Hertie School
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Policy Brief

Show greenwashing the red card

How Europe can make sustainable finance work

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#GreenTransition
#ESG
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What Europe needs is not a regulatory pause, but better legislation. In record time, the EU has rolled out a comprehensive disclosure regime for sustainable finance. But the nascent regulatory framework is challenging to implement, remains vulnerable to abuse by those seeking to game the system and fails to provide meaningful guidance to investors. Despite detailed legislation, financial market participants differ significantly in their expectations of sustainable investment products and face the risk of greenwashing, where issuers - intentionally or unintentionally - make misleading sustainability claims. To enable private investment to finance Europe's transition to net zero, this policy brief proposes short-term measures to combat greenwashing plus reforms that should be adopted once the next European Commission has assumed office. For the EU to uphold its status as a global benchmark for sustainable finance, lawmakers and regulators must urgently improve the rules in place and ensure that they are applied consistently across member states.

Private money is key for Europe to reach its climate goals. Financing the transition to net zero cannot rely on public money alone. With the aim of encouraging private investment in a climate-neutral economy, Europe has been rolling out a comprehensive disclosure regime promoting sustainable finance. The EU is asking companies to report in detail on sustainability risks and performance and thus give investors the information necessary to make sustainable investment decisions. Of course, it is the role of economic and climate policy to provide the regulatory environment conducive to boosting sustainable investments in the real economy. But sustainable finance can support the transformation to a clean energy economy by enhancing clarity on the sustainability of investment alternatives.

The EU sustainable finance framework is not working as intended. Thanks to regulatory action in the EU and pressure from various stakeholder groups, environmental, social and governance (ESG) investment has risen to the top of the business agenda. However, complex, patchy and inconsistent regulation, a mismatch between scarce green assets and strong demand for sustainable financial products, and greenwashing allegations involving big names in the fund management and ESG rating provider industry create uncertainty for both issuers and investors. Confused investors are losing confidence and hesitating over whether to go green. Honest issuers fear reputational damage over greenwashing accusations while others exploit loopholes in legislation or enforcement and sell 'sustainable' products that contribute little to the greening of the economy. Some of these practices have recently come under investigation by regulators. But lacking unambiguous rules and reliable sustainability data, authorities have their hands tied when acting on financial products with dubious environmental credentials. Where the regulatory framework fails to ensure certainty for financial market participants, it cannot attract the investment we need for transforming Europe's economy.

Europe must show a red card to greenwashing. To get private money to truly finance the green transition, this policy brief argues that the EU must take its sustainable finance framework to the next level and make it greenwash-proof. After explaining the importance of fighting greenwashing, we summarise the major shortcomings of the current sustainable finance framework and then make recommendations for ensuring that money spent for sustainable purposes genuinely serves action on climate. Our proposals include short-term measures that can help financial markets promptly play their part in the transition plus reforms that should be enacted in the next legislative term.

1 Greenwashing as the pivotal challenge for sustainable finance

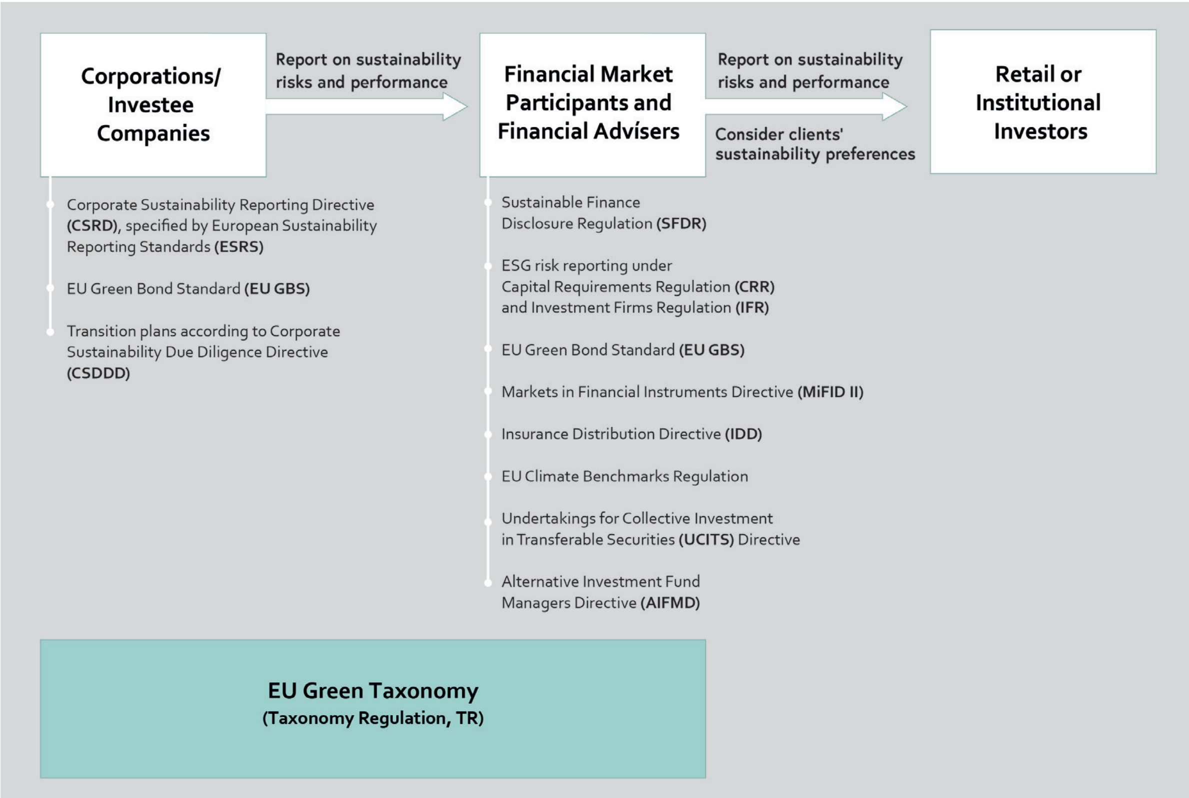
The EU has established a regulatory framework for sustainable finance that promotes investment in the transformation of the European economy. However, greenwashing in the financial sector indicates that the framework is not working as intended and may fail in its goal of attracting private money for the green transition.

1.1 How the EU regulatory framework shall work in theory

Sustainable finance is designed to reorientate private money towards sustainable economic activities. Following the 2015 Paris climate agreement which included the commitment to align financial flows with a pathway towards low-carbon and climate-resilient development, the EU Commission in 2018 adopted an action plan on financing sustainable growth. The idea behind sustainable finance is as follows: financial markets decide on capital allocation within the economy. If the objective is to reach a climate-neutral economy, climate change must become a relevant factor in financial decisions. So far, policymakers have, however, shied away from enacting measures that would oblige financial market participants to invest in sustainable activities or limit their investment in non-sustainable businesses. Instead of forcing investors to go green, EU lawmakers want to provide them with transparency on the sustainability performance and risks of companies and financial products. The EU Green Taxonomy is the central system for classifying economic activities that contribute substantially to environmental objectives. However, only the voluntary EU Green Bond Standard (EU GBS) requires investments financed with the proceeds of these bonds to be fully Taxonomy-aligned. The other legislative pieces of the EU sustainable finance framework merely contain loose references, if any, to the Green Taxonomy.

With the aim of empowering investors to make sustainable investment choices, the EU adopted a comprehensive disclosure regime. Figure 1 illustrates the stylised information flow within the EU sustainable finance framework. Financial market participants are at the centre of the disclosure regime. Under the Sustainable Finance Disclosure Regulation (SFDR), financial companies must publish sustainability metrics, disclose methods for incorporating sustainability factors, and report on the material adverse sustainability impacts for any product that has the full or partial objective of making sustainable investments. Financial benchmarks that wish to comply with the EU Climate Benchmarks Regulation must show how their methodology reflects ESG factors and disclose their alignment with the Paris Agreement. Capital Requirements Regulation (CRR) and Investment Firms Regulation (IFR) contain additional requirements for banks and investment firms to disclose ESG risks and calculate green asset ratios. Furthermore, financial advisers falling under the scope of the Markets in Financial Instruments Directive (MiFID), the Insurance Distribution Directive (IDD), the Undertakings for Collective Investment in Transferrable Securities (UCITS) Directive, and the Alternative Investment Fund Managers Directive (AIFMD), are asked to consider their clients' sustainability preferences.

Figure 1: Stylised information flow within the EU sustainable finance framework



Source: Own illustration.

The financial sector relies on the sustainability reporting provided by non-financial companies. To fulfil their own reporting obligations, financial companies need granular information from the real economy. The EU Green Taxonomy Regulation requires undertakings to disclose the proportion of their activities that are Taxonomy-eligible or Taxonomy-aligned. In addition, companies must report about sustainability risks and performance under the Corporate Sustainability Reporting Directive (CSRD) and the corresponding European Sustainability Reporting Standards (ESRS) that will soon replace the less detailed Non-Financial Reporting Directive (NFRD). On top of all this, transition plans drawn up under the Corporate Sustainability Disclosure and Due Diligence Directive (CSDDD), now being negotiated by EU co-legislators, will oblige companies to align their business with the Paris Agreement and, thus, provide additional sustainability data to investors.

1.2 Why Europe must address greenwashing in the financial sector

The environment for sustainable investments is, as of now, untrustworthy. Companies that lack accurate information from third parties, have limited capacity to reliably process sustainability data internally or try to unfairly benefit from higher prices charged for green products, may portray themselves as more sustainable than they actually are. The practice of making misleading sustainability claims is called 'greenwashing'. In the financial sector, the most widespread practices include cherry-picking and leaving out information, ambiguity, empty claims, exaggeration, arbitrary use of ESG terminology, and misleading or suggestive imagery. A consistent definition of greenwashing is absent from EU law, but the European Supervisory Authorities (ESAs) understand it as "a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services. This practice may be misleading to consumers, investors, or other market participants".

Greenwashing compromises financial market integrity and stability. Where investors are deceived by misleading claims about the sustainability of their investment, this is first and foremost an issue of consumer protection and the integrity of financial markets. However, the negative consequences of greenwashing do not stop at the buying side. Banks, investment firms, asset managers, benchmark administrators and non-financial firms issuing green debt, too, can suffer reputational damage, legal consequences, or economic losses if they – accidentally or intentionally – fail to make accurate and non-misleading disclosures. In either case, greenwashing allegations erode confidence in sustainable finance which is detrimental to making progress on a green capital markets union. What's more, omission and cherry-picking of relevant information on climate risks may endanger financial stability. Where financial market participants disregard climate risks which then suddenly materialise in destroyed property and devalued natural reserves, the resulting financial losses can be substantial and may spread to the broader financial system.

Ultimately, the EU's climate goals are at stake. Greenwashing has consequences that go far beyond financial markets. If sustainable finance fails to meet its declared objective of reorienting financial flows towards green investment, too much money continues to flow into unsustainable activities. Instead of promoting the swift transformation to a clean-energy economy, greenwashed financial markets create new carbon lock-ins and hinder the necessary investment in low-carbon technologies. At worst, misrepresentation of climate risks may lead to public misperception, delay climate change mitigation action and prevent the EU from reaching its climate targets.

2 Major shortcomings of the current sustainable finance framework

To ensure financial markets support the transition to net zero, it is important to identify and understand the circumstances that enable misleading claims. This section presents the major shortcomings in the current sustainable finance framework that drive greenwashing risks, namely

1. Scarce green investment opportunities in the real economy
2. Complex and burdensome requirements
3. Data constraints
4. Regulatory gaps and inconsistencies
5. Absence of reliable guidance for sustainable investors
6. Bad behaviour by financial firms
7. Enforcement gap

2.1 Scarce green investment opportunities in the real economy

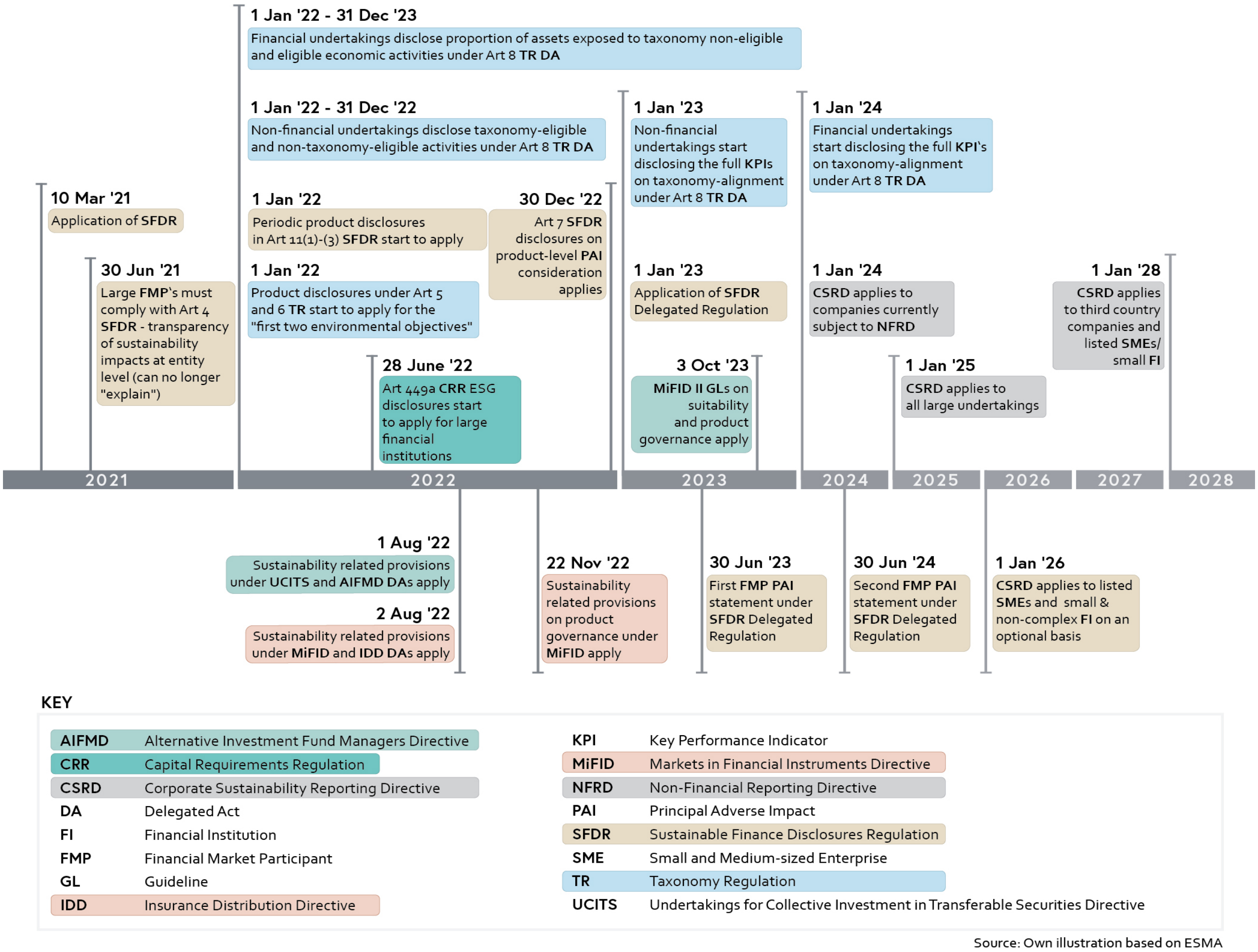
There is a mismatch between the strong demand for sustainable investment products and the limited pool of green investment opportunities available in the real economy. In recent years, the demand for sustainable financial products has clearly outpaced the increase in green real-world investment. As of 2021, ESMA deemed only 1.4% of EU fund equity and corporate bond holdings to be compliant with the strict sustainability criteria of the EU Green Taxonomy. In a context of very low levels of Taxonomy-aligned assets, investment opportunities with reliable sustainability performance remain few and far between. Given this lack of green projects and the competitive drive for market share and revenue, companies are tempted to bolster their sustainability profiles or issue financial products with vague green credentials. Reducing this mismatch requires first and foremost economic and environmental policies that create the right conditions to promote green investment in the real economy. Nevertheless, sustainable finance regulation could help to meet the strong demand for sustainable products by also taking into account investments that support the transition but do not yet satisfy the ambitious requirements of the EU Green Taxonomy (more on that below under 2.4).

2.2 Complex and burdensome requirements

Increasing transparency on sustainability performance and risks is necessary, but the rapidly expanding rulebook poses application challenges. Since the first sustainable finance strategy emerged in 2018, EU lawmakers have adopted an impressive number of new disclosure requirements and created tools to help investors identify sustainable investment opportunities. Figure 2 (on page 6) illustrates that the many laws passed in the recent past must be implemented within a tight timeframe. The majority of financial firms seek to comply with the complex regulatory framework and provide their clients with relevant and high-quality information on sustainability aspects. However, they face difficulties in developing reliable IT systems, building the right data infrastructure and in finding qualified staff with the skills and expertise needed to apply the new rules correctly.

The regulatory framework lacks simplicity and consistency. It is undeniable that the comprehensive set of sustainable finance rules adopted over the last five years creates complex requirements and far-reaching, sometimes overlapping reporting obligations. Delays in the adoption of technical standards and snap changes in regulatory guidance make it even more difficult for practitioners to stay on top of things and comply with all requirements. While the majority of asset managers and financial institutions think that ESG-related regulation is "necessary and ultimately manageable", the European Commission acknowledges the need to address the implementation challenges. It is carrying out an assessment of the SFDR, looking at issues such as legal certainty, usability and how the Regulation can play its part in tackling green-washing. Furthermore, within its strategy for cutting red tape by 25%, the Commission proposed streamlining reporting requirements and making it easier for European financial supervisory authorities to exchange information.

Figure 2: Implementation timeline of selected EU sustainable finance rules



Source: Own illustration based on ESMA, Sustainable Finance Implementation Guideline, 2023.

2.3 Data constraints

Limited availability and quality of sustainability data is compromising the reliability of ESG metrics and disclosures. At the moment, companies face serious difficulties in gathering data from all entities in their value chain and from the fact that most sustainability-related data is not audited or otherwise externally verified. Whereas financial companies must already disclose detailed information according to SFDR and CRR/IFR, the existing NFRD reporting requirements applicable to non-financial companies are rather rudimentary and reporting under the more comprehensive CSRD will start only in 2025 for the 2024 financial year. Due to this reversed sequencing of EU disclosure requirements, financial market participants must often resort to information provided under voluntary reporting frameworks developed by the private sector. However, the multitude of sources creates an informational landscape where proper scrutiny is cumbersome and sometimes even impossible. Limited data availability and reliability, compounded by difficulties in developing internally the expertise and data infrastructure needed, has forced financial institutions to make assumptions, settle for estimates or rely on external ESG data and rating providers such as MSCI and Moody's to meet their own disclosure requirements and provide accurate sustainability information to investors. This, however, does not come without new greenwashing risks.

ESG scores given by issuers can significantly vary across data providers. While ESG ratings are meant to fill current gaps in sustainability information, they present numerous shortcomings, including a tendency to focus on the quantity and quality of disclosures rather than actual performance when evaluating issuers. On top of that, the ratings differ in their focus: some capture both the sustainability risks for the rated company and the company's impact on the outside world ('double materiality'), while others look at just one of these two sides. As rating providers inadequately disclose their methodological choices, investors are in no position to understand the rationale behind the rating. Moreover, entities can cherry-pick those ESG ratings that present them in the best possible way. To address such problems, the European Commission has put forward legislation that would increase transparency on ESG scoring methods. This would help users, namely benchmark administrators and investors, better understand the reasoning behind individual ratings. However, it would not eliminate the variability in ESG ratings nor improve their comparability.

Data access and quality are expected to improve. On 23 May 2023, the European Parliament and the Council reached a provisional agreement on the creation of a European single access point (ESAP) providing access to public financial and sustainability-related information about EU companies and investment products. The ESAP platform will facilitate access to sustainability data for financial market participants but not before 2027. What's more, the Corporate Sustainability and Due Diligence Directive (CSDDD), if adopted by the European co-legislator, will require large companies to implement transition plans. This will improve the availability of standardised, audited forward-looking information about emissions reduction targets and transition pathways from issuers. Furthermore, CSRD reporting will commence in 2025. The CSRD constitutes a major update to the NFRD by introducing more detailed reporting requirements for company impacts on the environment, human rights and social standards and sustainability-related risk. The new rules quadruple the number of companies required to provide sustainability disclosures to over 50,000 from around today's 12,000, with phase-in periods for smaller or non-listed companies. Specifying the CSRD requirements, the European Financial Reporting Advisory Group (EFRAG) in November 2022 delivered the first set of horizontal draft European Sustainability Reporting Standards (ESRS) applicable to all companies.

Sustainability data from the real economy will remain scarce. Three developments could prevent the CSRD from closing the financial sector's data needs. First, substantially weakening the horizontal ESRS draft standards proposed by EFRAG, the European Commission has drastically reduced the number of mandatory data points in the final standards and has subjected the remaining data points to a materiality assessment. Disregarding demands from the financial sector and scientists, reporting of important climate indicators such as Scope 1, 2, and 3 emissions will thus not be mandatory for all reporting entities. Second, the Commission suggests amending the EU definition for SMEs. If the co-legislators do not object to the proposal for raising the SME thresholds for balance sheet total and net turnover by 25%, many companies would be spared from CSRD reporting. Third, the Commission proposed delaying adoption of the first sector-specific ESRS standards scheduled for June 2024 by two years to give companies more time.

Curbing the administrative burden on companies has its limits. The Commission's efforts to restrict the number of additional ESRS reporting requirements follow a joint push from the German and French governments to cut red tape "to what is strictly necessary" and calls by centre-right EU parliamentarians not to overburden companies with complex reporting obligations. While streamlining irrelevant and redundant disclosure requirements may well be warranted, discarding several parts of the ESRS endangers the consistency and functionality of the entire sustainable finance disclosure regime. Without detailed data from smaller companies, financial firms would still have to rely on external data to assess their sustainability, or make individual requests for information, which imposes additional administrative burdens on both sides. The sector-specific standards, in turn, are important to investors as they would provide data that is more informative and relevant. Furthermore, they would define uniform formats for the disclosure of transition plans. As a result, the Commission proposals to cut red tape undermine the objective of the ESRS to improve the availability, comparability and reliability of sustainability-related corporate disclosures. The latter are essential for financial market participants to make informed decisions and produce their own sustainability-related disclosures required by EU law.

2.4 Regulatory gaps and inconsistencies

The EU Green Taxonomy provides clarity on environmentally sustainable economic activities, but it has a limited scope. The EU Green Taxonomy Regulation is a unique system for classifying environmentally sustainable economic activities. It does not, however, provide for different shades of green. The assessment is a binary decision: either the economic activity meets the strict conditions and is thus taxonomy-compliant or it does not. As a result, investments that support the transition but do not yet meet the ambitious requirements of the EU Green Taxonomy are treated in the same way as environmentally harmful operations. Where there is no guidance for assessing the greenness of substantial parts of the economy, financial market participants lack clarity as to the qualification of economic activities and the financial flows financing them. What‘s more, the Taxonomy‘s scope is limited to environmental sustainability and a public classification system for socially sustainable economic activities is not in sight. The various limitations of the Taxonomy pose legal and reputational risks for honest players and allow black sheep to offer products with dubious sustainability credentials.

The SFDR fails to deliver reliable and relevant information for financial products marketed sustainable. The SFDR is a three-tiered disclosure regime (see Box 1). The more ambitious the sustainability credentials of a fund, the higher the compulsory disclosure requirements that it must fulfil. However, the SFDR suffers from three major shortcomings that create confusion and legal uncertainty. First, the SFDR concept of ‘sustainable investment’ mixes environmentally and socially beneficial investments. A fund pursuing only a social objective without caring about its carbon footprint may still qualify as sustainable. Although legal, this may confuse investors who expect any sustainable financial product to be environmentally friendly. Second, the SFDR does not include compulsory guidance to measure how a fund ‘promotes’ environmental or social characteristics or ‘contributes’ to these objectives. Instead of providing standardised methodologies and calculation metrics, the SFDR leaves it to issuers to define their own criteria for assessing a fund’s sustainability. This discretion can be abused for making misleading claims and makes it impossible to compare different products. Third, for environmentally sustainable investment, the SFDR is not fully aligned with the Taxonomy but allows the use of arbitrary resource efficiency indicators and applies a looser Do-No-Significant-Harm test. The lack of coherence between the two regulations confuses investors.

Box 1: Disclosure requirements according to the SFDR

The SFDR requires transparency according to the sustainability ambition of a financial product:

- Article 6 products may or may not integrate sustainability risk into the investment process.
- Article 8 products (often wrongly referred to as ‘light green products’) are those that **promote environmental or social characteristics.**
- Article 9 products (often wrongly referred to as ‘dark green products’) are those that **contribute to an environmental or social objective.**

The European Commission acknowledges that the SFDR needs to be reviewed. To clarify the interaction of the SFDR with EU climate benchmarks and the EU Green Taxonomy, the Commission published dedicated Q&As in April and June 2023. However, inconsistencies and unclarities remain that give rise to fears of greenwashing and mis-selling of products. That is why the Commission has launched a far-reaching review of the SFDR. The targeted and public consultations will run until the end of 2023 and prepare the ground for a legislative proposal after the European elections in 2024. Furthermore, the ESAs are preparing technical revisions to the SFDR Delegated Regulation so it focusses more on social and transition finance (more on that below).

2.5 Absence of reliable guidance for sustainable investors

The current framework fails to guide investors through the jungle of sustainable investment opportunities. To date, there is no public classification system giving reliable orientation on the greenness of sustainable financial products. Many ESG investors seek to generate a positive impact with their money. However, 'impact' is a term that is not yet recognised as a legal concept in EU law. Consequently, there are no specific requirements that apply directly to a financial institution's claim to engage in impact investing or to the marketing and distribution of a product that purports to be an impact product. Another blind spot in the sustainable finance rulebook is 'transition finance' that is meant to help the most polluting companies to slash their use of the most carbon-intensive fuels. Transition finance is crucial to reach the EU's short- and mid-term emission reduction targets. However, without a clear definition of transitional economic activities, investors, carbon-intensive firms and financial institutions struggle to channel financing to lower-carbon projects. And even when it comes to investment in a business activity that is demonstrably environmentally sustainable, there is only the voluntary EU Green Bond Standard (EU GBS) that ties the bonds' use of proceeds to Taxonomy-compliant economic activities. Issuers maintain their discretion to sell products without the EU label and thus ignore the Taxonomy's stipulations.

Labelling schemes developed by the financial industry lack reliability and standardisation. In the absence of a public classification system for sustainable financial products, financial institutions, benchmark administrators and ESG data providers have invented a multitude of private sustainability labels that are prone to self-certification and often lack transparency and comparability. Private labels can be misleading because their limited scope can result in cherry-picking information. Similarly, this may also be down to the design of their criteria because of a lack of ambition and too much ambiguity in the metrics used, or to a lack of ex-post controls ensuring that products and entities continue to meet the criteria. A prominent example here are net-zero initiatives that do not monitor the implementation of the targets. Given the limited reliability and the myriad design schemes of private labels, users cannot compare different products to find the ones that match their own sustainability preferences.

Retail investors are particularly vulnerable to misleading private labels. Consumers often do not understand the characteristics of specific products and the meaning of certain regulatory concepts. Many retail investors wrongly believe all SFDR Article 9 products must be Taxonomy-aligned and produce a positive environmental impact. This is in stark contrast to the existing regulatory framework that mostly leaves it up to fund managers to define why a financial product is green, and most consider sustainability as one of many input variables to improve the risk-adjusted returns of their investment strategy. Many consumers therefore are unaware that most ESG benchmarks present a low exposure to green industries, but a high exposure to the IT sector. On top of this, retail investors may not care to read the information provided in regulatory documents or fail to find relevant information where the issuer is opaque about the sustainable investment fund's holdings. The lack of easily accessible and understandable information often makes retail investors build their investment decision-making around fund names and labels, although this poses serious greenwashing risks.

No regulatory measures have yet been taken to better protect investors. Acknowledging the key role that labels play in terms of investor protection, the Sustainable Finance Action Plan of the European Commission foresaw the introduction of an EU ecolabel for financial products with public authority control. However, as so far only 16 out of 3,000 ESG funds would clear the bar for the EU ecolabel, the European Commission has not put forward a corresponding proposal. To combat the misleading use of funds' names as a marketing tool, ESMA has prepared draft guidelines on minimum requirements for ESG or sustainability-related terms in funds' names. However, owing to important concerns on the use of minimum thresholds when no clear definition of 'sustainable investment' is available, they are not in force yet.

2.6 Bad behaviour by financial firms

Black sheep who game the system undermine the credibility of the EU's sustainable finance framework. Since greenwashing, if undetected, may lead to a false positive image, higher product sales or higher prices, some firms try to exploit the loopholes in the regulatory framework or even knowingly violate the law. They aggressively market supposedly sustainable products with claims that are unsubstantiated, exaggerated, or based on cherry-picking. Investors cannot verify these statements – either because it would be very time-consuming or because not all the necessary information is publicly available. To give an example, a climate-focused fund's online advertisement claimed that retail investors would be able to achieve a calculable positive effect on their individual CO2 footprint that depends on the amount of their investment. However, the calculation of the fund's impact was based on estimates and did not include all companies in the portfolio, so the true impact could not be reliably determined. Another misleading practice consists of funds referencing their Article 8 or 9 SFDR classification in marketing materials or on their websites as an earned label ("light green fund" or "dark green fund") and over-egging its value, given that this classification alone is not enough to help appreciate the degree of sustainability of a fund and its investments. The SFDR is not a labelling regime, but a disclosure regulation designed to enhance transparency. By making misleading claims, financial firms deceive consumers and fuel doubts about how sound the regulatory framework is.

2.7 Enforcement gap

The novelty of sustainable finance regulation presents new challenges for supervisors too. Authorities tasked with overseeing sustainability-related information face similar challenges as market participants in applying the regulatory framework for sustainable finance. To understand and scrutinise sustainability-related claims, regulators must develop new expertise and skills and absorb a wide range of new obligations stemming from a regulatory framework that is not yet stabilised. In addition, the sustainability profile of entities and products builds on multiple pieces of mandatory and voluntary information that supervisors must check, covering both backward- and forward-looking data, as well as longer-term horizons than financial information usually covers. This is challenging for regulators tasked with protecting investors when they try to assess the plausibility and consistency of such claims.

A lack of supervisory oversight of sustainability-related claims increases the risk of greenwashing. In addition to implementation challenges, the absence of a comprehensive sanctions regime in SFDR, Taxonomy Regulation and CSRD hinders financial supervisors when it comes to acting against non-compliance with key provisions in the EU sustainable finance regulatory framework. It is hardly surprising then that the level of regulatory sanctions against greenwashing is very low in the EU and that the largest greenwashing fine on an asset manager to date was imposed by the U.S. Securities and Exchange Commission (SEC). The European enforcement gap lowers the expected costs of greenwashing and may incentivise market participants to avoid investing in resources such as capacity building or IT systems and setting up due diligence processes or exercising management oversight to tackle greenwashing risks. Weak enforcement may further encourage some firms not to play by the rules so as to gain an advantage over their competitors.

Dependence on national supervision leads to suboptimal results. While the sustainable finance rulebook is enshrined in EU legislation, supervision and enforcement lies primarily with national competent authorities (NCAs). This institutional setup carries the risk of fragmentation since national specificities exist in terms of financial supervisors' mandates and institutional cooperation arrangements among financial supervisors, competition authorities and consumer protection agencies. In addition, national competences carry the risk of supervisory capture. The negative consequences of forbearing national banking supervisors became clear at the onset of the global financial crisis. As for combating greenwashing, the readiness of NCAs to act vigorously could be thwarted by the political ambitions of individual member states to be the leading marketplace for sustainable finance. The risk of nationally biased supervision is aggravated by the fact that many national financial supervisory authorities in the EU are not sufficiently independent of political and economic influence.

The ESAs contribute to supervisory convergence across EU member states, but their powers are limited. With the development of common regulatory standards and the coordination of national supervisory authorities, the ESAs play an important role in the uniform implementation of the EU regulatory framework. In the field of sustainable finance, ESMA identified ESG disclosures as a Union Strategic Supervisory Priority and launched, together with NCAs, a Common Supervisory Action against greenwashing to foster a common understanding of risks and share best practices. However, the ESAs' scrutiny over NCAs is constrained by the fact that their decision-making committees consist of representatives from EU member states that can veto any action that goes against national interests. A European Commission proposal to reform the governance of the ESAs was blocked by the Council of the EU in 2019.

Civil liability is a blunt sword in the fight against greenwashing. Beyond the threat of regulatory action for non-compliance with the applicable law, the risk of civil proceedings should exercise a deterrent effect on cheaters. However, in the case of greenwashing, consumers rarely if at all suffer any financial loss if their investment turns out to be less green than promised. Since general EU financial markets and consumer protection laws are silent on ESG claims and investors can rarely claim any monetary compensation, financial firms escape severe consequences for potential wrongdoings. As civil liability in greenwashing cases fails to act as a deterrent, enforcement by regulators takes on even greater importance.

3 What Europe can do to combat greenwashing in the financial sector

Policymakers must act and should not wait for the next European Commission to take office. Financial market participants urgently need more clarity. Section 2 underlined the need for additional guidance, stronger rulebook consistency, and sound supervision. This section outlines two sets of recommendations. There is a first category of measures to improve the EU framework for sustainable finance that can be implemented before the European elections. A second category of measures involves new legislative action and will therefore have to wait until the next legislative period.

Table 1: Recommendations to improve the EU sustainable finance regulatory framework

Timeframe	Measure
Short-term	» Maintain a high level of ambition of the ESRS » Establish quality standards for ESG ratings » Bridge gaps in existing EU regulation
Medium-term	» Facilitate the application of the regulatory framework » Guide investors with reliable categories for sustainable financial products » Close the existing enforcement gap

3.1 Short-term measures

The current political cycle will soon come to an end with the European elections in June 2024. This means that two types of remedial action can be undertaken in the short term. First, amendments to European legislation already proposed by the European Commission and likely to be adopted by the European co-legislators and published in the European Official Journal before the end of the current mandate. Second, national measures that do not require the involvement of the European legislator.

Maintain a high level of ambition of the ESRS

Sustainability data from the real economy is crucial to address greenwashing in the financial sector. The entire sustainable finance disclosure framework can only play its role in guiding investor decisions if the integrity and ambition of the ESRS are preserved. Reducing red tape and not overburdening smaller companies with overly complex or irrelevant reporting requests is indeed warranted. However, substantially reducing the number of reporting companies and significantly delaying the release of sectoral ESRS, as the European Commission suggested in October 2023, will backfire as the financial sector and end-consumers heavily rely on this data. To ensure the consistency and functioning of the EU sustainable finance framework, it is of utmost importance that companies - and not only the biggest ones - provide granular and complete data.

The European co-legislators should not further dilute the ESRS. EU policymakers should resist any attempt to exempt a significant number of companies by inappropriately lifting the thresholds for the EU definition for SMEs. Since European Parliament and member states cannot change the delegated act that the incumbent Commission has put on the table to alter the SME definition, they should reject it and task the next Commission to come up with a more measured proposal that streamlines reporting requirements without compromising the framework‘s integrity. Furthermore, European co-legislators should object to the Commission proposal to delay the timetable for sectoral ESRS including uniform requirements for the disclosure of transition plans.

Establish quality standards for ESG ratings

To make ESG ratings a powerful tool for sustainable investment, they must fulfil minimum requirements on content. As long as public sustainability reporting is patchy and data collection remains cumbersome, ESG ratings continue to play an important role in filling information gaps. The ESG Ratings Regulation recently proposed by the Commission represents an improvement to the status quo in so far as it includes mechanisms to prevent conflicts of interest, entrusts ESMA with direct oversight, and introduces transparency requirements on the methodologies used. However, it would not eliminate the heterogeneity of ESG ratings nor improve their comparability. European Parliament and member states are debating the Commission proposals and have it in their hands to strengthen them within this term.

To reap the benefits of ESG ratings for sustainable investing, European co-legislators should strengthen the proposed Regulation in at least three respects. First, rating providers should clearly communicate the main purpose of their ESG ratings and separately report on the main components of E, S and G factors that feed into the final ESG rating score. Second, minimum standards should apply to each of the three different aspects of sustainability, including but not limited to the alignment with the 1.5°C target set by the Paris Agreement (E), respect of core International Labour Organization standards and UN Guiding Principles on Business and Human Rights (S), and fulfilment of the G20/OECD Principles of Corporate Governance and the UN Convention Against Corruption (G). It should be forbidden to use proxies such as industry averages as input variable to an ESG rating where there are indications that companies not disclosing any data actually perform below average. Third, each of the three factors E, S and G should be considered with a minimum weight to prevent companies performing very badly in one discipline being awarded the highest ESG rating score.

Bridge gaps in existing EU regulation

National financial supervisors should complement EU legislation by clarifying vague regulatory concepts. Until the next European Commission has taken office and can initiate legislation, national financial supervisors should use their regulatory powers to provide financial market participants with legal certainty about what 'sustainable investment' and 'promoting' or 'contributing' to an environmental or social objective genuinely mean. Such an approach would not be a novelty but build on existing practices. In the absence of European minimum requirements for sustainable investment funds, the German BaFin for example proposed a guideline that requires capital management companies to ensure that at least 75 % of any product they market as sustainable must be invested in sustainable assets. This minimum requirement would be complemented by a 10% limit on energy production and fossil fuels.

To avoid market fragmentation, regulatory action by national supervisors must be framed at EU level. As long as NCAs simply complement existing European legislation, they can at any time define methodologies or set minimum thresholds to specify unclear concepts, and then integrate them in their supervisory practices. To ensure convergence and promote the use of best practices, the ESAs should frame national rules that complement EU law by issuing guidelines on their own initiative that bind supervisors' actions across all EU member states. Since the very idea of a European rulebook is to set harmonised rules applicable to all financial market participants in the EU, the adoption of national laws following guidance by the ESAs can of course only be an interim solution. At a later stage, those minimum requirements should be strengthened in future binding legislation through the ordinary legislative procedure following a proposal by the next European Commission.

3.2 Medium-term measures

Owing to the European elections in June 2024 and lengthy legislative procedures, measures requiring new legislative action at EU level will have to be adopted in the next parliamentary term.

Facilitate the application of the regulatory framework

The next European Commission must improve the consistency of the entire sustainable finance framework. Recognizing that the SFDR is not working as intended, the current Commission has started a process for reviewing it in the next legislative term. However, to foster coherence within the entire sustainable finance framework, one should assess not only the SFDR but all relevant pieces of legislation. The aim of such a comprehensive overhaul must be to abolish contradicting or overlapping requirements, to make simplifications where possible and to harmonise in European law the guidance that national regulators might have developed to fill gaps in the existing legislation. A more consistent set of rules will facilitate application for practitioners, provide clarity for investors and reduce greenwashing risks.

There is a need to streamline reporting obligations at national and EU level. To rationalise and simplify reporting requirements in EU legislation, the European Commission has launched a call for evidence. However, the exercise to identify duplicative and irrelevant requirements should not stop at EU level but include also reporting obligations under national law. To consolidate overlapping requirements and effectively cut red tape for companies, reporting for the purposes of sustainable finance should follow the example of an integrated and consistent reporting system in banking regulation now being developed by the European Banking Authority. To avoid duplicative information requests, European governments should back the Commission proposal to make it easier for European financial supervisory authorities to exchange information and include also national data collections. Streamlining reporting requirements will not only reduce administrative burdens but also raise the quality of information provided by allowing companies to concentrate on reporting relevant data.

Guide investors with reliable categories for sustainable financial products

The EU sustainable finance framework must take the investor view. The SFDR provides investors with information on the sustainability of investment products. However, designed as a disclosure regime based on arbitrary characteristics, the SFDR does not define product categories that provide investors with reliable and comparable information on the greenness of financial products with different sustainability ambitions. The EU Green Taxonomy, in turn, gives a clear definition for environmentally sustainable investments. At this stage of the transition, however, the pool of eligible investment opportunities that match the high standards of the Taxonomy is too narrow to satisfy the high demand for ESG products. That is why the next Commission should not only introduce an ambitious EU ecolabel for financial products but acknowledge that there are several shades of green.

A product classification system would help investors find their way through the jungle of sustainable investment opportunities. To foster clarity and investor trust, the EU should introduce a product classification system that differentiates between 'transition', 'Taxonomy-aligned' and 'impact' finance. Taking inspiration from a proposal by the Financial Conduct Authority in the UK, the EU should develop for each of the three categories detailed minimum requirements and tangible product features. For example, both 'transition' and 'Taxonomy-aligned' funds could be structured with underlying assets meeting sustainability criteria set out in the EU Green Taxonomy, but the minimum proportion for 'transition' products would be set at a lower level than for 'Taxonomy-aligned' products. In addition, the definition of transition finance could build on forthcoming CSRD-driven reporting and refer to transition plans as required under the CSDDD.

Close the existing enforcement gap

EU law must provide for harmonised sanctions in case of non-compliance. Once the sustainable finance regulation has stabilised and financial market participants as well as supervisors have had time to adapt to the new regime, key legislation must be beefed up with a comprehensive sanctions regime. To date, only the Benchmark Regulation includes specific sanctions that supervisors must apply in case of market participants' wrongdoing. To ensure compliance with the EU rules and encourage financial firms to invest in internal governance and IT systems that minimise greenwashing risks, the SFDR, Taxonomy Regulation, and CSRD should also specify a catalogue of sanctions. Beyond those legislative changes, closing the enforcement gap requires EU member states to enable their national supervisors to do their job properly by giving them greater financial, technical and human resources. If Europe wants to remain a global leader in sustainable finance, it cannot rely on the U.S. SEC as watchdog over its green markets.

Financial supervision should be further integrated. To reduce potential capture of national supervisors, the independence of the ESAs from EU member states should be strengthened. Green financial products are traded more cross-border than conventional products, so the case for more EU integration is particularly strong here. However, making ESMA the single supervisor of green financial markets as the ECB nowadays is for banks in the banking union is not a low-hanging fruit. First, unlike the ECB, ESMA is not an EU institution but an agency and giving ESMA powers à la ECB would require a change of the EU treaties. Second, Europeanising supervision of greenwashing in the financial sector, but not in other areas of the internal market, would be difficult to implement for political and practical reasons as the national supervisory architecture in member states can differ a lot.

Before adopting a far-reaching institutional change, a first step towards increased European integration would be to improve the ESAs governance structure. By making the ESAs' decision-making committees more independent from national interests, they could more freely investigate whether NCAs correctly apply and enforce the European rules at member state level. While the last reform of the ESAs' mandate did not bring the necessary institutional changes, past experience with the Danske Bank case and the need to step up the fight against greenwashing should be reason enough for another attempt at reforming their governance structure. Finally, strengthening the ESAs' independence would prepare the ground for conferring more direct supervisory powers on them in future, which should remain the ultimate goal in a capital markets union.

4 Conclusion

Europe does not need a regulatory pause, but better legislation. French President Emmanuel Macron urged the EU to pause imposing environmental regulations, arguing it already has the most ambitious standards in the fight against climate change. Macron is right in saying European manufacturers need stability, but he is wrong that this excludes making "new changes to the rules". As this policy brief has shown, the nascent regulatory framework on sustainable finance is cumbersome to comply with and vulnerable to abuse by those seeking to game the system while falling short of providing meaningful guidance to investors. To allow private money to support Europe's transformation into a clean-energy economy, improving the legislation in place and ensuring that it is applied consistently across member states is ineluctable.

Limiting the administrative burden on companies must preserve the integrity of the sustainable finance framework. Complex regulation and ineffective supervision make the framework‘s application difficult for users and risk undermining the credibility of sustainable finance. To prevent sentiment in Europe becoming anti-ESG as in the US and seeing sustainability efforts discredited as “woke”, EU lawmakers must take action. Initiatives to cut red tape by eliminating redundant reporting requirements and allowing authorities to exchange the information collected are warranted to maintain practitioner acceptance. However, measures to reduce bureaucracy must not endanger the consistency of the disclosure regime as this would prevent sustainable finance from achieving its prime goal: mobilising private money for the green transition.

Europe must take action to defend its role as a global standard setter. At a time when other jurisdictions are making significant progress in establishing their own sustainability frameworks, the EU should take its sustainable finance rules to the next level to uphold its status as an international benchmark. Only if Europe manages to make its framework usable and greenwash-proof, will it remain relevant in the global context. The fact that important stakeholders are urging the International Sustainability Standards Board (ISSB) to follow the ESRS and apply the more ambitious concept of double materiality shows that the Brussels effect is still working. While a global framework for sustainable finance has yet to emerge, the EU should keep its own ambitions high.

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