall mean slowing these processes.
[2] Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services [IPBES global assessment]
[3] Intergovernmental Panel on Climate Change (IPCC) [AR6 Synthesis Report: Climate Change 2023]

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I - Mapping of the Sustainable Financial sector

“Sustainable” finance is not clearly defined but might refer to a range of financial actors declaring to take into account environmental, social and governance (ESG) matters in their decision-making process, as well as the goods and services they use or provide. The main players in the finance field considered in this report and their involvement are detailed below.

- **Institutional actors (sovereign, supranationals, public sector and authorities)**

Institutional actors include all legal entities under public law with executive or administrative capacity (i.e., governments, national and supranational administrations - including regulatory and supervisory authorities), legislative capacity (i.e., parliaments), and judicial capacity (i.e., courts). Their main activities are to design and adopt standards, support private actors in their implementation, monitor their application, and punish their violation. This may involve the creation of labeling frameworks for investment products.

- **Investors**

Investors include all shareholders and stockholders, bond holders and creditors. They are able to sway the markets by channeling capital and providing feedback on sustainability-related financial products. Furthermore, stock market investors are able to influence the strategic decisions of entities through shareholder commitment campaigns and voting rights. Therefore, the strengthening of investors’ demand for sustainable products and investors’ engagement have the power to foster sustainable practices.

- **Banking and Financial institutions**

Financial institutions are all legal entities that are licensed and/or regulated, including credit institutions, payment institutions, and investment firms, as well as insurance companies and providers. This encompasses investment service providers, collective investment management companies, and other financial services providers such as custodians, depositaries, clearing houses, financial investment advisors, participatory investment advisors, direct marketers, financial analysts not affiliated with investment service providers, data communication service providers, token issuers, and digital asset service providers. Their main sustainability-related activities involve the production and distribution of financial products (including loans, equity, and debt products), investments in assets, the operational application of standards, and market initiatives that lead to the implementation of new standards.

- **Civil society organizations**

Civil society organizations, NGOs, think tanks, universities, associations, circles, institutes and professional networks and their involvement in raising awareness, defending sustainable practices among private and public players as well as investors, and advocating for standards.

- **Companies**

Companies include all economic actors, issuers (listed or unlisted) or non-issuers, created for profit or non-profit, either commercial companies and entities they control de jure or de facto (i.e., holdings, subsidiaries, branches, representative offices), civil companies, foundations, endowment funds or even associations. Their involvement includes, among others: their decarbonization trajectory planning and implementation, the interim targets they set on the way to decarbonization, the disclosure of information on their sustainability efforts, etc.

- **Data providers and rating agencies**

Rating agencies, index providers, proxy voting advisory businesses, and financial and/or extra-financial data providers supplying non-financial information disclosed by companies or financial institutions.

- **Other actors**

This mapping would not be complete without mentioning other actors who also have a key role in the banking and financial sector:

- Auditors and statutory auditors, particularly in terms of monitoring and approving extra-financial information disclosures;

- Consulting and law firms, professional associations and federations to which financial institutions belong and which represent them, in particular in terms of assisting financial institutions in applying the standards and raising awareness of sustainable practices;

- Wealth managers, multi and single family offices which counsel UHNWI, particularly in terms of asset owning and investing with a structurally long-term investment horizon;

- Theorists and practitioners contributing to legal doctrine: scholars, researchers, lawyers, judges, public officials, etc., particularly in terms of clarifying, interpreting, and promoting the standards;

- Higher education institutions and training firms teaching finance, engineering, economics, law and other subjects. The objectives being to train them become safeguards over practices that could lead to greenwashing.

II - Regulation and Greenwashing

A. Regulation on reporting

This chapter examines grey areas in EU regulations that may enable greenwashing, even as they aim to support a green and fair transition. It is not intended to be exhaustive; rather, its main objective is to highlight what could be strengthened.

1. Disclosure and Reporting related EU regulations

With the ambition to reach the objectives convened at the 21st IPCC Conference of the Parties (COP 21, also known as *The Paris Agreement*[4]), the European Commission has changed its vision of finance and set itself three ambitions: "*To redirect capital flows towards sustainable investments, [...] to integrate sustainability into risk management, and [...] to promote transparency and a long-term vision*"[5]. To achieve these ambitions, the Commission, the European Parliament and the Council have developed, since 2018, various regulations[6,7]. First, the Ecolabel aims at enabling consumers to identify environmentally friendly products. "*The Ecolabel will address individuals [...] and will be based on the taxonomy that encompasses more activities than the Greenfin reference framework*"[8]. The second regulation is called the "Disclosure" regulation or regulation 2019/2088 (i.e., SFDR). This regulation requires financial market participants and financial

[4] https://unfccc.int/process-and-meetings/the-paris-agreement

[5] Deloitte & AFG. (2020). *Finance durable. Réglementations applicables aux sociétés de gestion*.https://www.afg.asso.fr/wp-content/uploads/2020/12/guidepro-finance-durable-201215web.pdf

[6] European Commission's Management plan 2024 – Financial stability, financial services and capital markets union

[7] NB. While regulations are directly applicable in all EU member states, directives are more complex to implement as they must be transposed into the national laws of each country.

[8] Comité du label GreenFin. (2021). *Compte rendu du 5ème comité.*

advisers to disclose information about the sustainability of their investment products. The third is the Climate transition benchmark regulation or regulation 2019/2089, aimed at offering a reference framework of "climate transition" and "Paris Agreement" indices. The fourth is the European Taxonomy, or regulation 2020/852. Through its regulations, the European institutions require financial actors and thereby firms, on a larger scale, to declare their exposures, work on appropriate sustainable metrics, and develop products in line with the transition.

Since 2020, the regulatory framework on sustainable disclosure has evolved to improve transparency. Two key European regulations are phased-in gradually, to shed light on the impact of “materiality” on financial and non-financial businesses:

- The SFDR (Sustainable Financial Disclosure Regulation), which defines sustainability disclosure obligations for manufacturers of sustainable financial products, and
- The CSRD (Corporate Sustainability Reporting Directive), which imposes a framework on certain companies[9] for them to disclose information within their Sustainability Reporting. The CSRD has since been reinforced by another directive the Corporate Sustainability Due Diligence Directive (CSDDD, [Directive 2024/1760]() entered into force in July 2024). A reporting directive that goes beyond EU-based Companies and incorporates UNGPs and OECD Guidelines, focusing on Environmental and Human rights impacts across supply chains for product and services sold on the EU Common Market.

These regulations aim at strengthening the transparency of sustainability information. They require companies to report upon their socio-environmental impacts, and therefore make visible the materiality of impact, until now invisible. In order to mitigate greenwashing, it is crucial to uphold and reinforce the transparency objectives of CSRD and SFDR, as they represent the primary step in combating greenwashing effectively. It is worth noting that these regulations could be reinforced, particularly addressing existing issues within the auditing sector, such as inadequate standards and minimal requirements for sustainability reporting. Regulatory bodies have taken steps to enhance the SFDR directive by soliciting feedback in 2023 and are poised to introduce a more widely accepted version[10]. The CSRD is under scrutiny and must be maintained in its original ambitious form if we aspire to genuinely address the challenge of greenwashing.

As the CSRD is an EU directive, its implementation will occur at the national level, and the magnitude of fines is not specified in the legislation. This means that the level and frequency of penalties will vary depending on each member state's regulatory authority responsible for ensuring compliance and administering penalties.

The expected publication of sector-specific standards in addition to the existing CSRD standards, dedicated to the 12 most carbon-intensive sectors, will be a further step in limiting the opportunities for greenwashing. It shall ensure that players within these sectors can be compared on the issues most relevant to the industry they operate in.

Other regulations are being debated that also aim at preventing companies from making misleading environmental claims about their products. The Green Claims Directive sets criteria for claims, requires transparency, and encourages the use of recognized labels. Violations can result in penalties as well as reputational risk. We highly

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[9] The CSRD will apply to a greater number of companies, (50,000 companies, up from 11,700), including all listed EU and non-EU companies, and EU firms meeting at least two of these criteria: 250+ employees, €40M+ revenue, or €20M+ balance sheet.

[10] For more details on the Shifters’ response to the SFDR consultation, please refer to: Response 1/3; Response 2/3; response 3/3. [Articles in French published between March and May 2024]

support this type of regulation that can encourage companies to engage in a more sincere and concrete path to sustainability.

Our recommendations

→ We recommend that regulators and Members of the European Parliament maintain a high level of ambition in sustainable finance to preserve the initial momentum and avoid a period of uncertainty or regulatory backsliding. In particular, we support the retention of sector-specific standards under the CSRD, which are essential for ensuring relevance and comparability across industries. We also call for the timely implementation of the Taxonomy, the CSRD, and the CSDDD, with an ambitious scope of application to address the long-standing challenges of data accessibility and comparability. We also strongly support robust disclosure requirements, credible due diligence obligations, and the adoption of a reasonable level of assurance to enhance the reliability of sustainability data.

→ We recommend that the regulator ensures that penalties reflect the stakes involved, providing a strong deterrent from both a financial and reputational perspective in case of misapplication of the regulation (e.g., CSRD, SFDR, etc.). We believe that minimum penalties should be clearly defined in the legislation, transparent and understandable.

→ We recommend CSRD regulation to increase transparency:

a) on the regulatory definition of performance by clearly stipulating its limitations,

b) and on indicators that go beyond ESG performance by including wider sustainability-risk metrics, beyond the CSRD Impact Risk Opportunities (IRO).

In this regard, clearly laying out the statement's limitations and the scope of definition will prevent green lighting, and risk indicators will help better support the unrolling of entities' sustainability, decarbonization and adaptability strategies.

→ We recommend regulations to ease the applicability of its directives through the publication of methodologies, data requirements, including a clear and engaging timeframe that encourages first movers.

→ We encourage regulations to ensure that the level of assurance moves from limited to reasonable to reduce the risk of greenwashing to the minimum. Reasonable assurance counts as the proof that sufficient appropriate evidence is gathered as a part of a systematic review that includes reviewing risks, responding to said risks, gathering more evidence, and evaluating obtained evidence.

2. EU Taxonomy Regulation

The European Taxonomy - Regulation 2020/852 of the European Parliament and Council - is a classification system for economic activities declared "sustainable" based on specific criteria, intended for market players and issuers. This system aims to support the "transition" to a low-carbon and resilient economy by 2050. The Taxonomy is also a science-based reporting tool, anchored in European law through level 2 acts (delegated acts). The Taxonomy has been adopted by the European Commission, but has been and remains subject to political stakes that may oppose the intention of the regulation. The debates around the inclusion of gas and nuclear power are good examples.

This regulation has been designed to evolve to incorporate new challenges and adapt to scientific and economic developments.

The European taxonomy is based on 6 environmental objectives:

- Climate change mitigation;
- Climate change adaptation;
- Sustainable management of marine and fisheries resources;
- Development of a circular economy and risk prevention;
- Reduction of pollution (air, water, soil);
- Biodiversity and land use protection.

The regulation identifies 'eligible' activities considered potentially 'sustainable.' However, some activities labeled as 'sustainable' may be ineligible because they are not yet covered by the regulations. Conversely, many eligible activities contribute significantly to GHG emissions, although they possess substantial potential to become more 'sustainable.' Thus, the 'sustainability' of an eligible activity can only be confirmed if it aligns with the following criteria, deeming it 'aligned' with the EU Taxonomy:

- Contribute to one of the six "Substantial Contributions" (SC) objectives to the transition;
- Do No Significant Harm (DNSH) to other environmental objectives;
- Finally, be in line with certain Social Minimum Safeguards (MS).

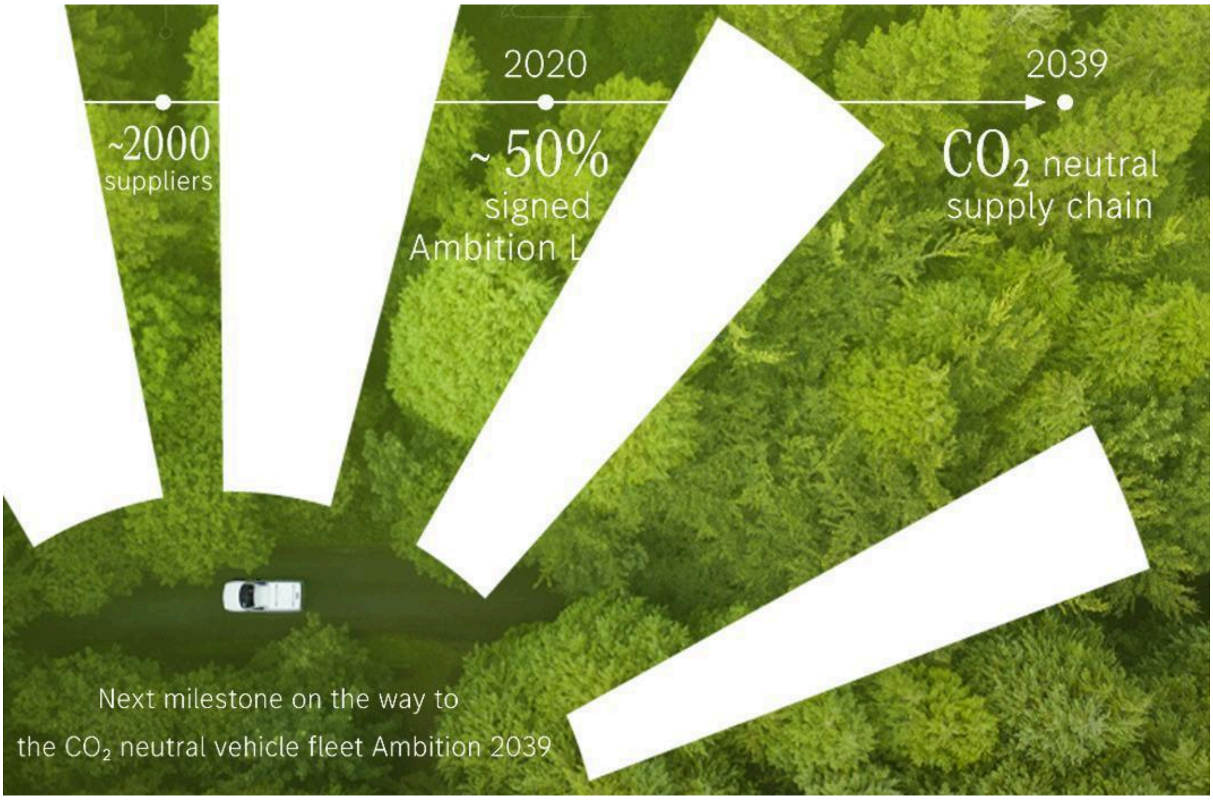
This regulation, closely intertwined with the SFDR and CSRD regulations, serves as a reference for compliance of so-called sustainable financial products, as it establishes a framework and defines criteria to their sustainability. In this sense, the taxonomy is also used within the Green Bond Principles and the EU Ecolabel, as the reference tool to evaluate the sustainability of the considered activity or product.

Our recommendations

→ *We recommend accelerating the development of "brown" and transition taxonomies initiated by the European Commission with support from the Platform on Sustainable Finance. These complementary taxonomies will encompass all* *sectoral activities and outline transition pathways that align with a carbon-neutral economy by 2050. By aligning with these taxonomies, companies engaged in non-green activities will be better equipped to identify potential transition pathways toward sustainability.*

→ We recommend that regulators promote the EU Taxonomy —starting with the green taxonomy and later including transition and "brown" taxonomies— by providing guidelines for financial market participants. This should involve mapping existing activities and future additions, along with case studies showcasing new technologies or activities expected to be classified as "green" or "transitioning".

→ We recommend ensuring the development of transition metrics, technical criteria, and targets aligned with or drawn from the IPCC, IEA, or other science-based scenarios. These should facilitate the monitoring of alignment with the Paris Agreement objectives and enable benchmarking across all activities.



III - Communication and Commitment

A. Carbon Neutrality related commitments

1. Definition

The concept of carbon neutrality first appeared in 2018, in the IPCC "1.5 degree report"[11]. It is defined as follow:

> *"Net zero carbon dioxide (CO_2) emissions are achieved when anthropogenic CO_2 emissions are balanced globally by anthropogenic CO_2 removals over a specified period."*

In our report, when we state "carbon neutrality", we mean "the contribution to global carbon neutrality".

As a consequence of the Paris Agreement, which was adopted in 2015, 196 countries (the Parties) committed to reduce global warming to 1.5 degrees without exceeding 2 degrees (Art. 2 and Art. 3), within the end of the century. Since global warming is a consequence of greenhouse gas emissions, each signatory has committed to reduce its emissions (Art.4) and to define emissions goals.

In conclusion, while the Paris Agreement established frameworks for emissions reductions, it did not specify exact limits. These limits were subsequently defined at COP 24, held in Katowice in 2018.

[11] IPCC, 2018: *Global Warming of 1.5°C. An IPCC Special Report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways, in the context of strengthening the global response to the threat of climate change, sustainable development, and efforts to eradicate poverty* [Masson-Delmotte, V., P. Zhai, H.-O. Pörtner, D. Roberts, J. Skea, P.R. Shukla, A. Pirani, W. Moufouma-Okia, C. Péan, R. Pidcock, S. Connors, J.B.R. Matthews, Y. Chen, X. Zhou, M.I. Gomis, E. Lonnoy, T. Maycock, M. Tignor, and T. Waterfield (eds.)].

The "1.5 degree" IPCC report was issued to provide tangible data for the COP 24 and therefore proposed a definition for carbon neutrality. It is also important to note that the "1.5 degree" report also described scenarios that led to carbon neutrality and, hence, global warming limitation.

The Paris Agreement and the following agreements reached during the COP contain key concepts:

- Global warming is a global issue, which cannot be contained without a global response, undertaken by all the Parties. As a consequence, the concept of carbon neutrality which should be applicable to the planet as a whole, is currently implemented through Nationally Determined Contributions (NDC) by the majority of signatory countries[12].
- Global warming containment and global temperature stabilization must be achieved by strictly abiding by trajectories and scenarios in order to reach carbon neutrality by 2050, as stressed and identified in the IPCC documentation via Shared Socio-economic Pathways (SSP1-1.9 of the Paris Agreement 1.5°C scenario[13]) referred in Special Reports and Assessment Reports;
- Carbon neutrality will be achieved by the reduction of greenhouse gas emissions and the increase of carbon sinks. Yet, it cannot be achieved unless there is a significant reduction in emissions, since carbon sinks are limited in space, number but also in time.

IPCC reports issued in 2022 note that the trajectories necessary to reach the 1.5°C objective have not yet been followed, and temperature rises above 2°C are expected before year 2100, with different climate consequences and extreme weather events impacting all the regions with varying magnitudes.

Carbon dioxide (CO_2) is the primary anthropogenic greenhouse gas (GHG) directly linked to climate change, but it is not the only one. Other gases, such as methane (CH_4) and nitrous oxide (N_2O), are also significant anthropogenic GHGs contributing to global warming. These gases are considered in IPCC reports and scenarios, with their impacts on climate assessed based on CO_2 equivalent calculations. Carbon neutrality should account for all GHGs in the carbon footprint assessment of a product, service, corporation, country, etc.

2. Carbon Neutrality and Corporations

As previously stated, *"Net zero carbon dioxide (CO_2) emissions are achieved when anthropogenic CO_2 emissions are balanced globally by anthropogenic CO_2 removals over a specified period."* Therefore, carbon neutrality cannot be claimed by individual actors alone. We argue[14] that the concept of carbon neutrality should not apply to corporations, products, or industrial assets for the following reasons:

1. The objective of IPCC Conference of the Parties is to reduce global emissions. If corporations are allowed to claim carbon neutrality without first reducing their emissions, those that merely offset their emissions will not be differentiated from those actively working to reduce them. This creates a scenario where offset

[12] Since the countries that are signatories have agreed and committed to their own trajectories of carbon neutrality, these NDCs are legally binding. [Nationally Determined Contributions (NDCs) | UNFCCC]

[13] [CMIP6: the next generation of climate models explained]

[14] Our position is consistent with the [ADEME Neutrality carbon report]

resources may be monopolized by companies that prioritize offsets over real emissions reductions.
2. Achieving global carbon neutrality requires a substantial reduction in emissions. Corporations must play a critical role in this effort by prioritizing emission reductions alongside any offset strategies they may employ.

Therefore, corporations should claim to ***'contribute to global carbon neutrality'*** instead of claiming to **'be carbon neutral'**.

Preliminary considerations and recommendations on Carbon Neutrality:

As far as corporations' claims on carbon neutrality are concerned, we would like to stress the following points:

1. It is crucial to clearly define what emissions are generated by corporations' activities and disclose the scope's shortcomings as all types of emissions might not be included (scopes 1, 2 and 3), and even when they are, they might not be comprehensive enough. This is especially true for financial institutions, which are currently quite reluctant to publish their financed carbon emissions (scope 3, category 15 of the GHG Protocol) ; refusing to do so is another form of greenwashing.
2. We believe that carbon footprint measurement is a strategic tool supporting emissions' reduction efforts. However, as of today, carbon counting methodologies are sometimes not transparent and comprehensive and may be restricted to some limited areas of scopes 1, 2 or 3 emissions. As a consequence, their conclusions may differ across different corporations belonging to the same sector and may vary in time if and when these methodologies are updated and better supported by data. Therefore, it is important to continue to improve these methodologies, and the data quality and transparency.
3. As reminded above, carbon neutrality can only be achieved through significant reductions in emissions. We believe that corporations' emissions should be compatible with IPCC scenarios limiting global temperature increase. We consider that corporations that are not aligned with these trajectories cannot claim to be contributing to the carbon neutrality objective. Certifying carbon trajectories with organizations such as SBTi may be a barrier to greenwashing since it guarantees the use of IPCC-compatible scenarios as long as the companies do not backtrack their commitments.
4. As far as offsets (i.e., negative emissions) are concerned, we would like to stress the following points:
   - The effectiveness and additionality of carbon offsets has yet to be proven.
   - Corporations may invest in carbon offsets outside of their value chain, e.g., reforestation in a country unrelated with the company's real estate footprint, through carbon offset marketplaces. We do not think this constitutes a way of compensating their own emissions, since it does not tackle the emissions that are part of their scope of activities.
   - All in all, we consider that carbon offsets give the false idea that a company could "offset" or "compensate" its own induced emissions through sequestered emissions. We believe companies should work distinctly on the 3 pillars: induced emissions, avoided emissions and sequestered emissions. Companies must have a strategy for all 3 pillars but still treat them as separate accounts.

The ESRS E1-6 and E1-7 disclosure requirements, under the CSRD regulation, support this perspective. And we are of the view that such transparency should be ensured at financial institutions levels.

5. Carbon emissions are difficult to evaluate. Energy consumed by companies is often more easily measured (in J, K/G/TWh or Mtoe) as consumptions are generally

followed in the accounting documents. Carbon emissions data should be systematically supplemented by the information on energy consumption by the companies and organizations, along the whole value chain and the energy mix of each segment.

Should the evolving regulations at the European level align more closely with our positions, we would continue to strengthen our stance and emphasize the importance of transparency. The specific list of sustainable information that companies are required to report is derived from EU-member states' national implementation decrees of the European legislation[15]. For these reasons, we are advocating for a robust and ambitious implementation of European legislation.

In the previous paragraphs we describe how the lack of accuracy in information disclosures can be misleading and it should therefore be considered as greenwashing if the disclosed information is not based on recognized methodologies supplemented by more easily measurable metrics.

***Our recommendations*:**

→ *We recommend corporations to clearly state how their business model contributes to global carbon neutrality from now on and in line with Paris-aligned long term trajectories;*

→ *We recommend that corporations claim to* contribute *to global carbon neutrality instead of claiming to* be *carbon neutral;*

→ *We recommend corporations to be transparent in disclosing their emissions, in quality (i.e., methodologies used) and quantity (i.e., results). They should not only include their direct emissions (Scope 1 and 2) but also the whole value chain - upstream and downstream - emissions (Scope 3), when assessing their carbon footprint*

→ *We recommend quantitative claims made by corporations to be supported by data related to global emissions and energy consumptions, and compared with historical data;*

→ *We recommend claims about GHG emissions to support and be compared to global transition trajectories;*

→ *We recommend that carbon offsets be subject to a much stricter use:*

- *Companies should not be able to use sequestered emissions as the main compensation lever for their induced emissions;*
- *Companies should act and communicate distinctly on the three pillars: induced emissions, avoided emissions and sequestered emissions[16];*
- *By providing details regarding the type of offsets they have invested in. In particular, they should highlight if these offsets are made inside or outside of their scope of activities and they should clarify whether their investments involve already existing or non-existing means.*

→ *We strongly support the 'Green Claim' legislative framework, which further expands the current Directive (EU) 2024/1760 of the European Parliament and the Commission. This framework aims to prevent the misuse of the term 'carbon neutrality' by corporations and empowers the general public and civil society to take*

[15] It is important to note that this applies to Directives, but not to Regulations, as Regulations do not require transposition into the national laws of each country.
[16] Refer to the NZI framework: https://www.net-zero-initiative.com/fr

civil or legal action if such misuse occurs. It is essential that corporations be held accountable. This legislative framework should include two key pieces of legislation:

- *Allowing the terms « carbon neutrality » in corporate advertisement only when the latter meets specific disclosure conditions. Failing corporations would be required to delete such claims and be subject to penalties. A good illustration is the French decree Nr 2022-539 which came into force in January 2023. This decree, part of the Climate and Resilience Law, is a positive step forward, but we believe it can be further strengthened.*
- *Strengthening the Corporate Sustainability Due Diligence Directive[17] even further, expanding the current Directive (EU) 2024/1760 of the European Parliament and of the Council[18] . We believe that it should include the spirit of the French law n° 2017-399 relating to the duty of care of parent companies and ordering companies[19] and the German Supply Chain Due Diligence Act[20] entered into force on 1 January 2023.*

French law on the path to mitigate greenwashing

Proposed improvements to the French decree Nr 2022-539[21] to further mitigate greenwashing risks

This Decree on neutral carbon claims by corporations in their advertisements, is a step in the right direction to reduce greenwashing risks. We believe that the decree can be further improved and tightened in order to ensure greenwashing risks are kept at the lowest level.

Our recommendations

→ We recommend that the directive's scope be expanded beyond corporate advertisements to include all forms of communication, such as annual reports, press releases, public statements, and conferences.

→ We recommend that all reduction targets align with a defined governance goal, considering the overall carbon emissions reduction targets and trajectories of the industry and individual corporations.

→ We recommend that corporations using the term "carbon neutral" in advertisements (including at the product or service level) disclose their emissions reduction plans, including quantified annual reduction targets at the company level.

→ We recommend that "carbon neutral" claims be retracted from advertisements, reports, and communications as soon as a company's carbon emissions significantly

[17] European Commission: Corporate sustainability due diligence

[18] Directive (EU) 2024/1760 of the European Parliament and of the Council of 13 June 2024 on corporate sustainability due diligence and amending Directive (EU) 2019/1937 and Regulation (EU) 2023/2859 (Text with EEA relevance) https://eur-lex.europa.eu/eli/dir/2024/1760/oj

[19] LégiFrance: LOI n° 2017-399 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre

[20] Bundesministerium für Arbeit und Soziales: Gesetz über die unternehmerischen Sorgfaltspflichten in Lieferketten

[21] Décret n° 2022-539 du 13 avril 2022 relatif à la compensation carbone et aux allégations de neutralité carbone dans la publicité https://www.legifrance.gouv.fr/jorf/id/JORFTEXT000045570611

deviate from their announced trajectory. Currently, the decree requires that these claims be removed only if emissions have increased between two consecutive years.

→ We recommend the adoption of science-based communication recognized by the EU, such as that proposed by the SBTi, ADEME in France, or the Net Zero Initiative, to mitigate litigation risks and navigate the complexities of complying with the decree.

→ We recommend that corporations establish a complaints procedure for reporting greenwashing risks and violations, which should also include mechanisms for employees to participate, enabling whistleblowing and addressing grievances effectively.

B. Other Sustainability related Commitments

Since the onset of the Covid-19 crisis, public awareness of climate risks has significantly increased. In response, many companies and financial institutions have made transition commitments aimed at reducing their exposure to these risks and addressing investor scrutiny. However, these commitments can sometimes be misleading and may be used as a form of greenwashing.

Simply combining transition commitments with Key Performance Indicators (KPIs) does not ensure transparency. KPIs can serve multiple purposes: they can assess corporate social responsibility (CSR) performance, define transition targets, track progress over time, and evaluate product sustainability. However, when employed to support a project or a company's transition, it is crucial to remain vigilant against greenwashing. This vigilance ensures that commitments are backed by tangible progress and that appropriate auditing and control measures are allocated and budgeted for throughout the lifecycle of the committed solution.

It is also important to recognize that the scope of these KPIs can be manipulated to obscure activities that significantly impact the environment. For example, companies may emphasize less significant activities to distract from their more harmful greenhouse gas emissions. Choosing specific KPIs can distort the reality of their transition efforts; for instance, an economic intensity KPI (CO_2/€ or $) may decline due to an increase in turnover or market value, even if overall emissions rise. To provide a clearer picture, companies should calculate emissions using relevant physical units, such as CO_2/kWh, CO_2/Tons of products, rather than using an economic carbon intensity.

Another example of mis-used or poorly defined KPI can be the use of absolute (or even intensity) emissions on a scope that is not material to the company's activities. For instance, an Oil and Gas company disclosing its scope 1, 2 and 3, but its scope 3 only include its employee business trips' emissions.

A textbook illustration of this issue involves a Canadian oil operator that secured a $1 billion Sustainability Linked Credit Facility (SLCF) through various Canadian financial institutions. This financing was backed by a loosely defined ESG strategy, highlighting the potential pitfalls of inadequate KPI definitions:

« reducing the intensity of GHG emissions from our operations by 35% by 2030 »
« achieving net zero emissions from our business by 2050 »

Upon closer examination, a troubling reality emerges: the reduction in greenhouse gas (GHG) emissions intensity applies solely to Scope 1 and 2 emissions, which account for only about 2% of the total emissions life cycle of the company's activities. Notably, there has been no commitment to decrease the absolute total emissions. Furthermore, the promise to achieve net-zero emissions for Scope 1 and 2 heavily depends on carbon-offset programs, which involve avoiding emissions elsewhere, rather than focusing on actual reductions from the company's core operations.

Therefore, in order to ensure real progress and prevent greenwashing, companies must adopt a critical approach and aim to shed light on all areas of impact, including those that may be less tangible.

Our recommendations

→ *We recommend adopting a "brown" and/or "transition" taxonomy to help develop guidelines or regulations focused on relevant and tangible indicators and targets. We consider public transition commitments a powerful tool that can either trigger greenwashing if poorly designed or support and incentivize market transitions if properly structured. We see taxonomies as one of the best levers to enhance transparency and guide sectoral transitions by showing the right pathways. Without clear information on viable transition pathways, anything goes. While we do not mean to appear pessimistic, we have noticed that many companies use this opportunity to make commitments that are not ambitious enough, ultimately hindering the transition to a sustainable future and endangering their own business models through suboptimal risk assessments and inefficient mitigation/adaptation strategies. We believe that creating a common commitment framework would enable a comparative approach to asset managers' and banks' portfolios.*

→ *We recommend that commitments focus on absolute emissions and on material scopes.*

→ *We recommend not only the development of a transition taxonomy but also making disclosure on green assets, transition assets, and stranded assets mandatory.*

→ *We recommend using physical intensity metrics instead of economic intensity metrics when using intensity emission KPIs. Some exceptions may apply when relevant and when they don't risk reducing intensity while increasing or maintaining emissions. For instance, portfolio managers who accurately correlate their numerator with their denominator.*

→ *We recommend developing transparency on the numerator in absolute terms and on the denominator when the economic intensity emission metric is used. Transparency will clarify why economic intensity decreases, whether it is due to reduced emissions or an increase in the denominator. We believe that both the numerator and denominator should be transparently developed to fully grasp the underlying issues related to the evolution of economic intensity.*

C. Reporting on Biodiversity

In a context of deep uncertainty, the financial sector needs to take into account the risks and impacts associated with biodiversity loss and how it translates into financial risks.

Identifying on a large scale the key indicators needed to monitor and assess biodiversity and ecosystem loss is a challenge that the financial sector must address.

EU regulators and institutions must help tackle the challenges of translating biodiversity risks into financial risks and incorporating biodiversity loss into economic and financial risk management models. This subject is already on the radar of the EU and has started to make its way into regulation, notably in terms of Deforestation[22] responsibility of importers of any good (especially processed food and other intermediate products like seeds for agriculture or animal breeding).

The topic is multifactorial and highly complex as it includes the limits of translating impacts and dependencies into financial risks while including concepts such as tipping points, feedback loops and the measurement of indirect impacts. The French legislature has started addressing this complex topic through the French Energy-Climate Law (2019-1147 Article 29).

In 2022, following the implementation of the French Energy-Climate Law's Article 29, French financial market players have published their environmental assessment which must be carried out following the double materiality concept. This assessment includes:

- Publication of policies of inclusion of ESG criteria within the investment strategy and statement of affairs;
- Assessment of internal efforts devoted to ESG issues;
- Definition of how corporate governance addresses ESG issues;
- Current situation and sustainability strategy in line with Paris Agreement goals;
- Current situation and biodiversity strategy;
- Assessment of how transition and physical risks are addressed within risk management.

For transparency purposes, financial entities are also required to disclose the rationale underpinning these elements, namely:

- Applied calculation methodologies;
- Data sources and quality assessment;
- Critical assessment of the current situation provided through published improvement plans setting goals and deadlines.

This regulation being quite recent, it includes several shortcomings. For example, we note that entities are free to choose the indicators and methodologies they publish. Therefore, the risk of cherry picking among published data remains and thus favors greenwashing practices.

Also, a variety of methodologies leads to a flawed comparative approach: more honest reporting can be considered more harshly than a similar report having buried negative evidence.

Finally, the scope of what needs to be published is wide in terms of information quantity and quality. Assessing reports is therefore complicated and makes it easier for financial entities to greenwash their findings.

[22] European Commission: Green Deal, EU agrees law to fight global deforestation and forest degradation driven by EU production and consumption

Our recommendations:

→ *We recommend European regulation to tackle more broadly the challenge of assessing biodiversity and nature-related financial risks. Financial market players need the EU regulators to step in to consolidate and standardize methodologies. The French Energy-Climate Law Article 29 can be studied to identify the potential limits, shortcomings and greenwashing risks of a European regulation on biodiversity data disclosure and reporting.*

→ *We recommend the clear establishment of global objectives for the protection and restoration of biodiversity, because it is a prerequisite for the development of regulatory frameworks, regarding reporting on risks and impacts related to biodiversity.*

D. Participation in market initiatives

Participation in market initiatives such as the Glasgow Financial Alliance for Net Zero (GFANZ), the UN-Convened Net-Zero Banking Alliance (NZBA), the Net-Zero Asset Managers Alliance, the Net-Zero Asset Owners Alliance, and the Net-Zero Insurance Alliance aims to address environmental, social, and governance (ESG) issues, support a resilient economy, and align products and portfolios with goals for greenhouse gas reduction, avoidance, capture, and offset. However, these initiatives have demonstrated limitations in effectively facilitating the transition from a "Business-as-Usual" approach to a low-carbon economy by 2050.

A recent[23] Banque de France NetZero conference has highlighted the current roadblocks for setting a pace compatible with the Paris Agreement:

- Lack of reliable open and transparent data,
- No common and resilient metrics and processes,
- Need for a firm drive to tackle greenwashing trends in order to instill confidence and reliability at all levels of the financial system, from Central Banks and Authorities through intermediaries and operators all the way to the portfolio holders and individual decision makers, all to be coordinated to avoid loopholes and false starts.

It was also made clear that waiting for a perfect one-size-fits-all solution enables greenwashing, as it provides excuses for non-compliance and frustrates innovative trailblazers who could offer startup solutions, particularly in the areas of data aggregation and valuation.

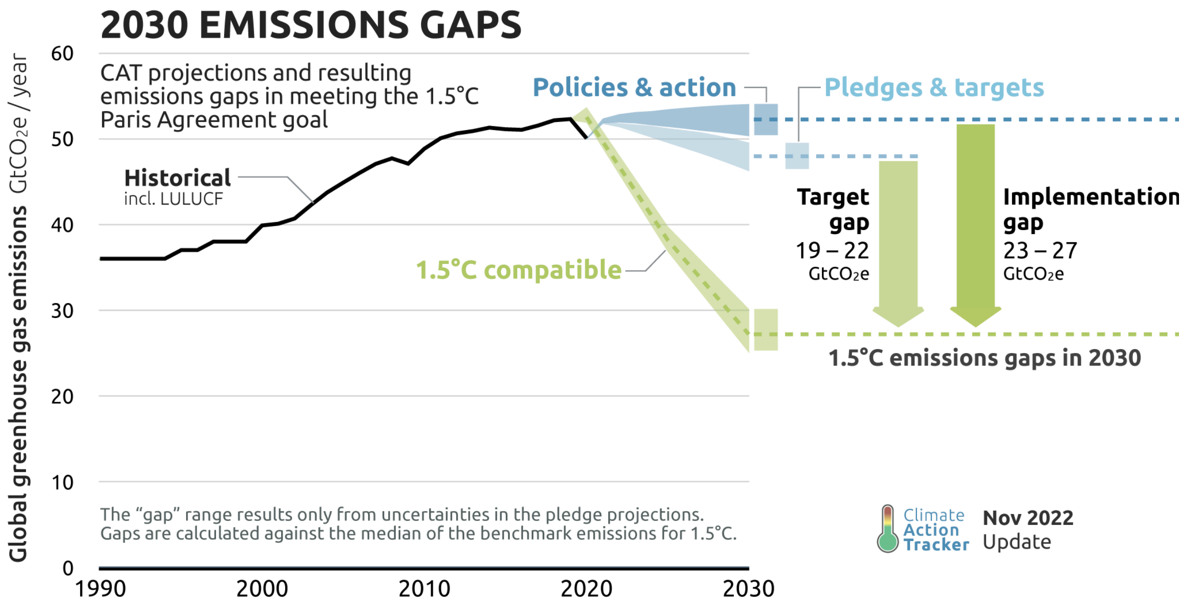
Our recommendations

→ *We recommend that market-based initiatives be required to align with Paris-aligned trajectories and to measure emission gaps and implementation gaps in their progress reports:*

- *Emission gaps are the gaps between projected future emissions in a "Business-as-Usual" scenario and those aligned with Paris Agreement targets.*

[23] "Net Zero Ambition" Paris conference on Monday 30 January 2023 at the Banque de France headquarters. Program in English retrievable at the following web link as at March 5th 2023: https://www.banque-france.fr/sites/default/files/media/2023/01/17/822435_programme-ambition-net-zero_complet_en_0.pdf

- *<u>Implementation gaps</u> are gaps between decarbonization commitments and the expected outcomes of current decarbonization policies.*



E. Misleading labeling

Beyond claims of carbon neutrality, companies often employ marketing strategies to create a perception of sustainability for their products or services. When marketing and communication strategies highlight terms like "green" or "sustainable" without adequate substantiation, they can foster confusion and mistrust among consumers and investors. As concerns about sustainability continue to grow, it is essential for companies to support their claims with clear and verifiable evidence to avoid greenwashing and build trust with stakeholders.

In this section, we focus specifically on labels for financial products, rather than addressing labels, certifications, or standards related to companies or broader corporate practices.

Our recommendation

→ *We recommend that investments in activities known to conflict with the Paris Agreement goals should not be marketed as "sustainable," "responsible," "impact", or "green". To earn this designation, corporations and financial institutions must assess the environmental impact of their investments and ensure that their practices align with the Paris Agreement. This requires transparency, accountability, and a commitment to actively contributing to a more sustainable future.*

IV - ESG Data and Methodologies

A. Introduction

ESG data currently available on the market is often considered insufficiently mature, granular, comparable, and reliable. This lack of reliable data leads to multiple greenwashing risks for financial institutions and presents a significant challenge for ESG activist investors seeking reliable information.

To tackle this challenge, financial institutions often rely on third-party data providers and ESG rating agencies. These entities play a crucial role in enhancing transparency around ESG risks and impacts. When their data is consistent and effectively addresses greenwashing, it can significantly support the transition to more sustainable financing. However, if their data does not facilitate the identification or filtering of elements contributing to greenwashing, it becomes not only ineffective but also harmful to efforts against greenwashing. This risk of unintentional greenwashing can arise at any stage of product development or ESG performance disclosure, whether related to a company's transition or not. Therefore, data providers and ESG agencies hold a position similar to that of external auditors and assurance providers, serving as safeguards against misleading greenwashing claims.

Our recommendations

→ *On June 13th, 2023, the Commission presented a proposal for a regulation on ESG rating activities; the Council and European Parliament reached a provisional agreement on February 14th, 2024. We recommend leveraging this regulatory* *framework to enhance comparability, reliability, and transparency in methodology within the market.*

→ We recommend monitoring the risk of an oligopoly in the ESG rating agencies and data providers industry, particularly when these agencies and providers are not Europe-based firms, which we view as a genuine sovereign risk for the EU.

B. Double Materiality

ESG (Environmental, Social and Governance) data, indicators, and information, call for two types of materiality when considering sustainability issues: impact materiality and financial materiality. This double materiality is controversial in the financial sector, as financial materiality is considered more relevant from a bank's risk management perspective. However, if the financial sector is to engage in a so-called "just" transition that includes social and environmental aspects, such as biodiversity loss or job loss due to transition to a low-carbon economy, the mere consideration of financial materiality will not be sufficient. Indeed, financial materiality does not take into account the dynamic and amplifying effects of ESG risks and domino effects, such as financial cost of climate change, biodiversity loss, natural resources scarcity, etc. Although not yet reflected in Corporates' financial balance sheet, and cost of risks, these ESG risks already impact companies' activities and their materiality are only expected to grow.

Up until now, the direct and financed impacts on the environment and on society have had few financial repercussions. Emerging regulations and more transparency on "impact materiality"[24] could lead to increased financial consequences and risks.

In line with the EU's perspective on double materiality —an approach not shared by many market participants, especially in the US— and building on previous statements, relying solely on financial materiality cannot adequately represent any actor's sustainability performance. "Double materiality" is a foundational principle of both the SFDR and CSRD regulations.

Consequently, the concept of single materiality may be perceived as a potential tool for greenwashing. For instance, a company that focuses exclusively on its financial materiality may inadvertently contribute to biodiversity loss within its value chain. By doing so, it neglects to consider, measure, or communicate the indirect consequences embedded in its materiality strategy. Such a company risks deceiving itself and external stakeholders about imminent supply chain risks and, at worst, engages in greenwashing practices.

Our recommendations

→ We advocate for a wider incorporation of double materiality into the data provided and utilized by financial institutions. This approach would enable international market participants to not only mitigate their sustainability-related risks and instances of greenwashing but also to progressively align with the EU's perspective on sustainability

[24] "Reporting boundary and value chain" section of the [2022 EFRAG Consultation Survey] on the European Sustainability Reporting Standards by the Project Task Force on European sustainability reporting standards (PTF-ESRS)

and a just transition.

→ *We recommend that any sustainability accountability standard implemented in the EU be anchored in the Double Materiality principle.*

C. Methodologies and scopes

Underlying Methodologies:
Greenwashing can occur at the outset of the investment value chain through the underlying methodologies used in ESG fund portfolio management. Fund managers may select, analyze, and evaluate portfolio companies based on internal or external ESG ratings. External ratings are often sourced from various rating agencies, each employing different methodologies to measure and aggregate environmental, social, and governance issues.

Both internal and external ratings are typically calculated using an arithmetic average that sums E, S, and G ratings while allowing for different weights assigned to each aspect. As a result, a company may receive a favorable overall rating due to excellent employee treatment, even if it significantly harms the environment. Therefore, methodologies like the arithmetic average can obscure negative impacts, which we consider to be a form of methodology-driven greenwashing.

Given the growing importance of ratings in sustainable investing practices, we view this characteristic as a foundational aspect of greenwashing in today's financial system.

Sensitive ESG Data Usage in Credit Granting and Ratings:
As some credit committees rely on the aforementioned ESG ratings, this reliance can introduce bias and risks when assessing both credit ratings and credit granting. The heterogeneity in ESG ratings, even for a single company, creates a risk of biased credit decisions.

Additionally, risk departments and credit committees, particularly in retail banking, should exercise caution regarding the use of ESG ratings. In this context, the risks associated with ESG ratings and greenwashing must be carefully considered in credit granting decisions. Some financial institutions prominently communicate their commitments to integrating ESG risks into their strategies, yet fail to implement appropriate restrictions in credit granting for poor ESG ratings.

Our recommendations

→ *While we don't try to analyze the complexity of usual credit indicators/ratings[25], we recommend that ESG risks aggregation use Geometric Means[26]. Even though the geometric average is a less common measure of central tendency, it is more accurate than the arithmetic one for percentage change and positively skewed data.*

Geometric mean is a barycenter taking into account the product of the values: Less sensitive than the arithmetic to high values, giving better estimates of the central

[25] For further details on the topic, refer to the KPIs and KRIs section.
[26] Investopedia: What Is a Geometric Mean? How to Calculate and Example

tendency, hence more appropriate for correlated series , where the arithmetic mean is smoother.

Whatever averages are used, they should be attached to standard deviations or the product of 3 dimensional standard deviations. Original data should be available in Open Source and accessible to evaluate dispersion and extreme values.

Lack of transparency:

Lack of transparency of underlying methodologies can lead to misinterpretations. We note that there is a strong divergence of ratings amongst ESG rating agencies (OECD, 2021[27]; Berg et al., 2019) and a strong correlation factor between high ratings and capitalization size hence inducing a company-size bias which mostly benefits large capitalization companies (Akgun et al. 2021; Peladan, 2019[28]). This casts a doubt on these ratings' reliability. Financial actors make important investment decisions based on them which undermines the trust investors can place in ESG investing.

Defective integration and lack of methodology disclosure:

Besides ratings, we also consider the defective integration and lack of methodology disclosure on GHG emission scopes to be linked to greenwashing. We consider that any company or portfolio manager communicating on GHG absolute emissions, GHG emission intensity and GHG reduction targets must disclose with utmost transparency the calculation methodology and the scopes included and those excluded. This consideration can be extended to other ESG pillars. For instance, on the social pillar, a company that highlights its good treatment of employees in its direct activities but excludes those working in upstream and downstream indirect roles demonstrates a lack of methodological rigor. This oversight can lead to misinterpretation by investors. In this case, both the absence of methodological transparency and the failure to account for scope 3 impacts should be viewed as forms of greenwashing.

Reliance on self-reported information by rating agencies

Moreover, rating agencies often rely on self-reported information, which should be systematically checked against data-driven analysis.

Our recommendations

→ We recommend establishing a minimum requirement for each of the E, S, and G ratings for any investment that may be labeled as responsible. Additionally, we advocate for a clear differentiation between each pillar - environment, social, and governance - to enhance transparency regarding the overall ESG quality of an investment. We believe that Environment ratings should be based on actual physical metrics, including the current footprint (e.g., absolute emissions), as well as

[27] OECD. (2021) .ESG Investing and Climate Transition: Market Practices, Issues and Policy Considerations. https://www.oecd.org/daf/fin/financial-markets/ESG-investing-and-climate-transition-market-practices-issues-and-policy-considerations.pdf , retrieved on 6-Jan-23

[28] Peladan, J.G. (2019). Is the Transition Risk Material? Testing the Net Environmental Contribution Metric on a Universe of Listed European Equities. https://dx.doi.org/10.2139/ssrn.3630338, retrieved on 6-Jan23

the company's impacts in relation to its industry's goals for alignment with the Paris Agreement. These metrics should be calculated using reliable methodologies, such as the GHG Protocol or SBTi, encompassing scopes 1, 2, and 3.

→ We recommend that any indicator, to be credible and useful, must provide access to the underlying methodology —and ideally, access to the underlying data— used for its calculation. This aligns with the principles of Open Science that are gaining traction in the research community. A EU Hub for "Open Sustainability Data" should be created, similar to what has already been done in the healthcare field[29]. To protect trade secrets, the data could be anonymized.

The risk of funds' greenwashing through ESG data agencies:

Some investors integrate ESG factors into their investment process using techniques that are less rigorous and consistent than those they use for other investment factors. These investors may align their strategies with a single rating agency and may end up with a portfolio of companies that is only sustainable in the eyes of one rating agency but not others (LaBella, Sullivan, Russell and Novikov, 2019). Indeed, the divergence in ESG ratings across different agencies indicates the methodologies' subjectivity, whether it be through the proxy they use, the way they manage outliers or the frequency of data updates.

ESG ratings often conflate uncorrelated indicators of E, S and G dimensions. Weights are allocated to each pillar. Overall, ESG rating schemes tend to reward companies with more disclosure (LaBella et al., 2019). These methodologies can conceal negative environmental impacts. Decisions made based on an aggregated ESG rating create a significant risk of greenwashing as cherry picking can occur among all decorrelated ratings of the same company available on the market.

For instance, ISS ESG Ratings aggregates 100 indicators from E, S and G data with little transparency on the methodology. In electric utilities, French main operator is graded C+, while its German counterpart is graded B- because the governance score is largely better for the latter than the former (2 against 8), despite the former's arguably better environmental track record, and electricity production being eight times less carbon-intensive in France than in Germany due to a larger use of nuclear energy.

	German operator	French operator
ISS ESG Ratings 2022	B-	C+
Carbon intensity (2021 data)	410gCO_2/kWh	51gCO_2/kWh

Source: French utility 2021 impact report ;
German utility 2021 Sustainability report ; ISS ESG Ratings

The best-in-class approach, also known as positive screening, consists in shortlisting the

[29] European Commission: European Health Data Space

best ESG-rated companies per industry. For instance, the Blackrock fund IESE: iShares MSCI Europe SRI UCITS ETF points out: *"The ESG data originated from external data providers (including MSCI and Sustainalytics among others)"* - hence leaving room for cherry-picking rating. *"These tools allow us to drive the whole chain of investment, from research to portfolio construction, portfolio modeling and reporting"*.

Our recommendations

→ *We recommend directing rating agencies to explicitly communicate on the Environmental rating of a company separately from Social and Governance ratings and taking into account cross-influence between environmental and social issues e.g., workers' health in extreme climate conditions, as pointed out by the French Third Constitutional Chamber of Representatives in a February 2023 report[30].*

→ *We recommend insisting on the transparency of methodologies and rationales used in company ratings.*

Use of portfolio temperatures in funds reporting

To make investment decisions, sustainable investors may look at different information in an ESG fund, such as the fund's name, the fund's GHG emissions and benchmark's emissions as well as annex data such as portfolio temperatures or company-level temperatures.

Sustainability-related information such as portfolio temperatures can mislead investors in the sense that the concept of temperature increases should only be applied to the planet as a whole (refer to III - Communication and Commitment). The objective of 1.5°C is linked to a balance between emissions and absorptions of GHG on a global scale. A company stock on its own, and a sum of company stocks in the form of a portfolio cannot pretend to be representative of the planet as a whole and its complex balance of carbon emitters and carbon sinks. Displaying a portfolio temperature could lead investors to think that their investment would lead to the achievement of this planetary and collective temperature limit and can be considered a misleading claim.

Our recommendations

→ *We recommend the regulatory bodies to tackle this topic by closely monitoring the underlying methodologies in order to ensure the scientific reliability and usefulness of these portfolio or corporate-specific temperatures.*

[30] Conseil Économique, Social et Environnemental: Enquête "Dérèglements climatiques et santé au travail" 2023

V - Labels

A. EU Labels and Labels inconsistency

Labels either create a focus on a specific activity or product and therefore hide the rest of what is done beyond what the label covers, or only offer a quick assessment/rating/picture of the sustainability related matters of an activity, a product or a company. In either case we cannot see the whole picture.

On the one hand, labels are considered as a tool to prevent greenwashing by some institutions and market participants, on the other hand they are often considered by experts as unsatisfactory and too weak to offer real sustainability related guarantees.

The lack of consistency and comparability between a multiplicity of standards make it difficult to interpret them, which in turn fosters greenwashing.

Some labels call a fund, a product or an activity “Green”, “Transition” or “Impact” even though the only underlying strategy or met requirements are only linked to the available sustainability-related disclosure, which is not exhaustive. Therefore, the use of these concepts is at best misleading, and at worse spreading greenwashing. Along these same lines, ESG Leaders fund qualification currently promotes and values best-in-class strategy or methodology thus highlighting products or companies that are not always aligned with Article 2.1c of the Paris Agreement. We believe that true strong ESG leadership means being aligned with science-based Paris-aligned trajectories.

Our recommendations

→ *We recommend strengthening transparency on minimum environmental and social safeguards, similar to a Do No Significant Harm (DNSH), but beyond what the label covers.*

→ *We recommend creating a comprehensive regulatory framework to check that the project, product or activity is coherent with the global transition strategy of the company or portfolio prior to certification/labeling.*

→ *We recommend that labels comply with a set of standards oriented towards energy/climate transition in line with the objectives of the Paris Agreement, excluding sectors and activities considered as harmful to the transition.*

→ *We recommend that the regulatory framework also provide guidelines and requirements in order to improve the comparability, the robustness and understandability of the different standards structuring all the labels.*

→ *We recommend close monitoring of label implementation by supervisors, auditors or controllers in order for them not to be misleading for the consumers, the public and investors. This monitoring will promote impactful products, funds or activities which significantly support the transition or sustainability.*

Improving labeling standards will enhance confidence in sustainable products and better support the transition.

1. SRI Label - SRI Market

The Socially Responsible Investment (SRI) label, a leading reference in Europe, is a label created by the French government in 2016 to comply with a set of criteria relating to a collective investment organization's management practices and its balance between economic performance and social and environmental impact. Today, it is the most widely used label in Europe for sustainable investment, with an outstanding asset under management of 653 billion euros as of April 12, 2021[31].

The success of the SRI label is largely due to its selection criteria, which focus on a fund's ESG (environmental, social, and governance) processes rather than the selected companies. The label was designed not to restrict innovative market players, that's why it is flexible for fund managers.

However, the current SRI criteria do not guarantee that investors finance the most responsible companies. The SRI selection process is based on a fund's ESG rating methodology, but these rating systems are still a work in progress and have low correlations with each other. As a result, the correlation between ESG rating agencies is 0.54, compared to 0.9 for credit rating agencies. This is due to the heterogeneity of ESG characteristics, indicators, and weighting in the final rating[32].

Therefore, the ESG rating methodology alone is not enough to force ESG funds to direct investments towards sustainable businesses. Unfortunately, SRI-labeled funds still finance companies with controversial ESG policies. According to a study by a leading

[31] Ministère de l'Économie, des Finances et de la Relance: Liste des fonds labellisés - Label ISR

[32] Florian Berg, Julian Kölbel and Roberto Rigobon, 'Aggregate Confusion: The Divergence of ESG Ratings' (2020). *Review of Finance* November 2022 https://doi.org/10.1093/rof/rfac033

French finance transparency advocate NGO published in 2020,[33] 94% of SRI-labeled funds financed companies involved in fossil fuels, human rights violations, or major ESG controversies. The study's small sample size (36 funds were studied) does not allow to draw statistically significant conclusions about the unsustainability of all SRI-labeled funds (there are 1276 labeled funds at 2024/09/30), however it does show that the label attribution system is not effective in highlighting sustainable funds and some may fall through the cracks.

In conclusion, it appears that the use of ESG criteria only supports commercial appeal, and raises the risk of becoming a prevalent practice in the asset management sector, which as a result, will undermine the SRI label's credibility. Therefore, there is growing concern that the lack of standardization and regulation in the ESG (Environmental, Social, and Governance) rating process may result in "greenwashing". For instance where funds receive SRI label despite contributing to financing companies with controversial ESG policies. The lack of effective filtering systems to distinguish between responsible and irresponsible investment funds calls for stricter guidelines to ensure that the SRI label accurately reflects a fund's true ESG practices.

Taking into account the above concerns, the SRI label is evolving towards a new reference framework aiming at strengthening the selectivity criteria, including exclusions, and relying on European regulations to apply the principle of double materiality.

In a nutshell, in this new framework, **exclusions are proposed, particularly on climate**: companies that generate more than 5% of turnover with coal and unconventional fossil fuels[34] would be excluded by the labeled funds. Oil majors will then de facto be sidelined as electricity producers whose greenhouse gas emissions are too high to be considered aligned with the Paris Agreement. Other proposals for exclusions are made on social issues (human rights, controversial armaments, tobacco) and governance (anti-money laundering, terrorist financing, fiscal responsibility).

Double materiality: Labeled funds would need to demonstrate that they incorporate the financial implications of ESG issues on portfolios. They should also measure the impact of their investments on sustainable development issues. To increase alignment with European ESG regulations, the Label Committee proposes greater consistency with SFDR, through consideration of the Main Adverse Impact (PAI).

Integration of climate policy: the next version of the label is expected to overweight climate change issues relative to G and S dimensions and other E issues (e.g., biodiversity). Companies in sectors with a high climate impact defined by European regulations, both in terms of energy production and consumption, should have a credible transition plan that is consistent with the objectives of the Paris Agreement.

More commitment requirement: The SRI Label wants to strengthen the requirements for shareholder engagement by requesting a greater level of transparency on the actions carried out and on voting by ensuring that certified funds vote in more than 90% of the general meetings of invested companies.

This new SRI version was approved by the French Ministry of Economy and Finance in November 2023 for an entry into force in March 2024. Funds already holding the public SRI label will have one year to adapt from the date of publication. As strongly

[33] Epargne: nos économies financent le chaos social et climatique - Octobre 2020

[34] For a more detailed description of these exclusions, refer to the new framework for the French SRI label, 2023

recommended by several climate experts and associations, the French minister eventually decided in favor of an exclusion of companies that exploit coal or unconventional fossil fuels, as well as those that launch new hydrocarbon (oil or gas) exploration, exploitation or refining projects. In addition, a transition plan aligned with the Paris Agreement will be required.

Our recommendations

→ *We recommend increased transparency and standardization in the ESG rating process. This would involve having clear and consistent criteria for rating companies and funds, as well as making sure that the information used for ratings is publicly available and independently verified.*

→ *We recommend the implementation of regulatory measures. Relevant regulatory bodies, supervisors, auditors or controllers can play a role in ensuring that asset managers do not make false or misleading claims about their ESG performance, and that the SRI label is awarded only to those that truly meet the standards.*

→ *We recommend institutional investors to mitigate the risk of greenwashing by doing due diligence on the ESG practices of companies and funds before investing, and by choosing products that have been independently verified as having strong ESG performance.*

→ *We also consider that a graded scoring system instead of labels (e.g., with a system of stars or colors for instance) would allow a clear vision on what each level contains and match with different levels of investors' expectations.*

2. Other labels

There are multiple labels, some that have existed for more than 15 years (*Finansol, Umweltzeichen*), others that were created more recently like *Greenfin, Luxflag Climate finance, Lux flag environment Lux flag ESG, FNG-Siegel, Febelfin, Towards sustainability*, etc.

Some are focused on the fund's ESG processes while others reward investments in selected companies considered as "green". Some follow a quantitative approach based on data and measurable criteria while others have a more philosophical and qualitative approach excluding *de facto* entire sectors. Some labels have been created by professional bodies, market organizations, regulators, NGO or even States. A national label may also try to promote its domestic industry, inducing a risk of protectionism in contradiction with the European single market.

The multiplicity of labels, purview, fields, objectives and promoters does not facilitate decision-making and may increase the risk of greenwashing:

> The French SRI label and the Belgian Towards Sustainability label illustrate the risk of confusion for the investors. Indeed, both labels are presented as ESG oriented, but the Belgian label also includes sector exclusions, which could create a misunderstanding regarding the difference between both labels for the end investor.

Furthermore, if the financial product is sold in several jurisdictions it can combine multiple labels which could let the investor think that this product is more sustainable than a product with a unique label.

Our recommendations

→ We recommend implementing a European label in order to guarantee a standardized specification for the funds distributed in Europe.

→ We recommend integrating existing EU regulatory frameworks into all new labels or standards implementation.

→ We recommend an annual review by an independent body of the eligibility of a fund to keep its European label.

VI - Debt Structuring

Green bonds and Sustainability-Linked Bonds (SLLBs) are financial instruments that serve different purposes in driving sustainability efforts.

- **Green Bonds** are Use of Proceeds debt instruments, where the proceeds are specifically allocated to environmentally-friendly projects in the real economy, such as renewable energy or energy efficiency.
- **Sustainability-Linked Bonds (SLBs)**, unlike green bonds, allow issuers to use the proceeds for general corporate purposes. The key distinction is that the financial impact of SLBs is tied to the issuer's performance on sustainability metrics, which is reflected in the bond's coupon rate.

As the public debate around greenwashing intensifies, the Green, Social, Sustainability, Sustainability-Linked (GSSS) debt market is facing increased scrutiny over concerns that instruments like Green bonds or Sustainability-Linked Bonds may be used to perpetuate false or exaggerated ESG claims, highlighting the need for greater transparency and standardization around sustainable finance.

Our first recommendation*, which applies to all green or sustainable products, use of proceeds, and sustainability-linked instruments, is to implement a requirement to favor a climate-related Indicator as the core KPI, criteria and impact indicator. This KPI should encompass all three emissions scopes (1, 2, and 3). If calculating these scopes proves difficult (which should be a minor issue given the size of companies that can participate in the bond market and their obligation to provide sustainability reporting in the majority of cases), the core indicator should integrate the most material scopes based on the company's activities. In case of difficulties, transparent proxies with clarity* *on the methodologies may be used. However, in all cases, if the company is unable to calibrate its indicator across all emissions scopes, it must disclose the activities from which the emissions were not included in the calculation.*

A. Green Bonds - Use of Proceeds financing

Green bonds are financial instruments intended to finance environmentally-friendly projects, but there are concerns about their implementation. Vague language used in high-level project categories makes it difficult to determine the specific nature of the projects being financed, and there may be no clear criteria for eligible project categories.

Green bonds have attracted public and media attention when the use of proceeds did not align with the objective of the Paris Agreement. We can provide several examples where claims of greenwashing have been raised for Green bonds:

- Green bonds issued by companies operating in oil intensive or highly polluting industries: While the Green bonds may fund environmentally-friendly projects, the misalignment with the issuers business strategy has been viewed as an attempt to greenwash the core brown activities by putting excessive attention on a few green projects. Several examples have hit the news:
  - In May 2017, the issuance of 500M euro Green bonds by the a major oil company operating globally with leading US and EU fund managers as shareholders[35] was boycotted by the main green bond indices. Indeed, the use of proceeds of the bond were meant to enhance the energy efficiency of its operations. Critics highlighted that these optimized operations would continue to provide fossil fuel energy and hence contribute to the greenhouse gas emissions. In this use case, the oil company did not take into account the Scope 3 emissions and this issue has been viewed as a way to greenwash its operations while continuing to invest in its core business of supplying fossil fuel.
  - In 2019, a major player in oil refining, listed on the Shenzhen Stock Exchange,[36] raised the equivalent of 140M USD in Green bonds to build an *energy efficient* Petrochemical plant. This issuance attracted criticism from many organizations as the plant would be used to process large volumes of crude oil.
  - A number of fossil fuel companies have been issuing Green bonds to invest in renewable industry projects [37]. While this may seem a legitimate way to divert from fossil fuel and to refocus on renewable energy, studies showed that green projects represent only 1 or 2 % of the companies overall investments, whereas the bulk of the investment is still being directed toward core fossil fuel energies[38]. This inconsistency between the highly marketed Green bonds and the reality of the investment have been interpreted as greenwashing operations rather than a true shift from the core fossil fuel business.
  - Other polluting industries have also raised concerns about the use of proceeds from Green bonds. For instance, a leading Asian airport hub authority's Green bonds have been criticized by investment analysts and newspapers for

[35] The green bond that rocked the market by reigniting the 'what is green' debate | Environmental Finance June 2017

[36] Oil refiner issues $140M green bond to fund new capacity | Reuters Oct 2019

[37] US power company issues second benchmark-sized green bond | Environmental Finance June 2016

[38] CSSN Research Report 2022:1: - Climate-Washing Litigation: Legal Liability for Misleading Climate Communications.

encouraging an increase in the air traffic, a major contributor to greenhouse gas emissions [39].

- Greenwashing claims have also been raised when Use of Proceeds showed a lack of ambition or an attempt to depict "business as usual" activities as green. For instance, companies have tried to issue Green bonds to develop more energy efficient automobiles with a cost-efficiency motive[40]. In reality these innovations are part of the business as usual R&D of the automobile industry and would not qualify as disruptive activities to align with the Paris Agreement goals.
- Other examples of greenwashing scandals arise when companies issuing Green bonds without properly assessing the wider risk from these bonds. For instance, investigation on Green bonds issued by a global leader in tyres manufacturing showed that use of proceeds have been partly repaying a previous loan that funded the deforestation of Indonesian virgin forest[41]. In this case looking at the overall risk, it appears that the Green bonds were used to deforest pristine forest and replace it with industrial cultivation of rubber trees.

In this last example, claims of greenwashing through misinformation have been raised. Indeed it has been stated that the management and the supporting financial institution were well aware of the previous deforestation of the pristine forest and chose intentionally to hide the information from investors[42].

Use of proceeds debts, such as Green Bonds/Loans, allocate their proceeds to the financing or refinancing of eligible green projects. In the case of refinancing, the **look-back period** determines how far back the issuer can apply the bond's proceeds to projects that have already been initiated or completed. We believe that an extended look-back period can mislead into thinking the debt is funding new green initiatives, when, in fact, the proceeds may simply be covering existing commitments rather than driving additional environmental impact.

In addition, the inclusion of a "cease to characterize as green" clause is essential to maintaining the integrity of the green debt market. It would serve as a safeguard, ensuring that issuers/borrowers are held accountable for adhering to the agreed-upon sustainability criteria, frameworks, and Green Bond/Loan Principles. Without this provision, there is a risk that issuers/borrowers could falsely continue to market debt as green despite failing to meet their commitments, misleading investors/lenders and undermining the credibility of the green debt market as a whole. This clause would provide a clear consequence for non-compliance, ensuring that green debts retain their environmental integrity and do not misrepresent their impact.

Our main recommendations for Green bonds

→ *We recommend clear and ambitious eligible criteria to be defined, so that investors can easily assess the environmental benefits of the projects being financed. Importantly, the issuing entity must express how the proceeds will finance transition efforts to a low carbon economy and not merely its "business as usual" activities. Therefore, we recommend that the EU GBS following requirements get normalized for all Use of Proceed bonds: "demonstrate how the use of proceeds of the Green*

[39] Airport Authority sells controversial green bond - International Financing Review January 2022
[40] Impax criticizes 'business-as-usual' green bonds: Environmental Finance
[41] European green finance is paying for deforestation in Indonesia | VoxEurope Journal Nov 2022
[42] How a project decried for its environmental impact became a flagship of European green finance | VoxEurope Journal Nov 2022

bonds feed into the transition plan of the company as a whole."[43]

For example, oil industry companies will not be able to issue Green bonds on marginal projects, if their use of proceeds are not feeding into a global strategy to divert from fossil fuel activities.

→ *We recommend companies issuing Green Bonds to provide granular transparency and regular reporting on the environmental impact of the projects being financed. Reporting of the positive ecological impact of the bonds must be provided each year during the life cycle of the bond and not solely ex-ante.*

→ *We recommend making the inclusion of a "cease to characterize as green" clause mandatory in the Green Bond and Loan Principles (or any green framework and credit agreement) as it is essential to preventing greenwashing and protecting the green debt market.*

Our complementary recommendations for Green bonds

→ *We recommend a link to the companies' sustainability and financial reportings to be included in its green bond annual reporting in order to guarantee a comprehensive approach. This would mean being able to spot when a highly polluting company continues launching new highly emitting projects concurrently with their Green bonds issuances, and measuring the proportion of green projects versus "brown" projects over time.*

→ *We recommend developing guidelines to accompany companies in the choice of criteria, impact reporting, etc. Although the large latitude given by the current Green Bond Principles framework has encouraged an exponential growth of the Green Bond market, it has also left ample room for greenwashing which undermines the credibility of the Green bonds labeling.*

→ *We recommend reviewing Green Bonds Principles to encourage alignment with the most stringent eligibility criteria of international taxonomies. The review could also promote the integration of the Do No Significant Harm approach and social minimum safeguards.*

→ *We recommend setting an exclusion list for sectors and activities considered as harmful to the transition. For instance, Green Bonds would not be issued for improvements to the oil industry, airport building, or deforestation. While these bonds may lead to marginal improvement in the ecological footprint of such projects, they in the long run will help expand sectors that are incompatible with the objectives of the Paris Agreement.*

→ *We recommend further science-based guidance on transition activities, potentially through a transition taxonomy to be developed, in order to maintain financing towards activities that can transition or support the transition without being "Green" activities per se.*

→ *Given that the public sector accounts for a great portion of green bond issuances (e.g., 35% in France), it is crucial that the public sector leads by example.*

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[43] Sustainable finance: Provisional agreement reached on European green bonds | Council of the EU Press Release February 2023

The governments should set higher standards than the private sector through their framework and detailed reports on the projects funded by their green issuances, ensuring full alignment with sustainability goals and fostering trust in the effectiveness of green finance.

→ *We recommend a maximum two-year look-back period for Use of Proceeds debts, to ensure that proceeds are allocated to genuinely new projects, rather than refinancing existing commitments, thereby driving additional environmental impact.*

Our recommendations for investors

→ *We recommend for investors to carefully scrutinize the terms of any Use of Proceeds bonds or Sustainability-Linked Bonds before investing, to ensure that they are aligned with their sustainability objectives and that they are not being used for greenwashing or social washing purposes.*

B. Sustainability-Linked Financing

a. Sustainability-Linked Bonds (SLB)

Sustainability-Linked Bonds are other instruments that were created to encourage companies to achieve sustainability goals through financial incentives, but there are concerns about greenwashing in their implementation as well. When carefully drafted, KPIs, Sustainability Performance Targets (SPTs) and Penalty structures may allow companies to avoid a real commitment to the global GHG emissions reduction, while still marketing their operations as transition-aligned. The basics of these mechanisms and the risks of greenwashing are detailed in the following sections.

KPIs and targets set in SLBs may not be material or ambitious enough to effectively reduce a company's carbon footprint, and some companies may manipulate data or omit material information in their impact reports while stating their progress toward their sustainability performance targets (SPTs). In addition, there is no standardized criteria for financial entities to assess the level of ambition of a company's proposed key performance indicators (KPIs) and SPTs.

Another issue is the lack of broader sustainability strategies accompanying Green bonds and SLBs.

For example, between 2019 and 2021[44], a US integrated power company, listed on the NYSE, was the second of its sector to issue a sustainability-linked bond, to finance part of a 3.6B USD all-cash acquisition of a competitor, with a major French bank appointed as Joint Bookrunner and Sole Sustainability Structurer and Coordinator as part of this issuance[45]. This operation was conducted without a plan to exit neither coal power generation, which still accounts for 41% of its portfolio nor "natural" gas generation, accounting for another 48%, i.e., a total 89% of fossil sources[46]. This raised questions about the effectiveness of SLBs in incentivizing companies to make meaningful progress toward sustainability goals.

[44] 2021 Sustainability Report: Sustainable Finance | Corporate PR issued on 3BL CSR Wire Sept. 2021
[45] $900M Sustainability-Linked Bond: Setting a North American Precedent | Press Release Jan. 2021
[46] A newly aligned fleet for a more sustainable energy future | Corporate web site 2023

Issuing companies can draft KPIs defined on a limited scope of their operations, while leaving their core activity free to continue intensifying the climate crisis.

As an example, a major Southeast Asian actor in maritime and land logistics for the energy sector, raised the equivalent of more than 40M euro in 2020 with an SLB[47], pledging to reduce the emissions of its ships. However, this reduction would be negligible compared to the increase of GHG emissions that the additional amount of oil transported by its ships produces[48].

Our recommendations for Sustainability-Linked Bond' KPIs

→ *We recommend KPIs to be ambitious and material, reflecting the company's core environmental and social issues.*

→ *We recommend Climate Targets' ambition to be independently verified and benchmarked against Paris Aligned Trajectories.*

→ *We recommend investors to demand transparency and regular reporting on the company's progress toward meeting its sustainability goals.*

→ *We recommend making climate KPI mandatory as a core KPI.*

→ *We recommend developing a broader KPI Registry, inspired from the one developed by ICMA. The goal would be to map all relevant E, S and G KPIs to support sectoral transitions. Some KPIs would be applicable to all sectors and others dedicated to each sector, with a level of ambition and benchmark-ability attached.*

Sustainability Performance Targets

Sustainability Performance Targets (SPTs) are the objectives that a company must achieve by a predetermined date, the success or failure of which triggers certain predetermined financial consequences at the time of bond issuance. These SPTs are governed by the Sustainability Linked Bond Principles (SLBPs), which are broad and non-binding principles. The SLBPs state that companies should disclose their SPTs and the process for setting them, as well as regularly report on their progress towards achieving them. However, there is no formal requirement for companies to disclose the specific consequences of meeting or failing to meet these targets, leaving room for potential greenwashing.

SLBPs state that:

"*The SPTs should be ambitious, i.e.:*

- represent a material improvement in the respective KPIs and be beyond a "Business as Usual" trajectory;

- where possible be compared to a benchmark or an external reference;

- be consistent with the issuers' overall strategic sustainability / ESG strategy; and

- be determined on a predefined timeline, set before (or concurrently with) the issuance of the bond."

[47] Stepping forward with confidence into a sustainable future | Corporate web site 2023
[48] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4099829

Issuers can also introduce a call option within SLBs' structuring. This option allows the issuer to buy back the bond before maturity at a fixed price (usually based on par value). Not only the issuer would benefit from the *greenium* associated with the sustainability aspect of the bond, but also the penalty would be avoided by calling the bond before meeting the SPTs. This option is attractive to issuers because it reduces risks of a coupon step-up penalty, when failing to achieve its SPTs.

*"The term **greenium** describes the idea that investors are willing to pay a premium to hold a green bond rather than a conventional bond, as they are willing to accept lower monetary returns in exchange for supporting environment-benefitting activities[49]"*

This option is included in the structuring of SLBs to a much greater extent than for traditional vanilla bonds and use of proceeds bonds: about 60% versus 10% and 20% respectively. Although not all forms of call options inherently reduce financial risk, this statistic is nevertheless noteworthy and highlights a risk of greenwashing.

Some studies[50] underlined how financial impacts were mitigated via various levers when SPTs were not met. These processes aiming at turning SLBs into a normal bond, can be considered as greenwashing. Indeed, mitigating risks when issuing an SLB consequently undermines the SPTs' success, but improves public image.

There are several levers used for this form of greenwashing: Target date and maturity date are adjacent, which mitigates financial impact of SPTs' not being met; even ambitious targets can be mitigated by combining them with late target date.

For example, a major global finance actor has helped draft such a skillful structured SLB for an Indian Cement company. While the step up is less than 1% in case of missing target, the assessment date is so close to the repayment date of the debt that the overall penalty will be negligible in terms of percentage for the issuer.[51]

The addition of call dates that can be executed before the target assessment date poses another risk of greenwashing in the SLB market. This structure allows issuers to potentially redeem the bond before the sustainability targets are assessed, effectively bypassing any financial consequences if the targets are not met. By giving issuers the ability to redeem the bond early, the perceived environmental impact of the bond is diminished, as there is no accountability for failing to meet the sustainability targets. This creates an incentive for issuers to prioritize short-term financial flexibility over long-term environmental performance, undermining the integrity of SLBs as true tools for sustainability.

Similarly, low penalties attached to coupon step-ups in case of failing to meet sustainability performance targets (SPTs) can render the penalties insufficient to drive meaningful change. When the financial consequences are not material enough to impact the issuer's behavior, the incentives to actually achieve the sustainability targets become weak. This structure risks turning SLBs into regular bonds with minimal environmental obligations, rather than instruments driving genuine sustainability outcomes. By allowing these low-impact penalties, the bond market risks being perceived as greenwashing, where financial rewards for non-compliance overshadow the intended environmental goals.

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[49] European Central Bank: "Pricing of green bonds: drivers and dynamics of the greenium" by Allegra Pietsch, Dilyara Salakhova Disclaimer: This paper should not be reported as representing the views of the European Central Bank (ECB). The views expressed are those of the authors and do not necessarily reflect those of the ECB. No 2728 / September 2022

[50] Ul Haq, Imtiaz and Doumbia, Djeneba, Structural Loopholes in Sustainability-Linked Bonds, World Bank Policy Research Working Paper Series October 2022: http://dx.doi.org/10.2139/ssrn.4099829

[51] Mines, pipelines and oil rigs: What a bank's 'Sustainable Finance' really pays for | The Bureau of Investigative Journalism UK Oct 2022

Our recommendations for SLB's SPTs

→ *We recommend building a strict SPT framework that would avoid methodological pitfalls in the bond market.*

→ *We recommend regulating the target dates of SPTs so that they are set in the first half of the bond maturity, or way before the call date.*

→ *We recommend implementing systematic penalties for premature calls and making it impossible to set a call date anterior to the SPT's date.*

→ *We recommend that* penalties attached to coupon step-ups are material enough to drive genuine sustainability outcomes.

Coupon step-up and coupon step-down

Coupon step-up and coupon step-down are two mechanisms that can be used in sustainability-linked bonds structuring to align the issuer's sustainability performance with the bond's financial performance. Both mechanisms are linked to specific sustainability targets, and the bond's interest rate is adjusted based on the issuer's performance against those targets.

In a coupon step-up structure, the bond's interest rate increases if the issuer fails to meet the agreed-upon sustainability targets. For example, if the issuer fails to reduce its carbon emissions by a certain percentage, the bond's interest rate may increase by a predetermined amount.

In a coupon step-down structure, the bond's interest rate decreases if the issuer meets or exceeds the agreed-upon sustainability targets. For example, if the issuer reduces its carbon emissions by a certain percentage, the bond's interest rate may decrease by a predetermined amount.

While coupon step-up and step-down mechanisms can be useful tools to incentivize sustainability performance and hold issuers accountable, their impact on the success of the transition to a more sustainable economy and their perception by investors is not yet fully understood.

The materiality of a coupon step-up varies across issuers, depending on their cost of funds and financial resources. Some argue that the usual 25bp step-up is not impactful enough[52]. According to the SLBPs, the variation of the bond's financial and/or structural characteristics should be commensurate and meaningful relative to the issuer's original bond financial characteristics. However, today's absence of a fixed number allows issuers to escape with an affordable penalty.

SLB is marketed as an issuer-level commitment, which could benefit from punitive and incentivizing mechanisms for the issuer to remain on track. However, while interest rate step-downs are standard in sustainability-linked loan markets, they are extremely rare in bond markets. Only a few issuers have come to the market with step-down SLBs. Investors tend to avoid such bonds due to the price uncertainties that could affect their tradability.

Coupon step-downs could help mitigate greenwashing risks by promoting a framework with ambitious SPTs and offering a financial incentive to achieve those targets. This mechanism might better support the transition to a carbon neutral economy by 2050.

[52] Half of sustainability-linked bond issuers see greenium larger than step up | Responsible Investor Feb 2022

We view coupon step-downs as an excellent opportunity for the financial sector and central banks to play a developmental role and determine the most effective monetary incentives and penalties. Although the impact community views the step-down SLB positively as an incentive for issuers to set more aggressive targets, investors' appetite has been relatively subdued. However, if an investor believes that the likelihood of default is lower if the company achieves SPTs compared to an agnostic company management, they may have an incentive to price a step-down SLB closer to a traditional bond. Accepting a step-down coupon will allow investors to walk the walk when it comes to sustainability, and if maximizing returns is central to investors, it should not be the only consideration in impact investing.

Our recommendation on coupon mechanisms

→ *We recommend that the regulator bring technical support to the transition while keeping the SLB market attractive and engaging investors to take more risks to support SLB issuers with strong targets. Regulations could be implemented to balance the incentives for issuers and the ones for investors. By doing so, they can help build investor confidence in the SLB market and promote the transition to a more sustainable economy.*

→ *We recommend developing clear guidelines on step-up and step-down mechanisms, taking into account their financial materiality, the attractivity of the bond and the target's ambition.*

→ *We recommend increasing the spread of step-up and step-down coupon mechanisms to effectively ensure issuers' commitments toward its transition. This will prevent coupons from being ineffective penalties or incentives.*

We believe increased ambition among SPTs structuring will attract more investors and should help enhance greeniums in the market. While the increased spread will raise financial risk for companies and for investors, this phenomenon should be mitigated by an improved greenmium. On the other hand, increased financial risk for the investors could be mitigated by the fact that more transition-aligned companies are less likely to default.[53]

→ *We recommend highlighting the contextual constraints and providing flexibility in the structuring of sustainability debt for High Yields issuers coming from developing countries or emerging markets, while remaining ambitious, in order to support their market integration, which is needed to finance their transition and not as easy to initiate as for developed countries or big corporations. Therefore, we believe that for those issuers encouraging more flexibility on the ambition of the coupon step-up is recommended and can be supported through international financing schemes.*

b. Sustainability-Linked Loans

The market for green, social, and sustainable loans, use of proceeds, and sustainability-linked instruments faces almost the same issues as the GSSS bond market.

For instance, in terms of greenwashing, the issues around KPIs' definition remains

[53] Social Sciences Research Network: Erlandsson, Ulf and Mielnik, Stephanie and Richardson, Josephine and Rimaud, Cedric, Notes on Risk-Neutral Pricing of SLBs and Step-down Structures, Oct 2022 http://dx.doi.org/10.2139/ssrn.4258897

material. A NASDAQ-listed low-cost airline's 2020 SLL is a good example of a poorly structured SLL in terms of enabling a real GHG reduction emission. As the SLL borrower is an airline company, the emissions reduction would have been the most relevant KPI to use side by side with science-based targets. But instead of structuring such a SLL based on carbon footprint reduction, its financial counseling partner, a global European bank, and the airline have used ESG Scores as the KPI of this SLL.

ESG scores raise multiple issues which have already been developed in previous chapter (refer IV - ESG data and Methodologies), among which the most problematic ones are that ESG scores may hide underlying sustainability issues (climate impact for instance) and that ESG scores lack correlation among extra-financial agencies and ESG data providers[54].

It would have also been very useful to have access to the issuer's carbon footprint reduction targets and trajectories, in order to understand its energy transition ambition.

In addition to eligibility criteria and key performance indicators, there are transparency issues in the GSSS loan market. Unlike GSSS bonds, the frameworks and SPOs (Second Party Opinion) for GSSS loans are not required to be made public.

The lack of transparency regarding the achievement of SPTs and their consequences is one of the main risks of greenwashing. Banks disclose little information about the interest rates assigned to loans and the impact mechanisms of SPTs. Sustainability Linked Loans Principles (SLLPs) are detailed and cover the entire value chain of creating these financial products. However, since these principles establish a framework rather than rules, there is a significant risk of voluntary or involuntary greenwashing (due to the difficulty of comparing apples to oranges).

Instead of step-up and step-down coupon issues, the GSSS loan market faces challenges in calibrating margin mechanisms on an annualized basis. One interesting feature of the GSSS loan market, which was already mentioned in the section on SLBs, is the systematic use of margin mechanisms to incentivize or penalize the achievement of annual targets. However, there is a risk of downward revisions of targets during lender review clauses, which poses an additional challenge to achieving these SPTs.

A new financial product has emerged within the sustainable debt market: **bonds that finance portfolios of Sustainability-Linked Loans (SLL)**. The International Capital Market Association (ICMA) has recently published guidelines[55] for this new category, which raises significant concerns about potential greenwashing. Specifically, the allocation of proceeds from these bonds often involves financing arrangements with limited public disclosure. To effectively combat greenwashing, we recommend implementing rigorous scrutiny of these new products. Furthermore, it is essential to mandate transparency through a predefined list of key performance indicators (KPIs) and corresponding ambition ranges for sustainability performance targets (SPTs). These targets should be aligned with trajectories consistent with the Paris Agreement.

[54] "First-ever airline to deploy a sustainability-linked loan (SLL) by amending its existing $550 million senior secured revolving credit facility (RCF)" Press Release on the corporate web site of the orchestrating financial counselor

[55] https://www.icmagroup.org/assets/documents/Sustainable-finance/2024-updates/Guidelines-for-Sustainability-Linked-Loans-financing-Bonds-June-2024.pdf

Our recommendations for SLLs

→ We recommend that Authorities and Lenders encourage greater transparency and ambition in the GSSS loan market.

→ We recommend KPIs to be ambitious and material, reflecting the company's core environmental and social issues.

→ We recommend making climate KPI mandatory as a core KPI. We also recommend Climate Targets' ambition to be independently verified and benchmarked against 1.5°C and 2°C aligned trajectories.

→ We recommend developing a KPI Registry, inspired from the SLB Registry developed by the International Capital Market Association (*ICMA). The goal would be to map all relevant E, S and G KPIs to support sectoral transitions. Some KPIs would be applicable to all sectors and others dedicated to each sector, with a level of ambition and benchmark-ability attached.*

→ We recommend the development of a minimum margin adjustment to be applied in case of non-achievement of SPTs to make these loans more credible and combat the greenwashing labeling of financial products that claim to support the transition.

→ We recommend ensuring that the discount offered by lenders must be sufficiently large to help offset the cost of these commitments, which will encourage companies to better respect their various commitments (SPTs, reporting, transparency).

→ We recommend preventing targets from being revised downward more than necessary during rendez-vous clauses with all lenders.

→ Similarly to SLBs, we recommend encouraging margin mechanisms to be more significant for High Yield borrowers from developed countries or big corporations, and more lenient for developing countries or emerging markets, which can be supported through international financing schemes.

→ For Bonds financing SLLs, we recommend mandating transparency through a predefined list of key performance indicators (KPIs) and corresponding ambition ranges for sustainability performance targets (SPTs). These targets should be aligned with trajectories consistent with the Paris Agreement.

C. Second Party Opinion

Second Party Opinions (SPO) play an important role in the fight against greenwashing by providing independent assessments of the environmental and social impacts of financial products. Such opinions can help investors and other stakeholders to identify and avoid products that make unsubstantiated or misleading claims of sustainability, and promote greater transparency and accountability in the financial industry.

However, it is important for Second Party Opinions to provide a real analytical assessment, rather than simply verifying its alignment with a given initiative, methodology, or standard. It is equally important for these opinions to clearly state the materiality of the chosen Key Performance Indicators (KPIs) and the alignment of the criteria for eligible categories to the Green or Transition Taxonomies when available. By doing so, SPOs can ensure that chosen KPIs are relevant, and that the criteria for eligible categories are consistent with the broader goal of limiting global warming.

It is important to note that the global ratings provided by SPOs are not as crucial as the analytical details contained in the opinion itself. The specific assessments provided by SPOs, including the materiality of KPIs and the alignment of the criteria for eligible categories, are fundamental in offering investors and other stakeholders a comprehensive understanding of the environmental and social impacts of the activities, projects, or transitions being financed. Therefore, SPOs should prioritize delivering detailed, transparent, and rigorous analytical evaluations, ensuring that financial products are assessed based on their actual sustainability performance, rather than on their marketing appeal.

SPO providers' integrity can be questionable, or even compromised, by potential conflicts of interest. Since the issuer typically pays for the opinion, there is an inherent risk that the provider may be incentivized to issue favorable assessments to retain the client's business. This situation echoes the abusive practices witnessed in credit rating agencies before the 2008 financial crisis, where issuer-paid ratings contributed to biased and overly optimistic evaluations. Such conflicts severely undermine the credibility of SPOs, raising doubts about the authenticity of claims made by green financial products.

Our recommendations

→ *We recommend establishing clear standards and guidelines for SPO providers. This could include requiring SPO providers to disclose or be audited on their methodology for assessing sustainability performance, ensuring the use of relevant and reliable data sources, and incorporating a comprehensive range of environmental and social factors into their assessments.*

→ *We recommend SPO providers to undergo periodic reviews and assessments of their practices to ensure ongoing quality and transparency. This could help build trust among investors and other stakeholders in the SPO market and ensure that SPO assessments are providing accurate and reliable information.*

→ *We encourage collaboration and coordination among SPO providers to improve consistency and comparability across the market, or impose standards to all SPO providers. This could involve establishing industry-wide standards for reporting sustainability performance and creating mechanisms for sharing data and best practices.*

→ *To address concerns about conflicts of interest and ensure the credibility of SPOs, we support the introduction of regulatory measures that mandate robust, independent assessment processes. This should enhance transparency and guarantee the integrity of SPOs.*

D. Vigilance and post-implementation work of suggested regulations

In case of regulatory changes based on our recommendations, monitoring tools would be necessary in order to efficiently observe market reactions and thus anticipate needed adjustments or more demanding implementation mechanisms.

For example, it could be interesting to study the pricing of SLBs with a step-down coupon in order to foster investor interest based on a lower probability of default (see the study cited above).

On a broader level, it would be interesting to study the implementation of ecological accounting for issuing/borrowing companies in the context of financial products pricing, and of SLB / SLL in particular. This kind of accounting could be interesting in the frame of financial products as it is more connected than the usual accounting with the sustainability requirements from the companies and includes fully the different ecological cost with a double materiality view, ensuring compliance with Article 2.1c of the Paris Agreements in particular. [56]

→ *We would also recommend the development of EU Principles that would clarify the ICMA and LSTA Principles' various loopholes in order to reduce the risks of greenwashing.*

→ *We recommend assessing the overall performance of debts by considering both their default rates and the achievement of ESG objectives set in the contract, with financial incentives (such as premiums) tied to these outcomes. Demonstrating that these debt products are safer, more profitable, and contribute to CSR goals would benefit all parties involved.*

E. Sustainability Coordinator/Structuring Agent Responsibilities

The Green or Sustainability Coordinator is responsible for advising the borrower on market best practices regarding the sustainable structuring of debt and coordinating communication between the borrowers and lenders. This role encompasses everything from drafting the framework to marketing the sustainability qualities of the financing, including the integration of green provisions in the credit agreement and coordination with SPO providers. The Sustainability Coordinator is essential in ensuring robust alignment with the Green Loan Principles and other market guidelines designed to promote sustainable financing and preserve market integrity by providing standards that capture the fundamental characteristics of these loans.

The market has observed poor practices where financing is structured with sustainability components, such as margin adjustments tied to unambitious sustainability objectives. In some cases, despite being marketed for their sustainability features, the Sustainability Coordinator structured the financing without labeling it as green or Sustainability-Linked to avoid alignment with the Green Loan Principles/Sustainability-Linked Loan Principles and other sustainable finance market standards. This practice of marketing sustainability features in lender presentations while structuring loans with sustainability components, triggering margin adjustments without referring to them as Sustainability-Linked Loans, raises the risk of misleading stakeholders and appears as a threat to the market integrity.

→ We believe that any financing incorporating sustainability components, especially when these features are tied to margin adjustments, should not only be labeled appropriately but also ensure alignment with established principles such as the Sustainability-Linked Loan Principles. It is paramount that regulations accompany the market in this direction to preserve integrity and address greenwashing risks. It is the responsibility of any Green or Sustainability Coordinator to ensure robust alignment with sustainable finance principles and to seek market best practices in all transactions.

[56] "How to re-conceptualise and re-integrate climate finance into society through ecological accounting", Hugues Chenet, Alexandre Rambaud [2020 working paper, Institut Louis Bachelier]

VII - KPIs and KRIs

A. The use of Benchmarking for climate-related KPIs

1. Benchmarking climate-related KPIs on regular indices

Stemming either from the emergence of stricter regulation or from investors' interest for the matter, fund managers have started to work on the comparability of climate-related performance indicators through the use of benchmarks. Portfolios are thus compared through a financial lens as well as an extra-financial one. Fund managers communicate on the ESG score of their portfolios, their carbon intensity, their portfolio's absolute emissions or on portfolio temperatures. These indicators can bear little significance for an investor when they stand alone, hence the need for a benchmark comparison. Inadequate benchmarks can be misleading for investors and lead to benchmark error.[57]

We note that a large majority of fund managers still use the same benchmarks for financial and extra-financial performance indicators. These benchmarks bear no environmental or social ambition and can lead to inaccurate comparisons when it comes to climate-related indicators.

Looking at a few examples, we studied several ESG funds. Funds are using benchmarks as: MSCI World Small Cap Net Return, MSCI World Net Return index or MSCI All Countries World Index for their reporting.

These benchmarking choices could be considered as greenwashing because they give the inaccurate idea to investors that these funds have a superior extra-financial

[57] Benchmark error is a situation in which the wrong benchmark is selected in a financial or extra-financial model, causing the model to produce inaccurate results. Investopedia

performance while this may not be the case.
When it comes to carbon intensity for example, an ESG fund may purely exclude a few of the most carbon-intensive firms of an index and find itself reporting on a positive alpha for their climate-related KPI. We would thus recommend funds to use a more adequate benchmark for extra-financial performance indicators.

Our recommendations
→ *We recommend evaluating the sustainability performance of funds (mainly Art.8 and 9), through robust benchmarks such as CTB or PAB, and ensure that the evaluation is transparent.*

2. Benchmark Comparison: Climate Transition Benchmark & Paris Aligned Benchmark

In 2019, co-legislators agreed to amend Regulation (EU) 2016/1011, introducing two types of climate benchmarks as well as ESG disclosures for all benchmarks (excluding interest rate and currency benchmarks).

The regulation now labels two types of climate-related benchmarks: the EU Climate Transition Benchmark (CTB) and the EU Paris Aligned Benchmark (PAB). The amendment includes several requirements specifications for both benchmarks. The EU CTB benchmark portfolio must be on a decarbonization trajectory while the EU PAB benchmark portfolio's carbon emissions must be aligned with the objectives of the Paris Agreement.

Since its launch, a number of providers have issued indices eligible under the EU's definition of Climate Benchmarks. These indices can have a true impact on capital reallocation both directly (through passive investment strategies) and indirectly (through the influence they bear on investment decisions of benchmarked active portfolios). However, any imprecisions or blurred lines in the EU regulatory definition of Climate Benchmarks can lead to a deviance from the primary goal of decarbonization and thus constitute a form of greenwashing.

We identify several imprecisions in the regulatory definition of the benchmarks which can lead to loopholes and undermine the credibility of EU-regulated climate benchmarks:

- Unlike the PAB, the CTB does not require any sectorial exclusion. This could jeopardize the credibility of this index. For instance, a carbon-intensive company whose revenue is dependent on the oil and gas industry for more than 50% can be eligible in a CTB benchmark. A distinction must be made between highly-emissive industries that must transition and stranded industries or stranded business models that are incompatible with a low-carbon economy. The macro-consistency of the real economy represented by the weights of the sectors in benchmarks must be preserved while still being consistent with overall economic alignment with a decarbonization strategy.
- The decarbonization reduction target of 7% per year is required at a portfolio-level and not an entity-level, for each of the index's components. Since the definition of a benchmark is that of a goal that must be achieved, we must design both CTB and PAB as the ideal portfolio in a low-carbon economy. This ideal portfolio must hold companies that are succeeding at the 7% reduction target while still being as diversified as the index of reference.

- The progressive integration of scope 3 is too permissive and can leave space for index makers to remain on a scope 1 and 2 level for two to four years still.

We note that climate strategies and benchmarks may exhibit strong sector deviations by organizing their decarbonization through divestments from sectors with strong climate intensity. An under-representation of sectors that are key for energy transition would be problematic. Since considerable investment is necessary to ensure electrification of the economy and decarbonization of electricity, underfunding of this sector in climate-aligned benchmarks or strategies would constitute a form of greenwashing. However, this macro-consistency rationale must not leave space for the inclusion of stranded sectors and industries in climate-aligned benchmarks which can also lead to greenwashing.

Regulators should be aware of this greenwashing pitfall: ensure sufficient macro-consistency to avoid the under-representation of highly-emissive industries in climate-aligned benchmarks, while rapidly pushing for the strict divestment from stranded sectors and activities.

Ideally, the macro-consistency of benchmarks should also take into account the necessary evolution of sectoral importance in our economies. For example, this involves recognizing the increasing proportion of renewable energy sources in contrast to coal and gas electricity production or other oil-based heating systems compared to heat-pumps.

Our recommendations

→ *We recommend including an exclusion requirement for both CTB and PAB for sectors that cannot be aligned with the Paris-Aligned Scenario.*

→ *We recommend accelerating the effective implementation of full scope 3 by all sectors.*

→ *We recommend applying the decarbonization reduction target at an entity-level instead of a portfolio-level.*

B. Key Risk Indicators

So far, the regulatory framework has been mainly focusing on sustainability indicators and little attention has been given to sustainability-related risks. We believe that sustainability-related risks should not be underestimated as they can lead to significant pricing adjustments and to potentially systemic new market failures (through credit cutbacks and non-insurability of risks). A more thorough analysis on these risks can also foster a culture for adaptability strategy, notably at an entity-level, which is very much needed. We note that sustainability-related risks are insufficiently covered in the EU regulatory framework.

In order to ensure utmost transparency for market participants and avoid intentional or unintentional greenwashing occurring through over-optimistic statements and measures, an assessment of sustainability-related risk or KRI (Key Risk Indicators) should be worked on at several levels:

<u>At an entity-level</u>:

- *Through disclosure requirements*: E1-15 in ESRS already requires companies to provide an understanding of how material climate-related physical risks may affect the company's performance and position over the short, medium and long term. However, this requirement solely focuses on physical risks and remains insufficiently specific in its definition of what is considered a physical risk. We believe risk analysis and reporting should also include notions of transition risk (e.g., reputational or regulatory risks, policy or technology shifts etc.).

- *Governance:* Embedding sustainability-related risks by linking executive compensation to the evolution of the company's adaptability measures and sustainability-related risk metrics can be a way of encouraging management to take heed of such risks and take action to take a step forward in their adaptability strategy therefore protecting their company, their investors, their lenders, and insurers from these risks.

- *Due diligence:* The CSDD Directive includes obligations on addressing environment-related risks and hereby completes the disclosure-focused approach of the CSRD. The CSDD requirements should give further guidance on the precise definition of environment-related risks and broaden its definition to include transition risks, market and regulatory risks, credit risks and insurability risks. These risk assessments should concern all entities present along the regulated entity's value chain: i.e., clients, suppliers and also their own capital-holders. The analysis should include for each stakeholder of the entity's value chain a geopolitical assessment to evaluate the regulatory risk depending on the country in which the company's assets, clients and suppliers are based. If we are to achieve this goal, an Open data policy for ESRS data points must be implemented.

Our recommendations

→ *We recommend broadening risk assessments in ESRS requirements to go beyond physical risks.*

→ *We recommend providing further details on how to assess physical risks.*

At the financial markets level:

- *ESG ratings:* Most often, ESG ratings take into account sustainability factors for the Environment, Social and Governance pillars on a Key Performance Indicator perspective rather than a Key Risk Indicator perspective. As a result, companies are rated according to durability factors such as carbon intensity (Environment), percentage of women in the company board (Social) and independence of board members (Governance). These KPIs lead to a "check-the-box" bias in the investment decision process and therefore for companies through investor's shareholder engagement campaigns. While putting the emphasis on unadapted indicators for some industries, it can also potentially be detrimental for adaptability goals.

- *ESG investment decision processes*: ESG funds often use a screening approach relying either on the above-mentioned ESG ratings or sectorial and normative exclusions. Several regulatory frameworks serve as guidelines for funds' investment decision process, such as the DNSH or the PAI. The overall objective of the DNSH disclosures is to ensure that financial market participants analyze and disclose adequate information about how their investments adhere to the precautionary principle of DNSH so that neither the environmental, nor the social objective is significantly harmed. PAI or Principle Adverse Impact are a set of mandatory indicators and metrics which aim to show financial market participants how certain investments present sustainability risks. These sets of indicators have implied repercussions on asset managers' investment decision processes through ESG screening or rating. We believe these indicators should be complemented with a set of sustainability-related risks that go beyond physical risks (transition risks, regulatory risks, risk of stranded assets etc.).

- *Financial products DICI:* The RTS (Regulatory Technical Standards) laid down in Delegated Regulation (EU) 2017/653 establishes that the generic KID (Key Information Document) for the UCITS and non-UCITS funds should show a range of risk classes in the format of the PRIIPs risk scale. We believe that at least the KID of UCITS funds should also withhold a sustainability-related risks scale. This risk scale could include existing sustainability risk-related frameworks such as the PAI or DNSH.

Our recommendations

→ *We recommend complementing the DNSH and PAI indicators with a set of sustainability-related risks that go beyond physical risks (transition risks, regulatory risks, risk of stranded assets etc.).*

→ *We recommend enhancing the risk management framework by incorporating sustainability risk indicators (e.g., Include sustainability risk scale in Key Investor Document (KID) for all UCITS funds; Add climate risk indicators as part of credit analysis, etc.).*

On a credit and insurance stability level:

- *Insurability analysis*[58]: The main areas of risk for the insurance industry are physical, transition and liability risks. The industry needs to develop a holistic approach to climate risk exposure by incorporating it in the insurers risk-modeling and capital requirements. Given the continuously evolving impact of climate change on natural catastrophes' frequency and intensity, a regular re-assessment of the capital requirements for insurers is an important step. Models also need sufficient granularity to integrate the latest considerations on climate change depending on the nature of the catastrophe and on countries or regions affected. The overall objective must be to ensure the solvency of the insurance sector against rising physical risk exposures. Transition risk, together with changes in social behavior are also expected to have a general effect on the viability of business models and on the NPV and break-even point of carbon-intensive projects. It is essential for insurers to assess climate risks both in the short term, and in the long-term using forward-looking scenario analysis and looking at both physical and transition risks. Recently proposed amendments to the Solvency II Directive by the European Commission reflect these considerations and should be strengthened and validated.
- *Credit risk analysis:* Climate change could affect the quality of a bank's credit

[58] For further information please refer to: [Banque de France Climate Change risks] and [Observatoire des risques climatiques, Michel Lepetit]

portfolio through its repercussions on the ability of households and firms to repay their debts or meet their obligations. Namely, physical risk arising from climate-related events can translate into a higher Probability of Default (PD) and Loss Given Default (LGD) on loan books (Bolton et al. 2020). Credit risk might also increase as a result of the fall in collateral values and the write-off of stranded assets. Furthermore, the transition towards a low-carbon economy could bear on the riskiness of credit portfolios via changes in property values, which might stem from tighter energy efficiency standards or similar climate-related policy interventions (Monnin 2018). As such, testing the resilience of corporations to potential materializations of physical and transition risks is of capital importance for the banking industry and for rating agencies. We note that rating agencies are increasingly re-evaluating credit risks in the light of growing climate-related risks. However, if we want to fully appreciate the potential systemic dimension of climate-related events, more work is still needed on how a climate-related asset price shock (e.g., stranded assets) could trigger other losses within a dynamic financial network, including contagion effects towards non-climate-related sectors.

A robust modeling of sustainability-related risks in the banking industry could impact the credit conditions for borrowers and the loan-to-value given to a collateral for any indebted client. These changes in credit policies have the power to impact any company or household's decision when it comes to climate-change adaptability and sustainability risk assessments.

- *Banks' capital adequacy ratios*: Central banks hold a major role by contributing to the coordination of the banking industry's efforts to combat climate change through the integration of climate-related risks indicators in their models. The ECB (Giuzio et al. 2019) has already established that Euro area banks' exposures to firms contributing to carbon emissions are sizable, with the 20 largest emitters accounting for approximately 20% of total large exposures (1.8% of total assets of the sample banks). Some studies find that banks' exposures to climate policy-relevant sectors represent a portion of loan portfolios comparable to their capital (Battiston et al. 2017), which raises serious concerns if a substantial part of these portfolios were to end up as stranded assets. Climate-related financial risks should be addressed at the earliest possible stages in order to reduce their effects on financial stability. We recommend including an assessment of European banks' Climate VaR (Value at Risk) in supervisory authorities' models which should accordingly impact all prudential regulation requirements they may have on banks. If we wish to maintain financial stability and avoid climate-related systemic risks, financial institutions should be required to hold additional capital in view of their climate risks. Nevertheless, it is crucial that the statistical model used to calculate a bank's Climate VaR is carefully crafted and gains consensus among both the banking industry and relevant stakeholders, including NGOs and think tanks.

Our recommendations

→ *We recommend incorporating ESG-related risks into credit risk analysis.*

→ *We recommend strengthening the Solvency II requirements related to climate risks by requiring insurers to identify any material exposure to climate change risks and, where relevant, to assess the impact of long-term climate change scenarios on their* *business.*

→ We recommend including a measure of climate Value at Risk (VaR) in the models used by supervisory authorities.

→ We recommend that banks be required to hold additional capital to account for their climate and other ESG risks.

→ We recommend allocating more resources to supervisory and regulatory authorities to address the issue of shadow banking, which poses a risk of capital escaping the regulatory framework.

On a financial advisory level:

Integration of sustainable risks into financial advisory firms: Investment firms should also adapt their financial advice with regards to a sustainability-related risks approach. The amendment to Delegated Regulation (EU) 2017/565 relating to the integration of sustainability factors, risks and preferences into certain organizational requirements and operating conditions for investment firms has started to implement the notion of sustainability risks in organizational requirements.
This regulation should be strengthened by giving further details on the sustainability risks that should influence investment decisions: physical risks, transition risks, short-term and long-term risks alike, so as to bypass the *tragedy of the horizon*[59].

Going beyond climate-related risk metrics:

There are numerous reasons to consider ESG risks as important, through the lens of double materiality. Contrary to what one might think from their definition, these two materialities are interconnected and amplify each other. Given that the transition towards sustainability carries the risk of increasing inequalities based on vulnerabilities, it is worthwhile to consider social risks in order to reduce their consequences, which can lead to economic losses. Thus, a fair transition and the consideration of double materiality not only benefit the reduction of companies' impact on society and the environment but also promote a better understanding of the inherent losses in different types of financing or credit.

To illustrate this point, two examples can be mentioned:

- The impact on biodiversity resulting from human activities leads to a collapse of resources, which eventually affects the activity and profitability of companies. Unfortunately, these risks are currently poorly evaluated (refer III - D. Reporting and Biodiversity).
- Similarly, work and employment are major aspects of a just transition, especially regarding issues of job adaptation and job losses by sector. In fact, in the context of the transition towards a low-carbon economy, some highly carbon-intensive sectors of activity are bound to disappear. Along with the elimination of certain "stranded jobs", the challenges of retraining are at the heart of the issues facing these sectors. These retraining efforts notably raise questions about the types of jobs offered, the training and pedagogical tools available and worker mobility, as well as the social

[59] https://www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability

dialogue deployed on these issues[60]. Therefore, a company in a sensitive sector that offers training related to the transition will better value its potential for professional development, job stability, and attractiveness. As a result, it will likely benefit economically from this policy.

- Moreover, risks related to stranded workers, child labor, or biodiversity losses can have a negative impact on a company's reputation and operations. Furthermore, bad governance practices can also lead to credit default. Therefore, taking into account ESG risks and considering the double materiality perspective can ultimately lead to better financial outcomes for companies.

[60] Gardes, C. & Fournier de Saint Jean, M. (2022). *Quels enjeux réglementaires, juridiques et de mise en œuvre pour le développement d'une finance durable ?* Cahiers de droit de l'entreprise. https://www.delsolavocats.com/Quels-enjeux-reglementaires-juridiques-et-de-mise-en-oeuvre-pour-le-developpement-d-une-finance-durable

VIII - Governance issues

The risk of greenwashing in governance could be defined as commitments to sustainability that are not credible or auditable and not in line with the practices observed within the governing bodies. We identified four risks of greenwashing in governance through: corporate culture, remuneration, audit and shareholder's rights.

A. Greenwashing risks in corporate culture

Coherence between publicly communicated policies and strategic decisions

Major banks are currently communicating out to civil society on their net zero commitments, while some are continuing the lucrative financing of fossil fuel expansion. This is seen as an incoherence behavior between their publicly communicated policies and the strategic decisions that follow, highlighting the issue of deliberate governance greenwashing at top management levels. Let's remember that the International Energy Agency clearly states that its 1.5° C scenario assumes that we stop the financing of fossil fuel expansions.

The legal actions taken against major banking groups by NGOs is an illustration of the possibility of greenwashing behind commitments with contradictory appearances[61]. We will let the justice system decide on this case but encourage banks to strive for more coherence in terms of financing and commitment to decarbonization.

Clear lobbying policy

[61] France: 3 NGOs file climate lawsuit over alleged failure to comply with French duty of vigilance law - Business and Human Rights Resource Centre Feb 2023

We can observe incoherences in companies' influence networks, aiming at opposite goals. For instance, 65 international companies have signed up to the Alliance to End Plastic Waste (AEPW), with the purpose of ending 'plastic waste in the environment and protecting the planet'. At the same time, according to Planet Tracker, 68% of the AEPW's founding members are also in the American Chemistry Council (ACC), which lobbied to weaken the UN's global treaty on plastic pollution. In addition, the AEPW and ACC focus on plastic recycling and recovery rather than plastic production reduction and more than 90% of AEPW members have not supported the ''Business Statement for a Legally Binding UN Treaty on Plastic Pollution ''.[62]

Another means of influence is the permeability of executive functions between business and public services.[63] For instance, the major global high-tech players usually identified by the acronym GAFAM, hired dozens of former high-ranking officials in the government or heads of regulatory authorities to help them in their influence work.[64]

To tackle risks of greenwashing induced by lobbying, a group of investors and the *IIGCC* instigated the "Global Standard on Responsible Corporate Climate Lobbying". Their objective was to provide a framework to ensure that all lobbying efforts (direct and indirect corporate lobbying) are directed towards activities that positively support Paris Agreement Goals.[65]

Board and senior management's role in sustainability

We anticipate belated, weak or flawed commitments, which might lead to weak measures, and therefore a delayed and disorderly transition or no transition at all, as defined by NGFS Climate Scenarios[66] with investors dedicating inadequate resources for the assessment of the credibility and monitoring of the defined targets through time and their compatibility with climate scenarios. As boards and senior management actually decide the level of transparency and sincerity related to the information disclosed to the investors, the related action shall be consistent and controlled on a regular basis. Therefore, the sustainability strategy, objectives and action plans should be understood and integrated by the management. In addition, boards should be evaluated on their ability to deliver results on climate commitments, with investors' engagement and shareholder vote incorporating these outcomes along with financial results.

Our recommendations

→ *We recommend all members of the management body to have, not only basic theoretical understanding but also technical and scientific knowledge in sustainability questions through ongoing training.*[67]

→ *We recommend allocating more resources to the oversight of the Transparency Register. Supervision of lobbyists' activities should be strengthened to mitigate the asymmetry in interest representation between industries defending commercial interests and NGOs or think tanks advocating for environmental protection and social rights.*

[62] Planet Tracker questions credibility of Alliance to End Plastic Waste
[63] Quand les parlementaires français sont aussi consultants, lobbyistes ou hommes d'affaires... - Observatoire des multinationales
[64] GAFAM Nation - Observatoire des multinationales
[65] Context - Responsible climate lobbying: The global standard
[66] NGFS climate scenarios provide a window into different plausible futures
[67] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.fit_and_proper_guide_update202112~d66f230eca.fr.pdf

→ *We recommend extending and strengthening the French Law Sapin II[68], on a European scale to enhance transparency obligations for lobbyists, NGOs, and companies.*

→ *We recommend that businesses aiming to decarbonize their activities begin with upstream discussions, following a decarbonization roadmap, such as "The Chairperson's Guide to Decarbonization"[69] published by the Climate Governance Initiative. For net zero agreements, decarbonization targets should be based on and validated by a scientific framework, such as the Science Based Targets initiative (SBTi), and businesses must demonstrate clear follow-through on their commitments. Furthermore, the framework and methodology used to audit these targets should be harmonized at the European level to prevent greenwashing and undesirable methodological gaps.*

→ *We recommend assigning responsibility for climate and environmental matters to multiple board members, functions, and investors to develop analytical capabilities for assessing the credibility of their climate and environmental targets and scenarios.*

B. Greenwashing risks in remuneration

Existence of clawback

Clawback refers to all or part of the variable compensation received by an executive that needs to be returned due to particular events or under circumstances defined by the clawback clause. Commonly, compensation received on the basis of incorrect accounting data or erroneous company accounts are concerned, even in the absence of fault.

In addition, it has been observed that a battery of financial consequences are tested after clawback adoption, among which, the increase of environmental, social and governance (ESG) and diversity performance.[70]

This practice has not yet become common and should also extend to sustainability matters; for example, a clawback could be triggered by exceeding thresholds for GHG emissions or wastewater discharge.

Remuneration policy properly disclosed and linked to sustainable-value creation

The risk of misleading information regarding remuneration policy is also to be overwatched. For example, the Danish Financial Supervisory Authority (DFSA) has put four pension and insurance firms on notice, because of the lack of details regarding sustainability risks within their remuneration policies.

Carried interests indexed on extra-financial performance

[68] What is the French Sapin II Law? https://www.dowjones.com/professional/risk/glossary/anti-bribery-corruption/french-sapin-ii-law/

[69] The Chairperson's Guide to Decarbonization Understanding the decarbonization roadmap

[70] Babenko, Ilona, Benjamin Bennett, John Bizjak, Jeffrey Coles and Jason Sandvik. 2019. Clawback Provisions and Firm Risk. Working Paper. Utah. https://link.springer.com/article/10.1007/s40685-020-00135-9

We note a new trend for Private Equity impact funds to sometimes index the share of profit earned by the general partners on extra-financial performance indicators (e.g. ESG scores or proprietary models evaluating climate-related performance). The lack of standardization and transparency on the methodologies used to calculate these performance indicators is a greenwashing prompt and can be highly misleading for investors.

Our recommendations

→ *We recommend the mandatory integration of ESG risks into remuneration. ESG objectives must be both ambitious and measurable. The portion of remuneration tied to ESG should not rely solely on qualitative objectives. For instance, European banking supervision provides examples of KPIs that could be monitored.*

→ *We recommend, following the sustainability training of the management body, that ambitious sustainability targets be established to drive meaningful actions. Failure to meet these targets or a lack of concrete steps in transition planning should result in negative consequences for sustainable clawbacks, affecting individuals across the hierarchy, from senior management to junior analysts. This ensures accountability and reinforces the commitment to tangible sustainability outcomes.*

→ *We recommend establishing a carried interest for private equity (PE) management teams based on the performance of funds in relation to their alignment with the transition trajectory defined by the IPCC by sector.*

→ *We recommend that rewards be calculated not only on past performance but also on the gap between the portfolio's trend and the target curve up to 2050.*

→ *We recommend that, during the validation process for the nomination of CEOs in financial institutions, the candidate's past track record in failing to integrate sustainability into their management policies be thoroughly evaluated. This ensures that the new CEO has demonstrated a strong commitment to sustainability and is well-positioned to lead the company in aligning with its long-term environmental goals.*

C. Greenwashing risks in shareholder's rights

Voting rights

When a shareholder majority approves an unambitious say-on-climate plan and markets it, this can be seen as a greenwashing lever diverting investors from real commitments.

For instance, a majority of shareholders from a global oil and gas actor, voted in favor of its Say on Climate in 2022, even though there was not enough information disclosed regarding the Scope 3 emissions reduction, nor the alignment with Paris Agreement Goals[71].

[71] Investors pressure TotalEnergies to align with Paris climate deal

Creating voting programs to incentivise shareholders, particularly passive ETF investors, to adopt more active voting policies is a growing trend that warrants close monitoring to mitigate potential greenwashing risks. Encouraging more shareholder engagement without ensuring genuine sustainability actions could lead to misleading claims, undermining the credibility of such initiatives.

The issue with passive/index investment

We identify an issue with voting rights through the rise of passive/index investment management. There are several reasons to believe that the rise of passive investing can have harmful consequences for firm governance, shareholders, and the transition. The scope of this problem is potentially immense as investors continue to flock toward passive investment vehicles.

The large asset managers that dominate the passive/index fund market are able to influence the outcome of shareholder interventions potentially creating widespread harm depending on the passive asset manager's responsiveness to climatic issues.

Our recommendations

→ *We recommend that General Assembly resolution documentation regarding companies' climate strategies include sufficient information (such as decarbonization objectives across all GHG emissions scopes in the short, medium, and long term, means to achieve those objectives, and alignment with Paris Agreement goals) to enable investors to assess whether the climate plan meets necessary requirements and whether they are fulfilling their role by voting wisely*[72].

→ *We recommend encouraging shareholders to actively use their voting rights to support climate ambition.*

→ *We recommend that passive/index investment management either be required to delegate their voting rights to fund investors or to transparently communicate how their voting decisions on ESG issues align with climate commitments.*

→ *We recommend developing a vote tracking framework specifically for climate plans.*

→ *We recommend implementing a framework that provides sufficient and scientifically-based information on environmental objectives to prevent any form of greenwashing.*

[72] Say On Climate › Forum pour l'Investissement Responsable - FIR

Acronyms Table

ADEME: Agence de l'environnement et de la maîtrise de l'énergie

AEPW: Alliance to End Plastic Waste

AMF: Autorité des marchés financiers

Clim Var: Climate Value at Risk

COP: Conference of the parties

COVID 19: Coronavirus disease 2019

CSDD: Corporate Sustainability Due Diligence

CSR: Corporate Sustainability Reporting

CSRD: Corporate Sustainability Reporting Directive

CTB: Climate Transition Benchmark

CVaR: Conditional Value at Risk

DFSA: Danish Financial Supervisory Authority

DNSH: Do No Significant Harm

EAD: Exposure At Default

EBA: European Banking Authority

EBF: European Banking Federation

ECB: European Central Bank

EFRAG: European Financial Reporting Advisory Group

EL: Expected Losses

ESA: European Supervisory Authorities

ESG: Environnemental, Social and Governance

ESRS: The European Sustainability Reporting Standards

EU: European Union

EU GBS: European Union Green Bond Standards

GAFAM: Google, Apple, Facebook, Amazon et Microsoft

GFANZ: Glasgow Financial Alliance for Net Zero

GHG: Greenhouse Gas

GSS: Green, Social and Sustainable

ICMA: International Capital Market Association

IEA: International Energy Agency

IGCC: Investor Group on Climate Change

IMF: International Monetary fund

IPCC: Intergovernmental Panel on Climate Change

KID: Key Information Document

KPI: Key Performance Indicator

KRI: Key Risk Indicators

LGD: Loss Given Default

LSTA: Loan Syndications and Trading Association

MS: Minima Social Safeguards

MSCI: Morgan Stanley Capital International

NFRD: Non-Financial Reporting Directive

NGFS: The Network for Greening the Financial System

NGO: Non-Government Organization

NPV: Net Present Value

NZBA: Net Zero Banking Alliance

OECD: Organisation for Economic Cooperation and Development

PAB: Paris-Aligned Benchmark

PAI: Principal Adverse Impacts

PD: Probability of Default

PRI: Principles for Responsible Investments

PRIIP: Packaged Retail Investment and Insurance-based Products

R&D: Research and development

RTS: Regulatory Technical Standards

SBTi: Science Based Target initiative

SDGs: Sustainable Development Goals

SFDR: Sustainable Finance Disclosure Regulation

SLB: Sustainability-Linked Bond

SLBP: Sustainability-Linked Bond Principles

SLCF: Sustainability Linked Credit Facility

SLL: Sustainability-Linked Loan

SLLP: Sustainability-Linked Loan Principles

SPO: Second Party Opinion

SPT: Sustainability Performance Target

SRI: Social and Responsible Investment

TCFD: Task Force on Climate-related Financial Disclosures

UCITS: Undertakings for Collective Investments in Transferable Securities

UHNWI: Ultra High Net Worth Individuals

UL: Unexpected Losses

UNEP: United Nations Environment Programme

UNEP FI: The United Nations Environment Programme - Finance Initiative

UNFCCC: United Nations Framework Convention on Climate Change

VaR: Value at risk

Other abbreviations

°C: Celsius Degrees

CO_2: Carbon Dioxide

J: Joule

kWh, GWh, TWh: Kilowatt-hour, Gigawatt-hour, Terawatt-hour

Mtoe: Million Tonnes of Oil Equivalent

Nr: Numero

USD: United States dollar

SSP: Shared Socioeconomic Pathways

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  Illustration: Christophe Thollet alias "Papa Vigere"

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This report stands as a collective effort, and we are truly thankful for the collaborative spirit that fueled its creation. May the recommendations herein contribute to fostering a more transparent and sustainable financial landscape in the European Union.

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THE SHIFTERS

The Shifters est une association créée en 2014 pour diffuser des idées et solutions visant à réduire les émissions carbones de nos sociétés et notre dépendance aux énergies fossiles (pétrole, gaz, charbon). L’association partage la vision du think tank **The Shift Project** sur la réalité du changement climatique et la nécessaire transition bas-carbone.