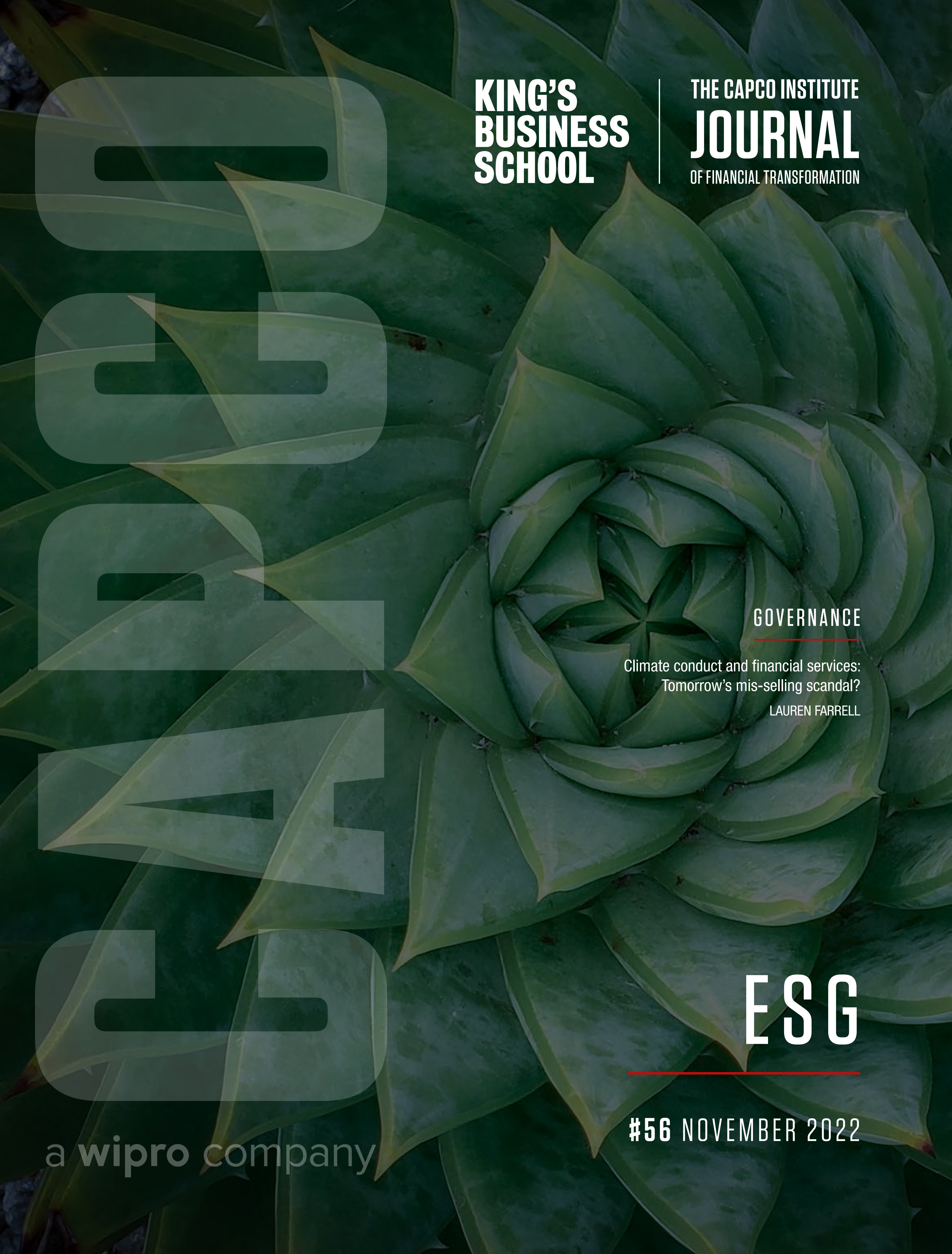

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THE CAPCO INSTITUTE
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GOVERNANCE

Climate conduct and financial services: Tomorrow's mis-selling scandal?
LAUREN FARRELL

ESG

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CONTENTS

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SOCIAL

GOVERNANCE

DEAR READER,

Welcome to edition 56 of the Capco Institute Journal of Financial Transformation, produced in partnership with King's Business School and dedicated to the theme of ESG – environmental, social and governance.

We all recognize that transformation towards a green economic system via sustainable finance is needed, welcome and inevitable. Our clients have a crucial role to play here. Acknowledging the scope and complexity of the evolving ESG landscape, we are perfectly positioned to prepare them for the ESG era.

With climate change accelerating and generating physical events on an unprecedented scale, governments and societies are considering measures to mitigate carbon emissions via net zero initiatives. The focus is firmly on greater sustainability and more equitable policies in response to shifting public attitudes. ESG considerations are reshaping investment risks on the one hand, and opening the way for green financing and sustainable technologies and innovations on the other.

This edition of the Journal examines all three pillars – environmental, social, and governance, highlighting efforts by regulators and practitioners to create a unified approach.

Moving forward, compliance with emerging ESG standards will be a critical differentiator for long-term business success. Data will also play a critical role in delivering the transparency and insights required to validate the ESG credentials of businesses, and investment strategies. Advances in areas such as machine learning, artificial intelligence and cloud technologies will be key to establishing a future model of sustainable finance.

This edition draws upon the knowledge and experience of world-class experts from both industry and academia, covering a host of ESG topics and innovations including the value of tracking Return on Sustainability Investment (ROSI) and the importance of moving away from purely external risks to addressing issues that can have positive commercial and societal impacts.

I hope that that the research and analysis within this edition will prove valuable for you as you shape your own ESG strategies, policies, and innovation.

Thank you to all our contributors and thank you for reading.

Lance Levy, **Capco CEO**

CLIMATE CONDUCT AND FINANCIAL SERVICES: TOMORROW'S MIS-SELLING SCANDAL?

LAUREN FARRELL | Associate, Capco[1]

ABSTRACT

In recent years, due to increasing awareness of the risks – and opportunities – provided by climate change, products marketed based on their strong environmental, social, and governance (ESG) credentials have exploded. In conjunction with this "gold rush" of new green products is the potential to misrepresent their true underlying nature; subsequently such claims made to consumers are not always credibly evidenced, which could lead to long-term legal ramifications. This paper introduces climate conduct and highlights ways in which products can be mis-sold through marketing. It further outlines the actions that regulatory bodies are taking to mitigate this, including the implementation of legislation and guiding principles for firms. Some risks and pitfalls for firms treading this "green-line" are given using case study evidence. Guidance is also provided for how firms should operate moving forward in this environment.

1. INTRODUCTION

In recent years, growth in products marketed on the basis of their strong environmental, social, and governance (ESG) credentials has exploded. According to the Association of the Luxembourg Fund Industry (ALFI), which represents Europe's biggest fund market, more than half the money that flowed into European funds in 2020 went into sustainable products,[2] totaling €1.4 trillion. Globally, ESG assets are expected to exceed U.S.$53 trillion by 2025, representing more than a third of the U.S.$140.5 trillion in projected total assets under management.[3]

Due to the increasing awareness of the risks – and opportunities – presented by climate change, pressure from investors for responsible investments is growing at a steady rate and ESG has come to dominate the agenda at board level meetings and on investor calls. Consequentially, an increasing number of financial institutions are either selling directly or partnering with third parties to offer green products to customers – a trend that is expected to continue and is generally welcomed in the context of climate change mitigation.

A 2021 survey by IResearch[4] reported that 63 percent of the 550 global financial service professionals surveyed said their products are green friendly, and 64 percent said their upcoming products have been designed to be socially, environmentally, and economically friendly. However, what comes with this "gold rush" of new green products, this clamor to seize upon a new opportunity, is the potential to misrepresent the true underlying nature of these green products.

Consequently, the potential risk of mis-selling cannot be understated as firms look to enhance perceptions of their environmental credentials and products. One can draw parallels with the U.K.'s payment protection industry scandal as a cautionary tale, and a marked nervousness is already becoming apparent within the financial services industry. In

[1] The author would like to thank the following for their help with this article: Amelia Bennassi, Kate Timperley, and David Gyamfi.
[2] https://bloom.bg/3BQFqtL
[3] https://bloom.bg/3UDBYLX
[4] https://bit.ly/3xZiibv

a 2021 survey from market researcher Cicero,[5] almost all financial advisers (97 of 100) polled were "very" or "fairly" concerned about the potential for allegations of mis-selling of ESG-badged investments.

Accusations of mis-selling outside of the financial sector are also growing rapidly,[6] with episodes such as the Dieselgate scandal making headlines, and regulatory bodies are increasingly aware of the need to mitigate against so-called "greenwashing" of products and services. These regulators are now moving towards legislation to make existing initiatives and frameworks binding to mitigate these risks for both firms and consumers. Frameworks such as the Taskforce on Climate-related Financial Disclosures (TCFD) highlight the need to identify transition liability risks, but firms should be aware of the potential harm from mis-selling at both company and sector-wide levels.

2. CONSIDERING CLIMATE CONDUCT

Conduct has been high on the U.K. regulatory agenda since the July 2006 introduction[7] of Treating Customers Fairly (TCF) by the Financial Conduct Authority's (FCA) predecessor, the Financial Services Authority (FSA). The intense scrutiny on banks' wider conduct since the financial crisis in 2008 has seen a doubling down by the regulator on its commitment to wholesale cultural improvements. As part of the focus on cultural improvements, annual data on conduct fines is published by the FCA on their website in a "name and shame" exercise.[8] Similar changes have also been instituted in jurisdictions outside of the U.K., most recently in Australia and New Zealand following the findings of their 2019 Royal Commission.[9]

On top of these "headline" conduct activities, there is a more subtle but still powerful conduct imperative running beneath the surface of the financial services sector. Across the industry it is clear to see that cultural enhancements are becoming ever more deeply ingrained throughout organizations, for instance:

- A broader focus on customers obtaining the right outcomes for their unique individual circumstances
- Explicit guidance around market abuse and annual attestations required by employees that they are adhering to requirements
- A greater focus on personal and transactional conflicts of interest – for instance, through the disclosure of personal account dealings
- An increased focus on who firms do business with, including indirect interactions, commonly referred to as "non-client counterparties".

The gap that currently exists is around whether firms have considered their "climate conduct" to be as important as other parts of their culture. Figure 1 covers four key areas of climate conduct.

Firms may be exposed to climate conduct risks because of the actions of individuals or the organization. Below we look at each of our four key areas in turn. Firms face reputational, financial, and regulatory repercussions where they fall short in their climate conduct.

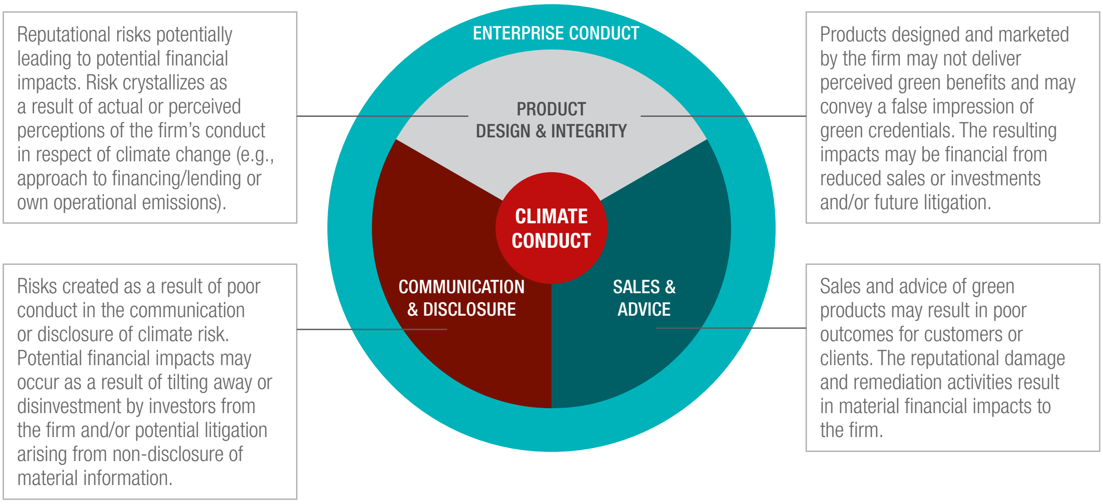
3. ENTERPRISE CLIMATE CONDUCT

Now more than ever, firms face unprecedented challenge and scrutiny over the way they operate and who they lend to, with the implication that "wrongdoers" and "laggards" run the risk that customers and investors will vote with their feet and wallets. Over recent years, several challenger banks have entered the market, each with a unique selling point: amongst these challengers are so-called "socially conscious" banks (such as B-Corps, certified Sunrise Banks,[10] and Aspiration[11] in the U.S.) predominantly focused on green financing and fighting climate change.

Especially among the younger generation, who are more likely to be both environmentally conscious and change providers if dissatisfied, those firms financing high emissions companies or failing to adapt their own operations to minimize carbon impact can expect a loss of their customer base to these greener operators. A 2019 report by Morgan Stanley[12] found that 84 percent of millennials cite investing with a focus on ESG impact as a central goal. Those companies that fail to

[5] https://on.ft.com/2HlvaAV
[6] https://bit.ly/3LKn16J
[7] https://bit.ly/3ShXUun
[8] https://bit.ly/3Ulxzas
[9] https://bit.ly/3yk3WTt
[10] https://sunrisebanks.com/
[11] https://www.aspiration.com/
[12] https://mgstn.ly/3LJVPF7

Figure 3: Key areas of climate conduct



adapt or respond face financial impacts to growth, and even liquidity, as new sales and customer or investor deposits are potentially reduced.

4. MARKETING PRODUCTS

Growth in green products has accelerated significantly, with firms offering increasingly different options across a range of product suites, both retail and investment. On the retail side, banks have launched green mortgages, electric vehicle loans, green savings accounts, asset-backed rooftop solar loans, and green current accounts. On the investment side, a plethora of green funds exist for people seeking a sustainable selection, along with bonds and covered bonds for institutional investment.

The third quarter of 2020 saw a record U.S.$76.5 billion raised[13] from 170 new green issuances, driven by sovereign wealth funds, multi-laterals, and banks. However, with this rush to "green-up" firms' product suites comes accusations of greenwashing, and an increased risk of compliance failures as green benefits sold to customers or investors cannot be credibly evidenced. The reputational and financial impacts arising from potential litigation in this area should not be underestimated.

In November 2020, the CMA began investigations into whether "eco-friendly" and environmental claims made to consumers could be misleading and breach consumer protection law.[14] The first investigation launched concerned claims made in respect to products and services. Final guidance was published in September 2021, hinging around the following principles:

- Claims must be truthful and accurate
- Claims must be clear and unambiguous
- Claims must not omit or hide important relevant information
- Comparisons must be fair and meaningful
- Claims must consider the full lifecycle of the product
- Claims must be substantiated.

Following this publication, in January 2022, the CMA commenced a further review concerning environmental claims in respect to the fashion and retail sector, identifying businesses suspected of greenwashing. This resulted in the opening of an investigation into three fashion brands, ASOS, Boohoo, and Asda, to scrutinize their green claims. The CMA plans to look at other sectors in due course.

[13] https://refini.tv/3rc4s1J
[14] https://bit.ly/3SCUWAl

The FCA have drawn their own line in the sand via the Feedback Statement 19/6, citing the need for transparency and trust when designing and marketing sustainable products. Their trust in the market for ESG/sustainable investments consumer research paper is due imminently and will follow close on the heels of their Authorized ESG & Sustainable Investment Funds Guiding Principles.

The Guiding Principles note that it is essential that products "marketed with a sustainability and ESG focus" must ensure that assertions made about goals are "reasonable and substantiated." The FCA also commented that, in receiving applications for new ESG and sustainable investment funds, "a number of these have been poorly drafted and have fallen below [our] expectations. They often contain claims that do not bear scrutiny."

Compliance departments must get on top of this new wave of guidance and retrospectively assess their existing and proposed product suites to ensure that strategies, benefits, and goals meet these criteria and can be validated and substantiated.

5. SELLING AND ADVISING ON PRODUCTS TO CUSTOMERS AND CLIENTS

If you offer a green product, how many staff in your front-line sales and advice teams can you comfortably say are qualified to discuss the associated benefits and risks to a customer?

Like payment protection insurance (PPI) and many other products previously mis-sold, green products are expected to present a particularly risky proposition due to the transitional risks of climate change. Products sold one day may quickly see their green credentials superseded due new innovations, resulting in customers trapped in expensive long-term commitments that offer poor value to them.

Firms should challenge their sales processes around green products – asking whether:

- Customer outcomes have been appropriately calibrated to capture green outcomes
- Green product recommendations can only be provided by suitably skilled persons
- Training programs have been developed and embedded that allow sales staff appropriate capabilities to offer green products
- Training programs are frequently reviewed and updated to offer timely refreshers in a fast-moving environment
- Employees are appropriately incentivized (noting inappropriate sales metrics in PPI) to sell green financing and investor products to clients
- Appropriate quality assurance and risk-based sampling is being used on what is a new addition to firms' product suites.

6. ONGOING COMMUNICATION AND DISCLOSURE

6.1 Product level

The FCA's 2021 paper[15] introducing climate-related financial disclosure rules and guidance for asset managers, life insurers, and FCA-regulated pension providers, showed a direction of travel towards more granular product and portfolio level information, rather than entity level as was formerly the case. As frameworks develop, data is gathered, and firms mature, we expect this to become even more granular over time. The FCA's 2021 "Dear Chair" letter to authorized fund managers stated the importance of "clear and accurate ongoing disclosures to consumers."[16]

Customers and clients will want to understand green performance and credentials of their own products held on an ongoing basis. At a customer-level, the FCA commented that "firms must ensure their communications are 'clear, fair and not misleading'. What we do not expect to see is firms exaggerating their products' green credentials." Firms failing to identify the necessary data and accurately disclose to this level run the risk of potentially being left behind, leaving them to rely heavily on their own assumptions, which are more likely to be challenged legally should they prove inaccurate. Based on the clarity of regulatory messaging, firms should be under no illusion of expectations in this area.[17]

[15] https://bit.ly/3LJW3vX
[16] https://bit.ly/3LNZK3R
[17] https://bit.ly/3LOamQ6

> *"What comes with this "gold rush" of new green products, this clamor to seize upon a new opportunity, is the potential to misrepresent the true underlying nature of these green products."*

6.2 Company-wide level

For the last few years, environmental group Extinction Rebellion (which has an explicit goal of net zero emissions by 2025)[18] has been targeting and damaging head offices of banks that it considers to be neglecting their climate responsibilities. These actions were arguably in part fueled by the readily accessible data that is published on the amount of fossil fuel financing that banks contribute to, either via direct lending or in advisory capacities.

Firms will come under increasing scrutiny for the quality, transparency, and granularity of their climate-related disclosures, both at an entity and customer/investor level. Turning first to entity-level disclosures, Frank Elderson, a board member of the European Central Bank, commented on bank regulatory self-assessments that: "Our overall initial snapshot is rather disappointing. None of the banks under our supervision meet all our expectations. All banks have several blind spots and may already be exposed to material climate risks. They are all still a long way off meeting the supervisory expectations we have laid out for them. And all banks need to catch up, as their climate risk undertakings will eventually influence their supervisory requirements."[19]

This stark message aligns to our own assessment of financial services disclosures. Our 2022 benchmarking exercise of around 90 financial institutions globally highlighted mixed standards across all areas of disclosure.[20] As more firms make commitments towards achieving Paris-aligned goals through science-based targets, so does the likelihood that the accountability and legitimacy of these claims get questioned.

7. RISKS AND PITFALLS

A history of mis-selling relating to ESG and climate credentials already exists. We have highlighted two case studies where misrepresentations of green credentials and benefits have been prominent.

Case Study 1: Dieselgate emissions scandal as a marker

BACKGROUND

In September 2015, the U.S. EPA (Environmental Protection Agency) identified irregularities in the emissions profiles of a number of VW based diesel vehicle platforms. Subsequent testing between real world driving emissions and the laboratory test figures differed wildly and the ensuing investigation identified a "defeat device" in the software. The actual mechanics and methods have not been fully publicly disclosed, but a very sophisticated and orchestrated deception was afoot. In essence, the vehicle would know when it was being tested due to inputs (or lack of) such as no steering, no brakes, and certain air and throttle position; under these circumstances it would default to a much lower power and emissions setting that would create an artificial view of the particulates and gas content for the test. The nitrogen oxide pollutants were 40 times higher under real use conditions, under certain conditions, than are permitted under U.S. regulation. [21]

With similar parallels to the influx of green products from financial services, the VW group saw a huge commercial opportunity to market its small diesel platforms as eco-friendly to the U.S. When combined with a significant sales campaign, focused on green credentials, it generated a wave of new car sales based on erroneous environmental claims. The EPA identified 482,000 cars in the U.S. alone, with VW identifying a further 11 million vehicles subsequently as the case caught global attention, with 8 million in Europe.[22]

The ensuing legal battles, claims and payouts started with VW setting aside a significant figure of around €6 billion in 2015/2016; by 2020 this rose publicly to €31.3 billion globally and has grown beyond this, albeit more privately. If this is not a cautionary tale of mis-selling, then the money that may have facilitated it should be. Statements obtained from the European

[18] https://bit.ly/3DY53vl, https://bbc.in/3UlsAXj
[19] https://bit.ly/3xXeaJ6
[20] https://bit.ly/3dTZUd8
[21] https://bbc.in/3fryH2d; https://bbc.in/2L0236V
[22] https://reut.rs/3Ce3597; https://bit.ly/3fkiOdl

Investment Bank by journalists implicate a loan facility of €400 million that was likely used as part of drive train efficiency. In an early 2016 press conference, the bank's President, Werner Hoyer, admitted that a facility provided by the EIB could well be implicated in the defeat technology and subsequently "put on hold" any new facilities while investigating further.

APPLYING THE LESSON TO CLIMATE CONDUCT

The implications for a financial services firm, when either creating a new green products suite or indeed the onwards use of its funding in green initiatives, must be considered from a risk perspective as a war on two fronts. Although there is a significant generational opportunity both to affect change and drive commercial and shareholder value, it is not without risk and must be very carefully navigated to not end up in the same "provisions" boat as VW. As discussed previously, our recent benchmarking exercise of around 90 financial services institutions globally highlighted mixed standards across all areas of disclosure. This could lead to many coming under scrutiny over their green credential claims.

Case Study 2: U.K. Green Deal mis-selling scandal

BACKGROUND

The U.K.'s Green Deal was hailed as the "biggest home improvement program since the Second World War" when it was launched by the U.K. government in 2013. It promised homeowners solar panels, insulation, and new boilers, with no upfront cost. Customers would need to take out a loan, but they were assured that the repayments would be no higher than the savings they would make on their energy bills. Problems started to emerge when it was discovered that the claim was based on a typical household's energy usage, and many homeowners who used less than this "average" have ended up with higher bills. On top of this, the loans were tied to the property, rather than the individual, which meant homeowners could potentially struggle to sell their house in the future. Faults also emerged in the quality of fittings conducted by approved installers. The multi-million-pound scheme was dropped by the U.K. government after just two years following low uptake and was described by MPs as a "complete fiasco". The scheme has left a legacy of thousands of households encumbered with high interest loans that they will potentially be paying off for decades to come. Mis-selling claims are now underway and are being handled by the Department for Business, Energy & Industrial Strategy (BEIS) and Ombudsman or, if elevated to appeal, the Secretary of State.

APPLYING THE LESSON TO CLIMATE CONDUCT

In Scotland, the firm Home Energy and Lifestyle Management Ltd (Helms), which was an approved installer, faced criticism for its selling tactics, with Citizens Advice Scotland producing a report in 2018 detailing the unorthodox methods reported by customers. Tactics included telling vulnerable and elderly people they were getting the work done for free and using high-pressure tactics to get them to sign up. One customer was signed up for a 25-year loan aged 82, meaning it would only be paid off when the customer was 107. The Green Deal shares many of the same mis-selling traits of PPI and should be heeded by firms when identifying green product types, partnerships, and sales approach and channels. At a time when the U.K. government is proposing replacing gas boilers by electricity-driven heat pumps as part of its Green Plan, the potential scale for mis-selling dwarfs that of the Green Deal. As firms move to offering their own products, or partner with third parties to supply these, there is increased risk of mis-selling, including failing to appropriately assess suitability, applicability, and affordability. Ensuring conduct frameworks remain dynamic to the new and existing risks posed by green and ESG-linked products is paramount.

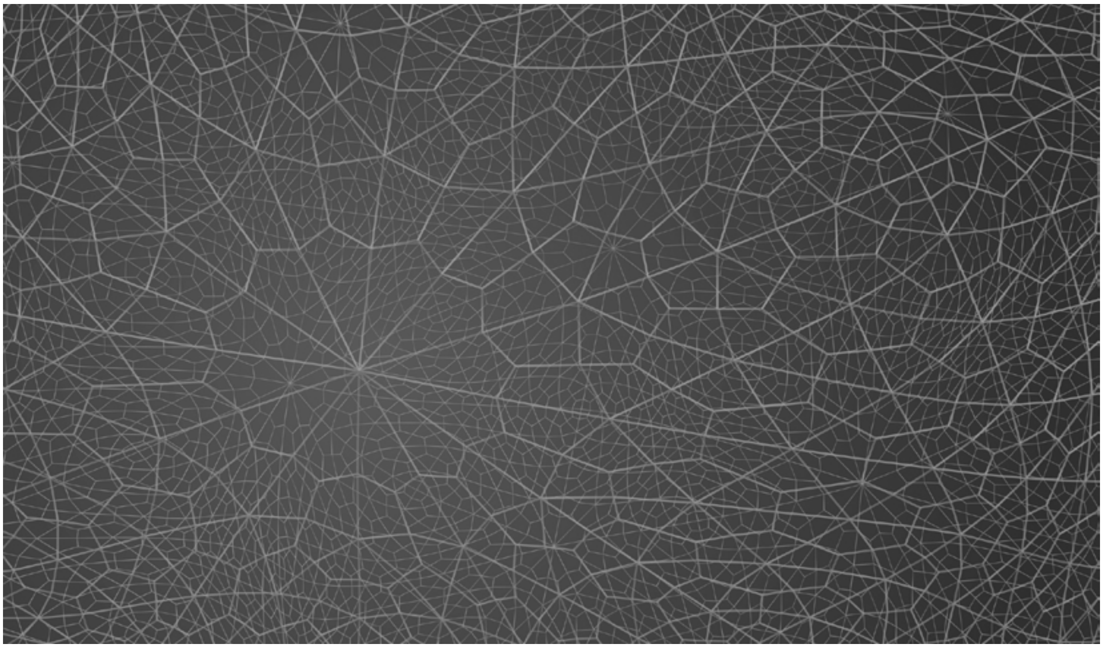
8. WHAT SHOULD FIRMS BE DOING

Given the risks that firms face, we would suggest that they take the following guidance into account:

- **Embed climate risks and opportunities at the highest level:** firms should be spotlighting ESG and climate risk and opportunities at the highest level. Firms are increasingly treating climate change as a principal risk, with its own dedicated risk management function, and board and executive level representation. Consideration must be given as an ongoing material strategic agenda point, moving away from it being a subset of a different business area such as finance or corporate affairs.
- **Taking a holistic view:** firms must ensure potential conduct risks posed by climate change are recognized

and factored into their strategy and risk management frameworks. In recent months, we have reviewed over 90 separate disclosures covering climate risk management, and only a handful consider climate conduct as a material first or second order risk for their firms.

- **Working through product lifecycles:** firms should be using risk assessments around green products and considering their full lifecycle, including interaction with third parties. Based on market trends, many firms are likely to partner and potentially outsource some elements of specialist product sales to third parties, consequently, they must ensure that their standards, risk management, and controls are equivalent to the firm's own, and that the firm can perform some degree of ESG sales audit and quality assurance.
- **Approach the data challenge:** with the acquisition of accurate data being widely recognized as a keystone in the implementation of a wider ESG strategy, the need for robust and scientific data when making environmental claims should also be considered. Firms should look to increase capacity to complete full lifecycle assessments of their products, ensuring that they are able to make valid and substantiated claims about their products. Movements in the development of global taxonomies will help to standardize and provide clearer ESG labeling guidelines. These classify which economic activities are seen as "green", and firms should be aware of region-specific regulations from governments and supranational organizations to help mitigate the potential for greenwashing.
- **Keeping pace with disclosure developments:** with current disclosure frameworks constantly and swiftly evolving, firms must constantly revisit and review their own frameworks on a timely basis, or else risk being left behind or failing to meet new standards of disclosure (e.g., Taskforce for Nature Related Financial Disclosures). Firms with the broadest awareness and consideration of disclosure will be able to find the greatest synergies and overlap, which will aid the reduction of unnecessary duplication and back-and-forth conversations with customers, clients, and suppliers. Following COP26, the pressure for action is intensifying[23] as the FCA confirmed that it does not necessarily require new powers or legislation to combat against greenwashing and it will be able to use existing powers to enforce this area.[24]



[23] https://bit.ly/3SAlj8N
[24] https://bit.ly/3SAlq4d

9. CONCLUSION

The complex subject of conduct in combination with climate change – arguably one of the widest ranging thematic issues of our time – presents an anxiety-inducing and risk-strewn proposition. When navigating this potential minefield, caution and process must be the watchwords at all levels of the firm when delivering robust and defendable frameworks to manage ESG products and services. Without this approach, it will be all too easy for firms to over-egg their "green pudding" and as Dieselgate attests, "where there's blame, there's a claim".

The danger of mis-selling green products and misrepresenting the positive ESG or climate credentials of a product may deliver short-term gains but could also lead to significant value destruction in the longer run. Climate compliant and friendly products are without doubt the next "gold rush", given they represent a moral and commercially attractive proposition that can benefit, to a greater or lesser degree, the entire global population. If the lessons of previous mis-selling mishaps are learned, then this could be the defining opportunity for the next generation of financial services' customers, firms, employees, and executives. If not, it has the potential to damage not only individual firms' balance sheets and reputations, but also broader efforts to make sustainable finance a reality – and ultimately the very future of our planet.

ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy specializing in driving digital transformation in the financial services industry. With a growing client portfolio comprising of over 100 global organizations, Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to deliver end-to-end data-driven solutions and fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its Innovation Labs and award-winning Be Yourself At Work culture and diverse talent.

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ABOUT KING'S BUSINESS SCHOOL

King's Business School, the ninth and newest faculty at King's College London, opened in 2017. It is accredited by AACSB and EQUIS and was rated one of the top 10 business schools for research in the U.K. based on the Research Excellence Framework 2021. It is rated fifth in the U.K. for Business Studies by the Times and Sunday Times Good University Guide. Based in the heart of London, the School is part of an internationally renowned research-intensive university with a track-record of pioneering thinking and the limitless energies of the city's businesses, policy-makers, entrepreneurs and change-makers to draw on. The School's commitment to drive positive change is at the heart of its research and education.

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