



# JOURNAL OF RESPONSIBLE FINANCE

A Quarterly Series on Emerging Trends



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# JOURNAL OF RESPONSIBLE FINANCE

A Quarterly Series on Emerging Trends

The Next Generation of Finance: Taking a Systemic  
Look at Risks and Opportunities

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## FOREWORD: GIZ AND SIDBI

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The close relationship between the health of the financial sector and that of the economy cannot be over-emphasised. Getting India back on a high growth path remains a major priority for the country. Efforts for a speedy recovery must, however, ensure that fundamentals for a stable, inclusive and responsible economy are embedded in the design of such a roadmap.

As a deployer of capital, the financial sector assumes a double role in contributing towards a robust economy. Not only does it have to compete in a fast changing environment, but how it lends and invests also impacts borrowers and consumers, both directly and indirectly. Dependence on the financial bottom-line alone to assess the health of a bank or investor, or that of a business to whom it lends, has proven to be hazardous. The financial crisis of 2008 exposed the short-termism of this approach. Environmental, social and governance (ESG) factors are increasingly becoming relevant in determining financial performance of enterprises—large and small—and of those who invest in them.

While globally there has been a forward movement on these issues becoming central to business decision-making, the financial sector in India has not caught up or articulated the extent of risk and opportunity arising from ESG beyond a few actors. There is a huge lack of awareness, concerted dialogue and action, inadequate capacities, tools and skills within financial institutions required to mainstream the ESG orientation in their core business.

GIZ and SIDBI under their bilateral cooperation project, ‘Responsible Enterprise Finance’, are working with a wide range of stakeholders to contribute towards fostering a common understanding of what ESG should mean for the financial sector in India not only in concept but also in practice. Generating greater awareness on international and national developments, good practices and challenges is one of the advocacy initiatives the project is embarking upon. We are very happy that we have a committed and proactive partner in the Indian Banks’ Association to launch the quarterly knowledge series called the Journal of Responsible Finance (JRF).

The first volume of JRF, titled, “The Next Generation of Finance—Taking a systemic perspective on risk and opportunities” explains the basics, the challenges, risks and opportunities in the field of Responsible Finance, bringing global and national perspectives together from wide cross section of thought leaders and authors from development banking, think tanks, credit rating agencies and innovative financing. We hope you enjoy reading the Journal and find it informative and engaging. A special note of thanks goes out to all our contributors.



**Stefan Helming**  
*Country Director, GIZ India*



**Ajay Kapur**  
*Head, SIDBI Delhi*

## FOREWORD: IBA

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There is a tough task ahead of bringing India's economy back on track, after a poor, below-five per cent growth record of recent years. The Presidential address on the new government's roadmap has pointed out several relevant issues that need to be addressed in this context. These include attracting investments into agriculture, manufacturing and infrastructure sectors; a focus on problems of urbanisation, access to housing, electricity, water; and energy security. Clearly, it is not just a matter of reviving economic growth, but ensuring growth is sustainable and inclusive.

The financial sector has a critical role here in two fundamental dimensions. First, by integrating environmental, social and governance (ESG) concerns into its decision making, not only can the sector be able to mitigate associated risks, but it can also tap new market opportunities for healthy growth. The second way is by promoting business to be more transparent and responsible in managing its social and environmental impacts and to be more innovative in creating solutions for climate change and poverty alleviation. The potential lies in the practice of responsible finance, a term reflecting on financial systems that integrate ESG concerns into the lending and investment decisions of financial institutions. Thereby setting appropriate incentives, the financial sector can create a 'multiplier' impact, given its influence on the business sector.

While globally, this influence is being increasingly understood and leveraged, in India, the financial sector's awareness of the business case for integrating ESG concerns to promote sustainable investments needs improved engagement. Likewise, while the international market for sustainable finance is growing and banks are offering innovative products and services, the Indian financial sector's capacities are still evolving on these fronts.


GIZ, in collaboration with SIDBI and IBA, has started a knowledge series in the format of a quarterly journal to be disseminated among Indian banks and financial institutions on a regular basis. The Journal of Responsible Finance (JRF) aims to enhance and share knowledge about trends, experiences, and best practices from Indian and international financial institutions. JRF aims to create awareness about the business case of integrating ESG factors into core business operations among banks, investors, regulators, and policy and decision makers. It will seek to discuss issues such as: Is integration of non-financial aspects in risk management economically viable and how does it improve the performance of financial institutions. It will highlight how innovation can lead to new opportunities for growth, such as financing energy efficient solutions and low cost housing. Besides awareness building, series will also discuss what kind of capacities and incentives that may be required for this purpose.

This first volume titled, "The Next Generation of Finance—Taking a systemic perspective on risk and opportunities" introduces and discusses the fundamental concepts, rationale and issues in the field of responsible finance. With topics ranging from the global experience to the Indian reality, this volume includes authors from rele-

vant sectors such as development banking, think tanks, credit rating agencies and specialists in innovative financing, and sets the Indian context to ESG both as risks and opportunities.

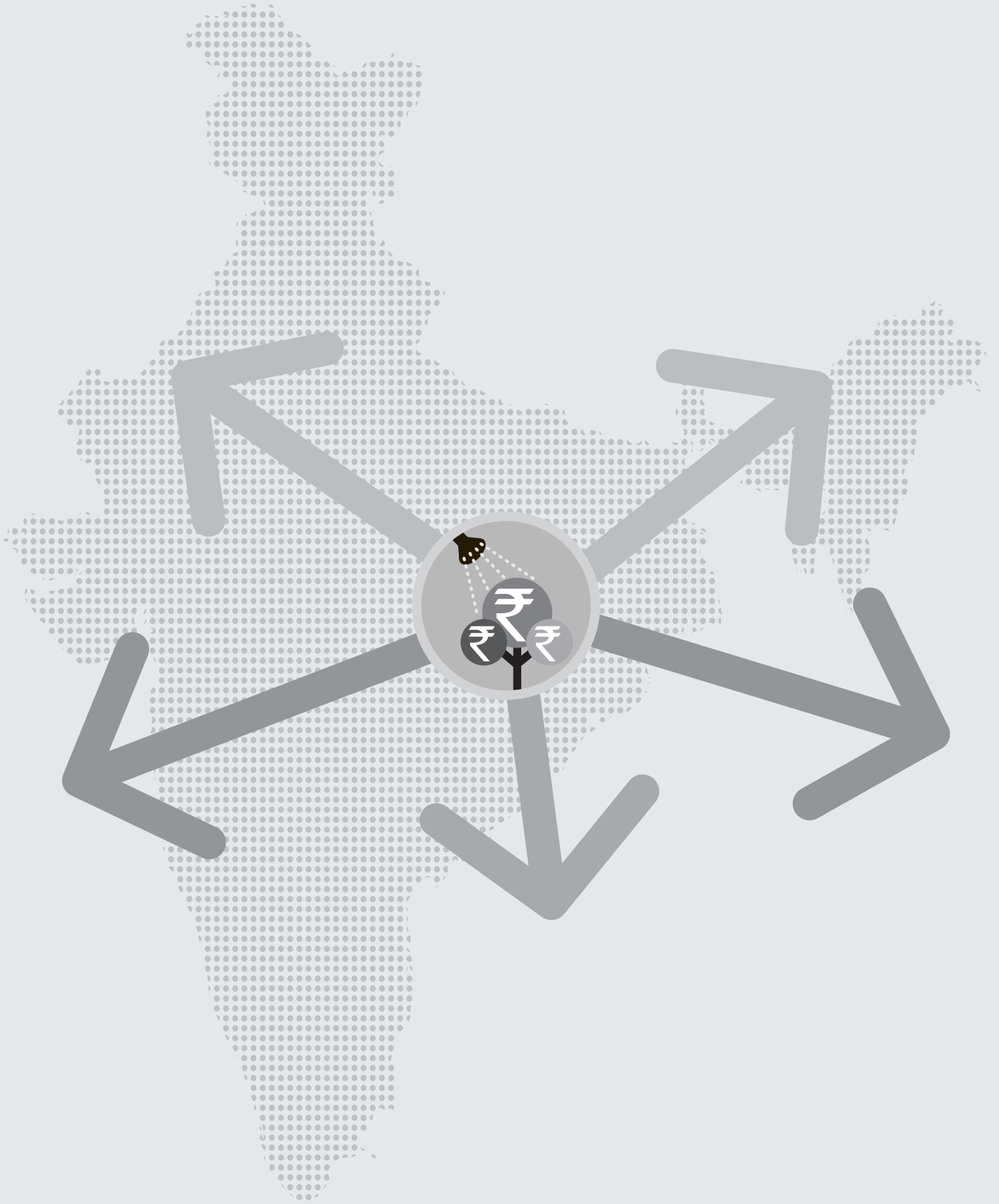
The Indian Banks' Association's (IBA) vision is to work proactively for a healthy, professional and forward looking banking and financial industry in a manner consistent with public good. IBA believes that Indian institutions will vastly benefit from the knowledge that JRF will bring to its audience, both in terms of the progress that has been made by some organisations and the challenges that need to be addressed. JRF will provide a much-needed structured platform for market participants to share views and lessons learned in this exciting journey towards making responsible finance an integral part of the Indian financial system.

On behalf of all of the authors and editors at JRF, we hope you find this inaugural edition both enlightening and informative.



**Mohan V. Tanksale**

*Chief Executive, Indian Banks' Association (IBA)*





# 1

## Finance and Sustainability: Regulatory and strategic dimensions<sup>1</sup>



### >> Subir Gokarn

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### A sustainability framework

#### The building blocks of ESG

Let me define sustainability in two dimensions: as an objective and a process. As an objective, it means alignment between the long-term interests of all the stakeholders involved in a particular activity. An activity is sustainable as long as it continues to maintain such alignment. As a process, it refers to the mechanisms that are in place to create and monitor this alignment. The likelihood of an activity being sustainable is enhanced by its having robust mechanisms.

At a policy level, these concepts play out in what is now understood as “sustainable development”. This means that a development strategy needs to take into account the perceptions of interest of the entire range of stakeholders, present and future, while deciding on patterns of investment and technology choices. Contemporary global thinking on development policy and strategy emphasises the value of sustainability both as an outcome and in terms of the choices and administrative processes that are required.

In this article, though, I want to focus on the applicability of the concept at a corporate or business level,

eventually linking it up to finance. The idea is essentially the same. Corporate sustainability comes from the ability of a company to align the interests of its various stakeholders.

A company has two categories of stakeholders. Internal stakeholders are shareholders, employees, suppliers and, most importantly, customers. External stakeholders are the larger communities in which they operate and, the future members of these communities, who are represented mainly by the impact of business operations on the environment.

This is the basis of the ESG (environmental, social and governance) framework. The E and S components reflect the interests of external stakeholders, while the G broadly looks at how the company aligns the interests of the internal stakeholders as well as between the internal and external groups. There are both process and outcome dimensions to the framework. Companies can be assessed on the outcomes they achieve with respect to each group of stakeholders as well as on the processes that they put in place to pursue these outcomes. In reality, many outcomes are unobservable.

## The finance–global sustainability architecture

The ESG framework is the foundation for a comprehensive global institutional architecture that promotes sustainable strategies by companies and gives finance a central role in incentivising these strategies. There are four components in it, of which three have a direct link to the financial sector.

### Pillar 1 The United Nations Global Compact (UNGC)

Initiated in the year 2000, this is a structure that encourages companies to build their business strategies and operations in compliance with ten core principles, covering the domains of human rights, labour, environment and anti-corruption. As of 2013, there were more than 8000 companies that had signed up with the Compact and this was supplemented by about 4000 civil society organisations, who effectively become monitors of corporate compliance. The compact defines corporate sustainability as “...a company’s delivery of long-term value in financial, social, environmental and ethical terms.” In effect, the signatories commit to honour each of the ten principles in the conduct of their business.

The UNGC publishes the Global Corporate Sustainability Report (GCSR) annually, which tracks the signatories’ compliance with the principles over time. The tracking helps point out the principles which pose the greatest compliance challenges and, over time, can become a useful input for regulators and policymakers, who obviously have a strong interest in corporate sustainability, since it feeds directly into sustainable development. As regards the participation of Indian companies in the structure, India has the 13th largest number of signatories, above 150, a list which includes both large companies and small and medium enterprises (SMEs).

### Pillar 2 Global Reporting Initiative (GRI)

A critical requirement for sustainability is information. All stakeholders need to know what the organisation is doing with respect to their and others’ interests. Every policy decision or action taken by a company can potentially help or hurt the interest of one or the other stakeholder group. GRI is a structure that facilitates this level of transparency and disclosure by companies. It lays out guidelines for sustainability reporting,

which allows all stakeholders to compare and contrast performance across companies, not just within a country, but across them as well. Sustainability reporting can be used in conjunction with standard financial reports to make a comprehensive assessment of the company’s overall balancing of stakeholder interests. More than 5700 institutions globally publish sustainability reports, with about 80 Indian companies now on the list.

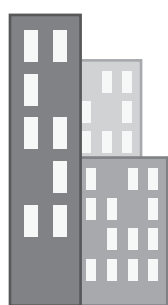
### Pillar 3 Principles for Responsible Investment (PRI)

This structure was set up in 2003, as a partnership between the United Nations Environmental Programme Finance Initiative (UNEPFI) and the UNGC. It began signing on members in 2006 and currently has more than 1200 signatories. The mode of operation is essentially the same as the UNGC, in the sense that the signatories commit to carrying out their business in compliance with some core principles. The difference is in the target group. Signatories to the PRI are essentially fund managers—large, small, long-term, short-term—the whole range of entities that manage money is included. There are six principles in this structure, which essentially require that investors put emphasis on ESG criteria while making their portfolio choices. In 2013 the amount managed by signatories was about \$2.2 trillion, not a very large proportion of the global fund pool, but no small change either.

### Pillar 4 The Equator Principles

This set of principles is the other financial pillar of the sustainability institutional structure. It applies to institutions that lend for business purposes, both banks and non-banks. The signatories to this agreement, referred to as the Equator Principles Financial Institutions, agree to make their lending decisions on the basis of adherence of projects to ten core principles, which cover the now familiar territory of ESG. The principles are not brought into transactions retrospectively and are accepted as being applicable to relatively large projects (above \$10 million), which obviously have far more significant risks relating to impacts on communities and the environment. Currently about 76 lending institutions are signatories, one of which is from India.

In an idealised state, the four pillars and the platform that they create reflect a “perfect information” frame-



work for sustainability. Under the UNGC, companies make certain commitments to executing their business in full compliance with a set of principles. They then report their levels of compliance with these principles—some use the UNGC Communication of Progress (CoP) reports while most do it in their sustainability reports based on common templates created by the GRI. These reports are used by investors who have signed up with the PRI to make their portfolio allocations, putting more weight on companies which show higher levels of compliance with the principles. These reports are also used by lending institutions who have signed up with the Equator Principles to decide which companies and what projects to lend to. The loop between finance and sustainability is thus closed.

In reality, there are risks of failure and backtracking that both companies and financial channels have to deal with. From the financial perspective, significant resources are allocated without reference to ESG benchmarks. This reduces the incentives for companies to comply with the principles. Investor horizons are particularly important in this regard. A dominance of short horizons in the market tends to penalise companies which are more committed to the sustainability agenda, which are typically preferred by long-term investors, for obvious reasons. So, the entire process needs to be seen in terms of convergence to the objectives that each of the pillars has set for itself.

Do companies that put a priority on the sustainability agenda generally do reasonably well on narrower financial metrics?

### Sustainability and financial performance

Do companies that put a priority on the sustainability agenda generally do reasonably well on narrower financial metrics? A recent article<sup>2</sup> categorises the findings of 159 research papers looking into the correlation between sustainability and financial performance for the period 1972-2008. Keeping in mind the evolving concept and definition of sustainability over this period, the following picture emerges.

In studies carried out by practitioners, 78 per cent of the papers show a positive correlation between sustainability and financial performance, while 13 per cent reveal a negative one. The rest are neutral or mixed. In studies carried out by academics, 60 per cent of them show positive correlation, 15 per cent show a negative one and 28 are neutral or mixed. Presumably, the academic studies control for other factors more effectively, which explains why the positive findings are somewhat lower even though they are still in the majority.

There is new emerging analysis of Indian companies on this basis. A 2010 study sought to correlate the governance scores of companies with some indicators of financial performance for a sample of almost 400 companies over three years.<sup>3</sup> The analysis indicated a significant positive relationship between the governance score, which, admittedly is only one aspect of sustainability practices, and some important financial parameters. For instance, after controlling for both firm-specific and time-specific factors, the governance score had a strong positive relationship with market capitalisation. Also, there was a negative correlation between the governance score and leverage, suggesting that better governed companies were able to raise equity capital more easily. Importantly, there were signs of a threshold effect; companies had to score above a certain level on the governance scale to realise these benefits.

At this point, though, it would be reasonable to conclude that, while there is evidence in favour of commitments to sustainability having a positive impact on financial performance, it hardly clinches the case. So, is the potential virtuous cycle of corporate sustainability generated by the interaction between the four pillars largely a matter of faith?

The answer is yes, to a certain extent. Companies that signed up with the UNGC and the GRI, investors that signed up with the PRI and lenders that signed up with the Equator Principles surely didn't do it entirely on the basis of expectations or improved financial performance. They did it because they believed that there was some higher purpose being served by pursuing objectives beyond narrowly defined financial benchmarks. In other words, there was an inherent trade-off in their decisions, particularly as far as short-term financial returns went. The true test of the sensibleness of their commitment would have

been over a relatively long period; did firms that put a priority on sustainability generate better financial returns over the long haul? It is extremely difficult to answer this, because formally defined sustainability practices are a relatively recent phenomenon and it is difficult to get a large enough set of companies over long periods of time which have been practicing sustainability but didn't quite know it themselves.

What the empirical evidence cited tells us, though, is that the anticipated trade-off may not be particularly strong, even in the short run. The evidence of zero or negative correlations dilutes the enthusiasm somewhat, but the bottom line is that a combination of faith and empirical evidence is driving the move towards sustainable practices. Either one follows them because they are intrinsically good or because they have tangible financial returns. The trick for companies, perhaps, is to adopt sustainability as an agenda, but to do it smartly, in terms of the goals and instruments, with an eye always on the financial dashboard.

### **National Regulatory and strategic dimensions**

Is there any role for public policy in this process? Clearly, for all companies to put a priority on sustainability is entirely consistent with the larger policy goal of sustainable development. The latter is not going to take place at a macro level unless all individual agents—consumers and producers—go about their daily activities in a consistent manner. Of course, all countries, and India is certainly one of them, have elaborate legislative and regulatory frameworks, which impose boundaries on corporate behaviour. In a sense, the sustainability architecture is a supplement to formal legal structures across countries. What the sustainability architecture aspires to is for companies to go beyond mere compliance and actively seek ways in which stakeholder interests can be advanced even while improving financial performance. It is the aggregation of these efforts that could have benefits at the macro level and, here, there may be a role for some regulatory initiative.

First, there might be value in an overall review of the regulatory architecture to see whether in its own way it is consistent with the sustainability principles. As was indicated earlier, the broad principles underlying

all four pillars of the sustainability architecture are quite similar. And, if we look carefully at any legislative and regulatory framework, it is not very hard to see that the same principles are very much at work. **A significant policy development in India reinforcing the sustainability architecture is that of the National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business (NVGs)** issued by the Union Ministry of Corporate Affairs in 2011, which encourage companies to manage their performance on a set of nine sustainability principles. Taking this further, the stock market regulator, Securities Exchange Bureau of India (SEBI), mandated India's top 100 listed companies (by market capitalisation) to report on these nine principles through a **Business Responsibility report** as part of their annual reports. There are expectations that the reporting requirement may extend to a larger set of listed companies beyond the top 100.

Second, large companies can afford to adopt sustainability agendas but smaller ones find them onerous. Since there is a potentially significant macro outcome from large numbers of SMEs increasing their adoption of sustainability practices, there may be a rationale for the government to incentivise these businesses to adopt these practices. Tax breaks and other fiscal instruments, for example, time-bound subsidies to implement certain changes in process could be considered, though, in the Indian context, the overall fiscal situation needs to be kept in mind. But, short of explicit fiscal commitments, many other ways of incentivising sustainability practices can be considered.

Enhancing training and capacity building through the existing service infrastructure for industry could be one of these. Organizations that are committed to the sustainability agenda and have succeeded in implementing it while preserving or enhancing financial performance could be brought in as partners in reviving public channels of knowledge transmission.

To reinforce the value of these new capacities, public procurement systems could give some weight to the adoption of sustainability practices. At the very least, they should take into account the overall compliance record of potential vendors. Once they do this, adding on a few points for going above and beyond shouldn't be too difficult.

The recent amendments to the Companies Act introduced a mandatory spending on CSR of two per cent of net profits on companies. We have to think about whether independent and un-coordinated efforts by companies, however sincere, are going to be the most effective way to fulfil this mandate. They will do so in the letter, but what we should be aspiring to is the spirit. Can we aggregate the resources from a large number of organisations in ways that provide a powerful impetus to some key social priorities? This leads me to a concept of CSR partnerships or consortia, which brings companies with shared CSR priorities together to create initiatives of significant scale, which in turn justifies efforts in design and monitoring. Companies may spontaneously come to this conclusion and initiate such partnerships, but I think the government has a role in one, signalling some priority areas in which such scaling up could yield significant benefits and two, bringing potential partners together.

Let me now turn to the strategic dimension of sustainability. Do companies have an intrinsic incentive to adopt a sustainability agenda and good sustainability practices? For many businesses, reputation is a significant asset and the loss of reputation resulting from a governance failure or an environmental accident or a conflict with local communities can create a huge business setback. This is a direct bottom line impact and any good management would be sensitive to it and take the precautions necessary to avoid it. This means doing many things that the sustainability architecture would recommend.

One, even as sustainability practices are adopted by companies in the interests of their business, the articulation and championing of a corporate sustainability agenda is very much the responsibility of the leadership. It is only when all the little things that are being done are given legitimacy by such an agenda that they become institutionalised and also expanded to other applications. Without this, they risk being victims of personnel changes or financial pressures. The leadership needs to elevate such practices to a status of permanence.

Two, while we have referred to some general evidence that sustainability practices and financial performance are positively correlated, each business has to be conscious of the fact that this may not hold in its case. It is necessary for the leadership to emphasise

to the organisation that financial performance remains as important as ever, even as a sustainability agenda is being put into place. Cost consciousness must not be sacrificed as an excuse for the transition. Practices that achieve both objectives, such as conserving paper or electricity, reinforce the message that financial performance and sustainability are entirely compatible with each other.

Three, from a financial perspective, the adoption of such practices may or may not make a company more attractive or a project more viable over relatively short time horizons. However, over longer periods of time, given the nature of the risks involved, there is likely to be a convergence between finance and sustainability. To the extent that long-term considerations are built into financial allocations, resources should flow into companies and projects which have better sustainability attributes.

## Concluding thoughts

I conclude with four key messages.

First, sustainable development as a macro strategy requires the adoption of sustainability agendas at the micro level. The first is not going to be achieved unless the people who actually produce, and consume, goods and services do so in a sustainable way.

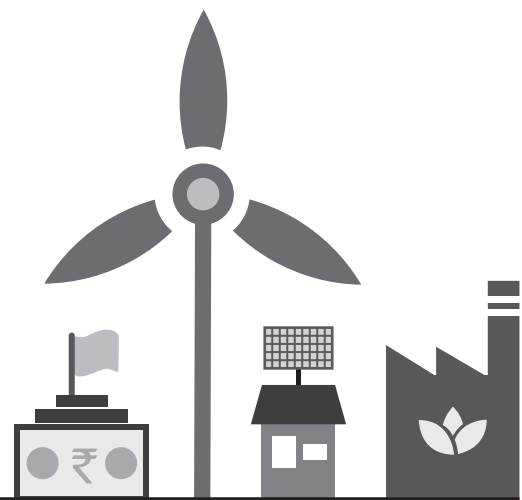
Second, there is a pragmatic framework in place, based on some unexceptionable principles, comprising both principles and agreements that provide guidelines to companies and financial entities. This framework creates the capacity for financial resources to be deployed in a manner which balances sustainability and financial returns.

Third, both the government and corporate leaderships have important roles to play in furthering the agenda. From the government perspective, thought needs to be given to how to reduce the costs of compliance with laws and regulations promoting sustainability, incentivising SMEs to adopt the agenda and, in the immediate context, effectively leveraging the CSR mandate to obtain the maximum benefit. Corporate leadership needs to articulate and champion sustainability agendas and emphasise areas in which sustainability and financial performance are most compatible. This, in

turn, brings about an alignment between the interests of companies and their investors and lenders.

Finally, sustainability is best seen as a process rather than an outcome; one which brings more and more

into alignment the interests of multiple stakeholders. The process needs to be continuously monitored, compliance rewarded and non-compliance reversed. The financial system is an integral part of the monitoring, reward and correction mechanism.



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# 2

## Paradigm Shifts in Financial Markets:

An overview of the evolving roles of market participants and regulators in mainstreaming ESG



### >> Sumantra Sen

Sumantra is the CEO at Responsible Investment Research Association, an investors' forum that facilitates mainstreaming of Environment, Social and Corporate Governance factors into Financial Markets. He is Managing Partner at Esgalier Advisors LLP, an innovative investment consulting organisation focused on financing sustainable infrastructure. He serves on the Advisory Board at ASrIA, Hong Kong and is a Partner at Contrarian Drishti Partners, an early stage investor. Sumantra is an MBA and member of the CISI, UK with over 20 years of experience in global capital markets and investment management, working with financial organizations such as ABN AMRO and Bank of America. He has co-authored Wiley Finance's "Evolutions in Sustainable Investing", and Random House's "Thirsty Nation".

Debates about India's emergence as an economic superpower may continue endlessly, but there is no denying its demonstrated performance as a high-growth economy. At least in the context of overall growth, the nation's economic model seems to have worked. With a growth rate of 7.5-8% in recent years and a GDP of more than USD 1.80 trillion, India is in a position that the world cannot ignore. Even though it keeps moving in and out of the Trillion-dollar club, the capitalisation of Indian companies puts our financial markets amongst the top 15 in the world.

India's economic reform process that was kick started in the early 1990s has had its share of intermittent derailments and decelerations, but the larger outcome has been an environment that is conducive to investment. The cumulative foreign direct investment (FDI) inflow in the past decade alone has been USD 187 billion. Inflows picked up in latter half of the previous decade with a ten-fold increase from USD 2.2 billion in 2004 to about USD 27.3 billion in 2012. And evidently, the present slow-down notwithstanding, India has the potential to regain and retain its position as one of the top five destinations for investment.

Yet, notwithstanding the impressive spells of advancement in its economy, financial markets and technology, India continues to be a country in transition. While policy reforms and entrepreneurial dynamism have put the nation on this path of development, there continue to be concerns with regard to governance standards at multiple levels. There are serious issues of inequality in its socio-economic track record, such as economic opportunities, living standards, work environment and public distribution systems. Also, in order for economic development to continue, India needs a major thrust on investment in infrastructure which is still in a relatively dismal state.

The business community and policy makers would be aware of the fact that the country and investee companies are being tracked on the above parameters, more so than ever before. International investors may not seek complete integration from India but may well still be looking at some adherence to global standards in managing these issues. It is time for the country to set course for "real" growth, address the gaps in policy and implementation and take that position of an economic power house which, many believe, it can still become.

## Galvanising global financial markets

The concept of responsible investment and finance, which offers a set of approaches to integrate environment, social and governance (ESG) issues into investment analysis and decision making processes, has been slowly and steadily gaining ground across global markets. They are sometimes interchangeably referred to as “extra financial” information as they may combine a wide range of issues which are likely to have a short, medium and long-term effect on corporate performance. There has been a visible transition of interest in the inclusion of ESG indicators in investment portfolios and investment policies from the fringes to the mainstream in several developed financial markets. There are several ways to define responsible finance and investments, and to evaluate how vast the discipline has become. But for starters, one can consider the subscription to the United Nations Principles for Responsible Investment (UN PRI) as a benchmark. The number of signatories of UN PRI is now more than 1100, collectively representing assets under management (AUM) worth USD 34 trillion or about a significant 15% of the world’s total investable financial assets.

In a movement that started taking shape more than two decades ago, investors began to assemble on a common platform—Sustainable Investment Forum (SIF)—to research, articulate and create multi-stakeholder dialogues on related issues. According to a 2012 report from Global Sustainable Investment Alliance, the Washington DC headquartered USSIF has a total AUM of around USD 3.74 trillion. Similarly, EuroSIF members now represent assets worth USD 8.76 trillion. In other parts of the world, the Social Investment Organisation (SIO) in Canada; The Responsible Investment Association Australasia (RIAA) and closer home, the Hong Kong-based Association for Sustainable & Responsible Investment in Asia (ASrIA) are dedicated to promoting sustainable finance and responsible business practices in these various markets.

Regardless of how the market is evaluated, it is clear that this is a growing trend among mainstream investors. The recent inclinations also indicate maturing disposition towards developing models and tools for ESG integration, for all asset classes, and not just public equity. Investors are adopting a wide array of strategies: Sustainability-themed, Best-in-Class (investment in sectors, companies or projects selected for positive ESG performance relative to industry peers), Norms-based

screening (of investments against minimum standards of business practice), Exclusions (from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria), ESG Integration (systematic and explicit inclusion of environmental, social and governance factors into traditional financial analysis), ESG-Themed (investment in themes or assets specifically related to sustainability such as clean energy), Engagement/voting (this strategy leverages shareholder power to influence corporate behaviour) and Impact investments (targeted investments aimed at solving social and environmental problems).

Growing demand from asset owners is the primary driver of ESG mainstreaming. Globally, asset owners, including pension funds and insurance companies, are leading the way by adopting integration strategies for their entire portfolios. For instance, CalPERS, the USD 260 billion pension fund, has approved integration of ESG issues as a strategic priority.

On the same lines, for business lending and project finance, banks are aligning their operations to the Equator Principles (EPs). This is a credit risk management framework for managing environmental and social risk in project finance transactions, on principles that are based on the International Finance Corporation (IFC) Performance Standards. Since its establishment in 2003, signatories to the EPs have grown from 16 to 79 at present.

Analysts at investment management firms increasingly see sustainable investment as an opportunity to grow their practices by staying ahead of the curve, differentiating themselves from their competitors and most importantly, better meeting the needs of their clients.

Another reason ESG integration is gaining traction is the growing conviction that strong ESG indicators act as a gauge for good risk management and strategic planning. Importantly, a number of studies are supporting this understanding. A 2007 report<sup>1</sup> pooled results from 36 studies that suggest a neutral-to-positive relationship between strong ESG indicators and long-term financial performance.

Regulators and policy makers all over the world acknowledge the significant bearing of environmental, social and governance externalities on the health of





their economies. Through legislation and regulation, many governments are addressing the critical issues that impact society and are emboldening—if not mandating—investors to pursue greater business responsibility and active ownership practices.

The National Voluntary Guidelines (NVGs) issued by the Ministry of Corporate Affairs (MCA) in 2011, encourage companies to demonstrate their adoption of a set of nine principles of economic, environmental and social responsibilities through credible reporting and disclosures on an 'apply-or-explain' principle.

In the same year, the Securities Exchange Bureau of India (SEBI) passed a board resolution which mandates listed companies to report on their extra-financials through a Business Responsibility (BR) report which would form part of a company's annual filings.

Stock Exchanges across the world are exploring how they can work together with investors, regulators, and companies to enhance corporate transparency and ultimately performance, on ESG parameters and thereby encourage long-term approaches to investment. The UN Sustainable Stock Exchanges initiative is one concentrated effort in advancing commitments on this front. As this collaboration advances, in the medium to long term, there may be more objective inclusion of such extra-financial disclosures in listing requirements on such exchanges.

### Tracking ESG advancements in India

Although responsible finance practices have existed closer home in several parts of Australasia and Asia for more than a decade, they have not yet found similar footing in India. However, regulatory measures taken particularly in the last 3-4 years have been quite enabling and are possibly the better demonstrated examples of the change taking place in India's financial markets. The National Voluntary Guide-

lines (NVGs) issued by the Ministry of Corporate Affairs (MCA) in 2011, encourage companies to demonstrate their adoption of a set of nine principles of economic, environmental and social responsibilities through credible reporting and disclosures on an 'apply-or-explain' principle.

In the same year, the Securities Exchange Bureau of India (SEBI) passed a board resolution which mandates listed companies to report on their extra-financials through a Business Responsibility (BR) report which would form part of a company's annual filings. Companies have been advised to describe measures taken in line with the key principles of the NVGs issued by the MCA. This SEBI directive has been made immediately applicable to the top 100 listed companies (by market capitalisation) and remaining companies are expected to come under its realm in due course of time.

A recent legislation in the new Companies Act 2013 contains provisions related to socially responsible corporate behaviour and marks the attention of the policy makers on better disclosure benchmarking for companies operating in India. This law proposes that companies conceptualise and implement a formal CSR policy and report key activities.

Spirited implementation of the new guidelines and reporting mechanisms for sustainability disclosures will contribute towards raising greater awareness among financial institutions and companies about the potential benefits of managing sustainability performance.

While the regulatory space has been abuzz, the response from domestic financial organisations and investors to take the cue from the above measures continues to remain relatively weak. In contrast to developed or even several developing markets, Indian institutions including insurance companies and state pension funds, are entirely inactive in this space. In spite of the growing global adoption, there are only two PRI signatories from India as of now—IDFC and Soloron Sustainability Solutions, and also only two Indian UNEP-FI signatories, Yes Bank and IL&FS. IDFC also happens to be the only Indian signatory to the Equators Principles till date, while Yes Bank has formulated its own Environmental and Social Policy (ESP) based on these principles. The Carbon Disclosure Project (CDP), which works with shareholders and corporations to disclose

greenhouse gas emissions, has been able to gain some traction in the last two years and now has a total of 8 Indian signatories including HDFC Bank, IDFC, IDBI Bank, IndusInd Bank, Reliance Capital, State Bank of India, Tata Capital, and Yes Bank. Several international banks operating in India, such as Standard Chartered, Deutsche Bank, HSBC, Goldman Sachs and J.P. Morgan are signatories to one international standard or the other. While most of them may be managing their own footprints well, there is no evidence of deploying a formal ESG framework for their investment portfolios in the country.

The central bank, RBI, did take a lead in issuing a circular, “Corporate Social Responsibility, Sustainable Development and Non-Financial Reporting—Role of Banks in December, 2007, but expectations around sustainability issues highlighted therein were not met by most banks. RBI has so far not followed up with guidance for these issues.

In the investment management community in India, fundamental awareness of ESG issues exists but there are no established illustrations of decision-making models that integrate extra-financial factors. Due to some publicised corporate governance mishaps in 2009, managers are looking for “management quality” and sound governance practices but the factors around environment and social issues are mostly overlooked. The lack of attention from domestic investors, coupled with short and unpredictable holding periods, limits the application of E&S practices.

**BSE launched the first live carbon index, the BSE-GREENEX, in collaboration with gTrade**

These prevailing circumstances of low demand and adoption of ESG issues in India is reflected in the slow development of responsible investment products in the country. No specifically themed ESG product was initiated after ABN AMRO India launched its Sustainable Development Fund. This fund (subsequently managed by Fortis Asset Management and BNP Paribas) was eventually merged into regular equity portfolio after listless growth for more than five years.

### **Recent positive trends indicate a shift**

The good news is that if one does take a closer look, it is possible to recognise the growing awareness

amongst all financial sector stakeholders about these issues. While the participants, as mentioned earlier, are already aligning themselves with internationally accepted principles, there are other financial organisations that are in the process of developing their own frameworks and sets of best practices.

In the last two years, some domestic asset managers have initiated the development of informal E&S frameworks, primarily based on the mandate from their international institutional investors. Many domestic advisors are now working with international investors and investment managers in directing investments into thematic E&S spaces or providing expert advice for managing risks associated with these factors. Even as the assets thus managed remain relatively insignificant, these developments may well pave the way to much needed product and standards development.

Stock Exchanges have distinctly upped their ante as well. BSE launched the first live carbon index, the BSE-GREENEX, in collaboration with gTrade, a consulting firm working on innovative financial solutions for mitigation of GHG emissions. The index takes the BSE-listed companies as a baseline and recognises companies in line with prescribed metrics on their carbon emissions performance. BSE has also joined the UN SSE initiative and is working collaboratively with several global exchanges in driving best practices. MCX Stock Exchange is also working towards developing recommendations to listed companies on ESG disclosures.

There is, however, a wide variance in adoption of best practices across the financial sector. In many parts the actors seem to be interested but have yet not been able to develop suitable models to reflect their perspective on ESG factors.

### **Next levels of engagement**

One of the pre-requisites for wider adoption is adequate disclosures. The voluntary and “comply or explain” basis for disclosure recommended under BRR is a great start. Although one would like to assume that most companies will go through the routine very seriously, the next level of challenge will be effectiveness. It will be important to align these disclosures to investors' questions and other stakeholders' interest as well as to emerging standards. Market participants including asset managers and analysts need to pay at-

tention to sustainability issues across all links in the investment value chain.

As the original drivers have shifted from brand enhancement and reputation management to include strategy, innovation and cost reduction, they have to increasingly view ESG information as relevant to risk or return and not simply a matter of values or ethics. The financial sector's demand for enhanced quality and comparability of data is the key, as it increasingly engages with the sustainability agenda around factors that are material to investment performance. India is under-researched in regard to most of the above issues and their linkages to its economic growth, as the corporate and financial sectors' understanding of growth has not included extra-financial factors. There is also limited documentation on the long-term priorities of investors considering India and their experiences with regard to pre- and post-investment phases.

The effectiveness of advancing the thought capital and best practices will also depend on the capability of the financial community to deploy the above data. The sector needs to invest in developing analyst literacy in interpretation and analysis of ESG information. The investor relations practice in the corporate sector, which integrates finance, communication, and compliance, can play an active role here. The recommended way forward would be to facilitate the integration of extra-financials well inside mainstream discussions on business strategy and into the scope of companies' C-suite or Board level responsibilities. The regulatory

measures provide the platform for both sides—corporates as well as analysts—to improve their approach to ESG issues. Analysts need to enhance the quality of their research and models, and companies need to map ESG issues against value drivers and adapt their communication to investor requirements. The channel of communication may still be at a nascent stage but these efforts can contribute to the creation of a level playing field where both economic growth and sustainability through markets can be achieved. Just as in developed markets, other stakeholders such as media, retail investors and civil society can play an actively supportive role in campaigning against companies that engage in irresponsible environmental or social practices and in rewarding those who have strong ESG performance indicators.

Going by recent experiences and evidence, it can be concluded that this shift, even if at a relatively slower pace, is happening in the domestic financial markets. Although temporarily challenged, the country's higher economic growth potential may enable domestic firms to invest more in ESG best practices, cushioning their related earnings' volatility and likely cost impact in the long term. Most of the next level milestones will be achieved by enhancing the capabilities of professionals and on fostering healthy communication around extra financials. Investee companies, investors, stock exchanges and other enabling agencies today have the opportunity to transition towards a new paradigm for creating sustainable business models.



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# 3

## The Finance Industry Dilemma



### >> Robert Tacon

A banker with more than 40 years of experience, Robert has worked in South Africa, Europe and the UK and has had extensive exposure to Asia, Africa, the Middle East and South Asia. Robert is the founder of Boundes Sustainability Ltd (BSL) a Sustainability and Credit Risk consultancy. Through BSL, he has facilitated numerous credit and sustainability risk training programmes in several countries. He earlier served with the United Nations Environment Programme Finance Initiative (UNEP FI) as Treasurer and then as Chair until December 2009 and is currently involved as advisor and speaker. Apart from lecturing on credit risk and sustainability issues at various platforms, Robert has engaged in research work for the Cambridge Programme for Sustainability Leadership and has run several sustainability programmes for banks and industry in China. He has recently been engaged with the development and delivery of the Sustainable Banking Principles in Nigeria and the OECD research project in relation to the adoption of the Ruggie Framework on Human Rights in the finance industry.

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As we entered the first decade of the 21st Century, the mood was one of optimism. Economies were growing, profits appeared to be strong and consumer confidence was high. However, below the radar, things were not as rosy as they first appeared. The first rumblings of the financial earthquake were starting to be felt and it wasn't long before North America, the UK and Europe were hit by a financial tsunami far more powerful than anything witnessed for a very long time. Countries rapidly fell into recession, banks and insurance companies were failing or being bailed out, businesses were going into liquidation and the "man on the street" was losing his job and house.

It didn't take very long for the blame to be fixed on to the banking industry. Headlines decrying "Greedy Bankers" were everywhere. These bankers were seen to be providing credit without due care and then creating financial instruments that were not understood by many, including regulators and rating agencies, but, on the face of it, were creating vast profits and eye-watering bonuses for many sen-

ior bankers. The media saw the banks ignoring ethics and governance in pursuit of profit. It was also seen that this headlong dash ignored the impacts on people and the planet.

As we entered the second decade of the 21st Century, things did not improve. Economies continued to bounce along the bottom (and some still do) and banks continued to create an atmosphere of animosity from the media, the politicians and the public. The position has not been helped by new disclosures around the manipulation of Libor rates and other market prices through data falsification.

So, can things improve? If so, what needs to be done to change the public face of not only banking but the finance sector as a whole? Many articles have been written about the paradigm shift needed to both save the face of banking and finance and also to "save the planet" from the ravages of human development. The cry is for the finance industry to embrace sustainability and also to consider the vast array of business oppor-

tunities available to help combat climate change, improve environmental management and tackle human rights violations. It might be appropriate at this point to go back a bit in time to consider how the finance community has taken sustainability into its business decision-making.

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## “Today we have an unprecedented opportunity to align economic, social and environmental goals”

**JONATHON LASH**

From Financial Crisis to Sustainable Global Economy, Jonathon Lash, January 2009  
(Former President of World Resources Institute)

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### **A history lesson**

Most of the major global players will probably admit that they were starting to take an interest in the risks facing their borrowing customers from environmental legislation way back in the early 1990's. In the United Kingdom, the British Bankers Association formed an Environmental Risk Working Group to consider these issues and the members openly worked together to develop policy and procedures to understand the associated risks. At that stage it was not as much about ethics but more about understanding risks and adapting risk assessment processes to recognise the problems. There was also increasing recognition of these issues amongst banks in North America and Europe. Most institutions didn't see this as a competitive issue but one of collaboration and therefore it seemed only natural to work together through organisations such as the United Nations Environment Programme Finance Initiative (UNEPFI) to build knowledge and capacity.

Increasingly, however, financial institutions (FIs) were being targeted by the NGO community for their involvement in major infrastructure projects that were seen to be damaging the environment and impacting indigenous populations' human rights. This resulted in a number of major institutions working together to develop the Equator Principles (see <http://equator-principles.com/>). While aimed specifically at project financing, this initiative became a magnet for banks globally to adopt the Principles and for the NGO community to pay even greater attention to the FIs and the schemes that they were financing.

Whilst infrastructure projects, have, by their very nature, a huge potential for environmental and social impact, it is the day-to-day lending to businesses that probably causes the greatest aggregate environmental and social damage. Most of these global and large regional FIs recognised this and developed internal policy, procedures and staff training to ensure that environmental and social considerations are taken into account.

There were also moves in many countries by banks to develop local codes of practice. These had limited success as such codes were seen to restrict an institution's international business. The playing field in most countries was not, and in many cases still not, level!

The investment community was also active. Many of the major global players were already members of UNEPFI and in 2006 a group of investors launched the Principles for Responsible Investment (PRI) which calls on signatories to actively take account of ESG issues in their investment analysis and decision-making procedures. PRI has over 1000 signatories with trillions of US Dollars under management (see <http://www.unpri.org/>).

### **Does sustainability awareness pay dividends?**

If one looks at the list of banks that are members of UNEPFI or have adopted the Equator Principles or who are members of other initiatives and then at a list of banks that were affected by the financial crises, one would very quickly draw a conclusion that the incorporation of sustainability commitments does not appear to have curbed poor business practices. However, it is probably only fair to recognise that in many cases, the problems they faced did not come from basic lending and project finance in the initial stages at least, but rather from their involvement in exotic banking instruments and toxic debt in sub-prime mortgage lending. Most of the major international banks would contend that they do place a strong emphasis on taking environmental and social issues into account and in many cases also consider the implications for climate change as well, as part of their lending analysis.

So, has the PRI made a major difference? Its members are some of the largest institutional investors in the world who invest trillions of USD into the world's major corporations. These funds represent

the savings of millions of people across the world and are typically invested for the long term. This would imply that the institutional investor should have the ability to encourage companies in which it invests to promote sustainable business practices. In reality, however, most of these institutional investors do not hold shares in any given company for any length of time and therefore it is questionable how much influence they can exert.

There are however, a group of banks that do believe that having sustainability at the heart of their DNA does make good financial sense.

### Global Alliance for Banking on Values

“The Global Alliance for Banking on Values” (GABV) is an independent network of banks using finance to deliver sustainable development for underserved people, communities and the environment. Members include: ABS Switzerland; BancoSol, Bolivia; Cultura Bank, Norway; One Pacific Coast Bank, California; Triodos Bank, Netherlands; and Vancity, Canada.

In March 2012, the GABV issued a report titled “Strong, Straightforward and Sustainable Banking”.<sup>1</sup> The report aims to show how member institutions recorded steady growth and profitability during the financial crisis. The report compared the performance of sustainable banks against 29 large banks defined by the Financial Sustainability Board as “globally systemically important financial institutions” (GSIFI). These included, inter alia: Barclays, Royal Bank of Scotland, HSBC, Bank of America, JP Morgan, Citigroup and Bank of China.

Key conclusions of the GABV 2012 report with relevance for investors and public policy include:

- A clear statement of the Principles of Sustainable Banking was needed, and has been developed, to highlight characteristics distinguishing sustainable banks from other financial institutions.
- The historic and prospective financial performance and support to the real economy of sustainable banks compares favourably with GSIFIs.
- Measuring non-financial returns of banks in a meaningful way presents a major challenge and will require significant multi-stakeholder efforts.
- Sustainable banks will need to raise capital externally if growth trends continue.

- There may be potential innovative approaches for finding new sources of patient financial capital for sustainable banks.

The research also found several key differences between the GABVs and GSIFIs. These include:

- GABVs are more than twice as likely to invest their assets in loans, lending on average 70% of assets;
- Lending increased by over 50% during the period 2007 to 2010 while lending in the GSIFIs only increased by 20%;
- The equity to assets ratio also appeared to be stronger in the GABVs at close to 9% against the global players’ position of around 5%.
- RoA (Returns on Assets) was also superior for the GABVs at around 0.5% whilst GSIFIs averaged 0.33%.

The term sustainability has more often than not raised questions around definition. The research undertaken by the GABV has produced a set of Principles of Sustainable Banking that have been endorsed by its members:

#### GABV Principles of Sustainable Banking

- 1 Triple bottom line approach at the heart of the business model
- 2 Grounded in communities, serving the real economy and enabling new business models to meet the needs of both
- 3 Long-term relationships with clients and a direct understanding of their economic activities and the risks involved
- 4 Long-term, self-sustaining, and resilient to outside disruption
- 5 Transparent and inclusive governance
- 6 All of these principles embedded in the culture of the bank

This research was conducted over a period during which many of the global players, the so called GSIFIs, were facing very difficult market conditions with severe strains on their capital. This meant that they were in many cases reducing their lending book. It is also interesting to note that a UK bank which prides itself on its sustainability stance was not included in the



research. The Co-operative bank has been recognised as being a bank that places sustainability at the heart of what it does. This has, however, not meant that it was immune from the travails of banking. It faces a severe capital crisis that has threatened its very existence and has recently been dragged through the media over governance and issues with its chairman.

Be that as it may, the research does appear to point to a conclusion that sustainability and careful consideration of the environment, biodiversity, human rights and climate change lead to financial benefits.

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“Doing good is beneficial for banks and society not just in a theoretical and ethical sense, but also financially, when measured against conventional benchmarks such as the financial bottom line.”

PETER BLOM

Chair of the GABV and  
Chief Executive of Triodos Bank

Sustainable banking: The business case, James Niven,  
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### A new world order?

The question is then, what are the finance community, the regulators, the rating agencies, *et al*, doing about making the changes necessary to ensure that we see a changing world order that puts sustainability at its heart?

All is not lost, in the banking arena at least. We are seeing a number of initiatives, which, if successful, could see a significant change in the way banks operate and are perceived. In a number of countries, steps are being taken to develop sustainable banking principles either by the banks themselves or by the regulator or both.

One such initiative is The Nigerian Sustainable Banking Principles (see Table 1).<sup>2</sup> The Principles were developed by the Nigerian banks in cooperation with the Central Bank of Nigeria. Whilst adoption of the Principles is voluntary, banks will be expected to report to the Central Bank on their progress in implementing the Principles or explaining why they are not adopt-

ing these. The latter action could be seen as putting that bank's lending portfolio at increased risk, as all potential issues would not have been incorporated into the lending analysis. In this scenario a bank could be required to increase its capital ratios.

These Principles were developed in line with the local environment and economic situation. The aim was to ensure that there is financial inclusion, women are treated fairly and that all environment and social aspects are taken into account in financing decisions. The Principles also call for banks to work together on community development and are encouraged to develop global best practices. The Principles are supported by clear guidance to ensure that there is a uniform understanding of the underlying meaning.

As with all Principles, the challenge is implementation. Banks will need to develop their own internal systems to analyse environmental and social risks in lending, develop an internal environment and social management system, develop products and services to meet the challenges of financial inclusion and women's empowerment. All this cannot happen overnight but a number of the local banks have begun the journey and recently all executive and non-executive directors went through an awareness programme to help the process. The sustainability world will be watching their progress with great interest.

A number of other countries such as Kenya, Mongolia and Bangladesh are looking at developing their own sets of principles. In some instances this is bank-led with the regulator being invited to participate, while in others, the regulator is taking the lead role. So, is this the future for embedding sustainability into the local market?

Developing a set of principles, whether for banking, investment or the insurance industry, can help “level the playing field” in a country. However, such programmes are only as good as the regulatory regime built around them. Whether introduced by the regulator, as with the Chinese Green Credit initiative, or by the industry itself as a voluntary initiative, signatories to such principles need to be seen to collectively adhere to them or else they will fail.

To make a meaningful difference any new principles need to make clear commitments that are:

- Target-based
- Time-bound
- Positive in terms of committing investment in certain areas
- Negative screens that restrict damaging practices, say, towards biodiversity
- Are regularly reported on

### Opportunities in the green space

According to the United Nations Environment Programme, “in a green economy, growth in income and

employment is driven by public and private investments that reduce carbon emissions and pollution, enhance energy and resource efficiency, and prevent the loss of biodiversity and ecosystem services.”

The UNEP report, *'Towards a Green Economy'*,<sup>3</sup> talks about an “an era of misallocation” with capital flowing into a fossil fuel economy with little flowing into “renewable energy, energy efficiency, public transportation, sustainable agriculture, ecosystems and biodiversity protection, and land and water conservation. Indeed, most economic development and growth strategies encouraged rapid accumulation of physical,

**TABLE 1: The Nigerian Sustainable Banking Principles**

**1 Our Business Activities:**

**Environment and Social Risk management**

We will integrate environmental and social considerations into decision making processes relating to our Business Activities to avoid, minimise or offset negative impacts.

**2 Our Business Operations:**

**Environmental and Social footprint**

We will avoid, minimise or offset the negative impacts of our Business Operations on the environment and local communities in which we operate and, where possible, promote positive impacts.

**3 Human Rights**

We will respect human rights in our Business Operations and Business Activities.

**4 Women’s Economic Empowerment**

We will promote women’s economic empowerment through a gender inclusive workplace culture in our Business Operations and seek to provide products and services designed specifically for women through our Business Activities.

**5 Financial Inclusion**

We will promote financial inclusion, seeking to provide financial services to individuals

and communities that traditionally have had limited or no access to the formal financial sector.

**6 E&S Governance**

We will implement robust and transparent E&S governance practices in our respective institutions and assess the E&S governance practices of our clients.

**7 Capacity Building**

We will develop individual institutional and sector capacity necessary to identify, assess and manage the environmental and social risks and opportunities associated with our Business Activities and Business Operations.

**8 Collaborative Partnerships**

We will collaborate across the sector and leverage international partnerships to accelerate our collective progress and move the sector as one, ensuring our approach is consistent with international standards and Nigerian development needs.

**9 Reporting**

We will regularly review and report our progress in meeting these Principles at the individual institution and sector level.



financial and human capital, but at the expense of excessive depletion and degradation of natural capital, which includes our endowment of natural resources and ecosystems”.

The finance section of the report looks at the total sectoral target investments needed to move toward a green economy and concludes that approximately 2% of global GDP will be required each year to achieve this goal. This equates to approximately USD1.3 trillion per year through until 2050 mainly to the energy supply, transport, industry and buildings sectors. However significant investment will also be needed for forestry, tourism, waste management, water and fisheries. The report suggests that the largest commitment of funds will have to come from the private sector.

So financial institutions will increasingly be judged on whether they invest in the old polluting technologies or whether they direct their investment to the new green economy.

The report identifies: “Estimates by the private financial sector also underline the scale of the challenge. The World Economic Forum<sup>4</sup> and Bloomberg New Energy Finance calculate that clean energy investment must rise to US\$500 billion per year by 2020 to restrict global warming to 2°C. HSBC estimates the transition to a low carbon economy will see a total growth in cumulative capital investments of US\$10 trillion between 2010 and 2020 (HSBC 2010)<sup>5</sup>”

Thus going forward, there is a great opportunity for smart financial institutions to seek out these opportunities and re-align their portfolios.

### In conclusion

It is essential that the finance community understands the risks to their business from not addressing issues such as climate change, deforestation, loss of biodiversity, water scarcity, pollution and unsustainable agriculture, and develop forward-thinking risk practices to manage them.

There is a great window of opportunity to address these issues as the market, the regulators and the rating agencies ponder the future of financial regulation. We are increasingly seeing local initiatives taking place in the emerging economies. In most cases it is these economies that are being directly impacted by the ravages of a changing climate, environmental degradation, loss of natural resources and the impacts on the population of poverty and exploitation.

Although the GABV report can be criticised for taking a fairly narrow timeline for comparison purposes, what it does show is that there is a strong financial case for making sustainability the heart of an organisation. However, for this to be workable it is probably necessary for most, if not all of the major organisations within a country to embrace this view. Here the regulator and/or the banking association can play a pivotal role by acting as the catalyst. There is also a role for a leading institution within the country, by showing the way for others to follow.

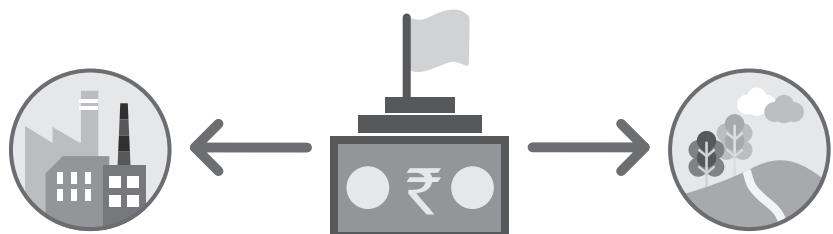
For a country like India with a growing population and the demands that that places on economic development, this is possibly a crossroads moment. Choose the right path and the Indian finance community could be the inspiration for ensuring that People and Planet are embedded into the financing equation.

- This is an ideal time for banks to take a leadership position on global sustainability and the green economy.
- There are clear business opportunities in building a green economy. Based on various sectoral targets of investment needed for a green economy as set out in UNEP report, an annual investment of approximately 2% of global GDP averaging around USD1.3 trillion is required. This covers the agriculture, build-ings, energy supply, fisheries, forestry, industry, tourism, transport, waste and water sectors.
- Of this some USD500 billion is required in the renewable energy sector alone.
- There are increasing business risks arising from climate change, loss of biodiversity and water resources, destruction of forests and other natural asset depletion.

Perhaps a quote from Pavan Sukhdev,<sup>6</sup> the author of the UNEP Green Economy report puts everything into perspective: “So whereas Wall Street by various calculations has to date lost within the financial sector \$1-\$1.5 trillion, the reality is that at today’s rate we are losing natural capital at least between \$2-\$5 trillion every year.”

The question is whether or not will the finance industry both in India and globally take up the challenge!

Further Reading: Lenses and Clocks: Financial stability and systematic risk, June 2012, Paul Clements-Hunt, The Blended Capital Group, International Institute for Sustainable Development (IISD) and United Nations Environment Programme Finance Initiative (UNEPFI).



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# 4

## Integrating Environmental and Social Risk Management: The International Finance Corporation's approach to operations and investments



### >> Atiyah Curmally

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### Introduction


This article covers the International Finance Corporation (IFC)'s approach to managing environmental and social risks in its operations and those of its clients with particular emphasis on its financial institution clients. It also includes a discussion of IFC's Sustainability Framework and Performance Standards and approach to environmental and social risk management for financial markets.

### IFC's sustainability framework


The International Finance Corporation (IFC), a member of the World Bank Group, is the largest global development finance institution focused exclusively on the private sector in emerging markets. IFC enables sustainable economic growth by financing private sector investment, mobilising capital in international financial markets, and providing advisory services to businesses and governments. In order to achieve its purpose, IFC offers development impact solutions through firm-level interventions, standard-setting and business enabling environment work. Its

firm-level interventions include direct investments in companies, investments through financial intermediaries, advisory services, and through the IFC Asset Management Company.

IFC is committed to ensuring that the costs of economic development do not fall disproportionately on the poor or vulnerable and endeavours to achieve this commitment through its promotion of sustainable development outcomes by working with business partners with a shared vision and commitment to sustainable development.



IFC's investment and advisory activities across the globe consider four dimensions of sustainability—financial, economic, environmental, and social. Financial sustainability enables IFC and its clients to work together to make a long-term contribution to development. Economic sustainability enables projects to contribute meaningfully to host economies. Ensuring environmental and social sustainability in client operations and supply chains helps protect and conserve natural resources, mitigate environmental degradation, secure a social licence to operate and address the global challenges of climate change. Sustainability is also viewed as an opportunity to transform markets, drive innovation, and add value to clients by helping improve their business performance.



In FY13, IFC's investments, including funds mobilised from other investors, reached an all-time high of close to USD 25 billion and provided capital to more than 600 projects and companies across 113 countries in the emerging world. IFC invested USD 18.3 billion from its own account and mobilised USD 6.5 billion from other investors. At present, IFC's investment portfolio stands at close to USD 50 billion in nearly 2000 companies across 126 countries. Over 50 per cent of these investments are in markets where environmental and social issues are increasingly material. Issues may range from climate change to resource scarcities to rising social pressures to increasing vulnerabilities.

IFC's approach to sustainability is based on its Sustainability Framework which promotes sound environmental and social practices, broadens IFC's development impact, and encourages transparency and accountability. The Framework articulates IFC's strategic commitment to sustainable development and is an integral part of its approach to risk management by

enabling IFC to manage a diverse client base—many of which are financial institutions.

IFC's Sustainability Framework consists of:

- The Policy on Environmental and Social Sustainability, which defines IFC's commitments to environmental and social sustainability;
- The Performance Standards, which define clients' responsibilities for managing environmental and social risks; and
- The Access to Information Policy, which articulates IFC's commitment to transparency (see **Box 1**).

### Performance Standards

Eight Performance Standards form the core of IFC's sustainability framework. These Standards address a range of environmental and social issues facing the private sector and also define areas of opportunity. They are designed to help clients avoid, mitigate, and manage risk as a way of doing business sustainably and improve their environmental and social performance through a risk and outcomes-based approach. This, in turn, has a direct impact on the risk profile and quality of IFC's own investment portfolio. The Performance Standards help companies identify opportunities to develop competitive solutions that are good both for business and developmental outcomes, while supporting safer working conditions, more effective and transparent community engagement, and resource efficiency and pollution prevention measures that can lead to cleaner air and water.

Companies also find that they are able to generate long-term value for stakeholders by lowering financial and reputational risks, thereby improving access to capital; are able to better position themselves in mature markets as leaders in sustainability; to improve efficiency and reduce costs; and to generate opportunities for growth and innovation. IFC's most recent annual client survey showed that more than 90 per cent of its clients that received support from IFC on environmental and social matters found the assistance to be vital.<sup>1</sup> Feedback included helping clients improve relationships with stakeholders, strengthen brand value and recognition, and establish sound and long-term risk management practices.

When a project or financial institution is proposed for financing, IFC conducts an environmental and social

review as part of its overall due diligence. This review takes into account the client's assessment of their direct and indirect business impact and the client's capacity and commitment. It also assesses whether the client has a strategy to meet the IFC Performance Standards. Together IFC and the client identify any gaps, and an Environmental and Social Action Plan is defined to ensure that the risks and opportunities are addressed over time. IFC in turn, supervises projects throughout the life of an investment including monitoring and supporting client commitments to environmental and social performance.

### **Approach to environmental and social risk management for financial markets**

Sound, inclusive, and sustainable financial markets are vital to development as they ensure efficient resource allocation. Banks, as financial intermediaries between different sectors of society, are central to any solution to address global and national environmental and social challenges. The financial sector has a crucial role to

play in the allocation of capital to environmentally and socially sustainable uses. The sector can also influence business behaviour towards more responsible practices and business strategies.

IFC's work with financial intermediaries has helped strengthen financial institutions and overall financial systems and it has built up a network of more than 900 financial institutions operating in more than 100 markets through its engagement with financial institutions over the last 15-plus years. This allows for support to micro, small, and medium enterprises. It also enables IFC to reach sectors that are strategic priorities, for example, women-owned businesses, climate change and underserved regions such as fragile and conflict-affected states as well as in housing, infrastructure, and social services. In FY13, IFC commitments in financial markets totalled USD 3.6 billion, about 20 per cent of commitments for IFC's own account. Including IFC's support for trade finance, the figures are USD 10.12 billion, just over 55 per cent of IFC commitments for FY13.

#### **BOX 1: Access to Information Policy**

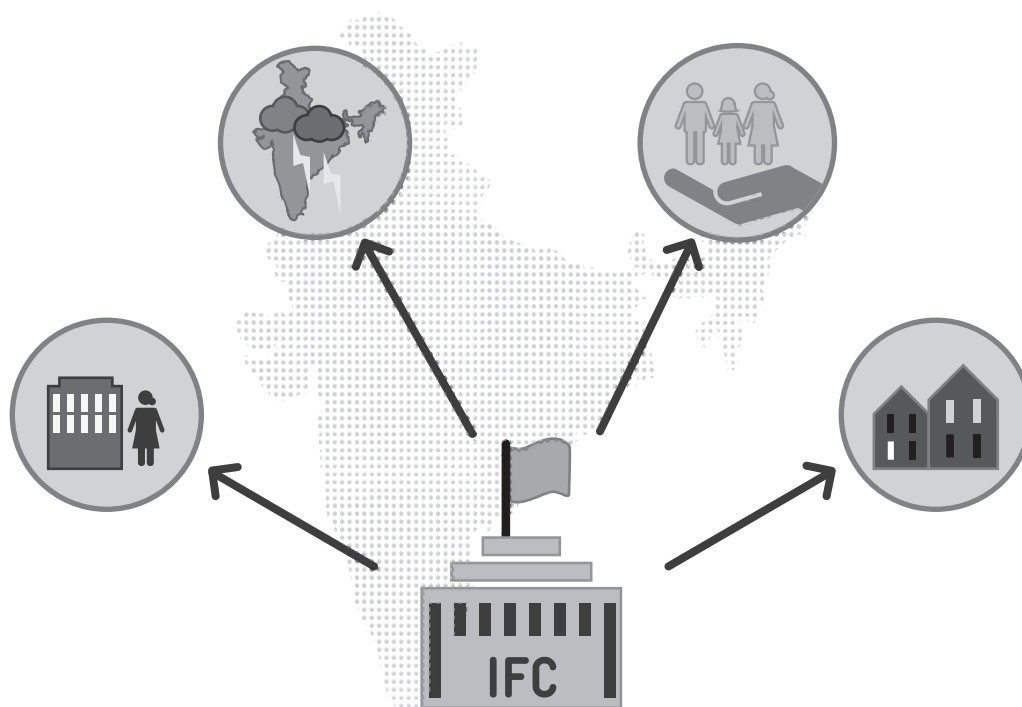
As a global public institution with operations in many regions and sectors, IFC affects a diverse range of stakeholders. Transparency and accountability are fundamental to fulfilling IFC's development mandate. The Access to Information Policy, which came into effect in 2012, improves IFC's ability to communicate development impact and management of environmental and social risks. This increased transparency about operations and investments allows for more informed dialogue and feedback. IFC discloses information on the environmental, social, and development performance of projects during all stages of its investment cycle.

The disclosure of development results for IFC's investment projects is being phased in by region, with its Latin America and the Caribbean, East Asia and the Pacific, and Europe and Central Asia regions beginning disclosure in FY13.

All other regions will begin disclosure of development results in 2014. Increased transparency regarding investments through financial intermediaries includes the periodic disclosure of the list of names, locations, and sectors of high-risk sub-projects supported by IFC's investments in private equity funds.

IFC's project-level and annual report data sets are now also available on the World Bank Group's Open Finances platform. This initiative increases the accessibility of IFC's project and financial information.

IFC believes that greater transparency improves business performance, promotes good governance, including better project outcomes over time, increased awareness on the part of affected communities, and ultimately stronger relationships with stakeholders.



### **Sustainability adds measurable value to banks' lending portfolios**

IFC has seen growing evidence of this in its own investment portfolio and with its financial markets clients. Over the last 10 years, IFC has achieved a more than 23 per cent real return on overall equity investments. Loans with better environmental and social risk ratings also tend to have better credit risk ratings. An internal study on the link between sustainability and the performance of a sample of listed equity clients provided convincing evidence of a correlation between environmental and social and financial performance. The better sustainability performers were also generally better financial performers. Sustainability leaders also performed better by a significant margin across a number of environmental and social performance aspects including investing in staff training and capacity development, reporting on sustainability initiatives, investing in stakeholder engagement, and developing initiatives to reduce greenhouse gas emissions.

### **Capacity-building of the financial sector**

Through its engagement with financial institutions, IFC supports the capacity development of the banking and financial sector to manage environmental and social risks. This is achieved in part through supporting financial institutions with the development and implementation of an Environmental and Social Man-

agement System, and by enhancing financial institutions' in-house capacity for the day-to-day management of portfolio risks, including environmental and social risks. Financial institutions undertake individual transaction appraisal and monitoring as well as overall portfolio management in accordance with the environmental and social risk profile of the activities they finance. Financial institutions are also instrumental in directing finance to green banking as described in a subsequent section.

### **Tangible benefits**

According to IFC's 2007 report, *Banking on Sustainability*, which included a survey of 120 financial institutions in 43 emerging markets, the integration of sustainability into existing management systems and practices brings tangible benefits. In addition to those mentioned previously, this can also include new clients, greater access to financing, access to cheaper financing, greater shareholder value and improved goodwill in the market.<sup>2</sup> 74 per cent of the surveyed commercial banks reported a reduction in risk as a result of their considering environmental and social issues. Another 48 per cent noted improved access to international capital, 39 per cent benefited from improved brand value and reputation, 35 per cent developed new business, and 26 per cent benefited from improved stakeholder engagement.

Benefits are also reflected in external acknowledgement such as the Financial Times/IFC Sustainable Finance Awards. An example is Yes Bank in India, which has been awarded Sustainable Finance Awards on three occasions and has also consistently been recognised by other organisations for its sustainability performance. (For a summary of challenges and opportunities faced by the financial sector in India, see [Box 2](#)).

## Emerging trends for the financial sector

### Financing innovation

Support for sustainable finance presents untapped market opportunities for financial institutions. As an example, mounting evidence continues to demonstrate that climate change, which is a fundamental threat to

business and the fight against poverty, can have adverse and irreversible impacts. Investment needed to stabilise the climate will reach at least USD 700 billion annually between now and 2030, and it is estimated that the private sector will provide 80 per cent of the financing. The two largest climate sectors for private sector investment traditionally have been renewable energy and energy efficiency, even while enabling policy frameworks to support hydropower, biomass, wind and solar power are being developed.

Renewable energy is a USD 89 billion market in the developing world and growing steadily. According to a study by consulting firm McKinsey & Company,<sup>3</sup> the global energy efficiency market will be USD 170 billion by 2020, with 65 per cent located in developing countries and 49 per cent in industries. This provides major opportunities for private sector investments in energy efficiency equipment and energy efficiency up-

### BOX 2: IFC experience in India – Opportunities and Challenges for clients

IFC's investments in India support commercial banks and non-banking financial companies which in turn provide long-term finance to corporates and project finance.

Integrating the performance standards has at times been challenging for reasons such as capacity constraints to undertake due-diligence or monitoring, absence of quality and cost-effective third party consultants to support financial institutions with undertaking due-diligence, and limited leverage with certain transactions such as syndicated loans where the financial institution is not in the lead. Additional constraints include inconsistency in the quality and coverage of lenders' engineer reports on environmental and social aspects and resource constraints if financial institutions do not earmark funds for environmental and social management system implementation to undertake due-diligence. Finally, these challenges are exacerbated by inconsistent regulatory enforcement of environmental and social regulation across the country and within sectors.

These challenges, however, also lend themselves to opportunities. For example financial institutions, especially banks, find that the leverage to introduce sustainability criteria increases with borrowers when there are multiple financing relationships (relationship banking, working capital, asset finance, overdrafts, bill financing) with the same borrower. Financial institutions also stand to benefit from developing smart products that link the environmental and social performance of borrowers with incentives such as interest rate reduction or waivers on defaults or extension of grace periods.

External opportunities lie in providing capacity building support by way of training programmes, developing interactive web-based tools or next generation smartphone applications and software for use by financial institutions. A further opportunity lies in developing a cadre of consultants available to provide independent support to financial institutions.

grades in various industries, commercial and residential buildings, and agricultural production.

In 2013 IFC issued the world's largest "green" bond raising USD 1 billion for climate-related investments

While the potential is significant, most financial institutions have still to consider support for sustainable finance as a strategic priority. Constraints cited by financial institutions include weak technical capacity to appraise sustainable finance projects; limited long-term funding; expectations of high transaction costs and large up-front investments to open new markets; and uncertainties with government regulations. However, institutions that have expanded their business offerings have added value for their clients and helped, for example, small and medium enterprises become more resilient in the face of energy shortages and energy price volatility. IFC has invested USD 10.5 billion in climate-related investments since 2005, including USD 2.5 billion in FY13 (see Box 3 for details on IFC's Sustainable Energy Finance programme and country level interventions).

In 2013, IFC issued the world's largest "green" bond raising USD 1 billion for climate-related investments, an achievement that underscored the private sector's growing demand for triple-A-rated green bonds. IFC also launched the IFC Catalyst Fund, an innovative fund of funds, managed by the IFC Asset Management Company, focused on climate-related investments. In FY13, IFC made its first investments through financial institutions in new green buildings, including mortgages for energy-efficient homes in India.

### **Environmental and social risk management frameworks**

The primary and most basic way for financial institutions to initially integrate sustainability into their operations is through development and integration of an Environmental and Social Management System into any other type of existing risk management system they implement to manage credit, liability, market and other types of risks. Sound environmental and social management systems protect financial institutions against reputational risks as well as financial

losses. The growing list of additional business benefits for financial institutions includes improved brand value, lower cost of capital, and improved quality of loan portfolio. As a result, a growing number of financial institutions worldwide are adopting policies, systems and lending practices to manage impacts and increase positive outcomes.

This is reflected in the increasing number of private sector led approaches to managing environmental and social risks by financial institutions. The most prominent of these is the Equator Principles, a credit risk management framework for determining, assessing and managing environmental and social risk in project finance transactions, now used by 78 private sector financial institutions in 35 countries covering 70 per cent of international project finance debt in emerging markets. The Equator Principles use the IFC Performance Standards as the benchmark for reviewing transactions. In addition to the Principles, 15 European Development Finance Institutions and 32 Export Credit Agencies from countries belonging to the Organisation for Economic Co-operation and Development also use the Performance Standards as the foundation of their respective risk management frameworks.

IFC's role has been that of convener and technical advisor to the Equator Principles Steering Committee. IFC continues to act as the key technical and strategic resource for the Equator Principles Financial Institutions and any other financial institutions with interest in applying the environmental and social risk management framework articulated by the IFC Performance Standards. In support of this role, IFC routinely shares experiences and lessons learned in applying the Standards framework with external users through the Performance Standards Community of Learning Forum. IFC has organised seven global 'Community of Learning' events and three regional events in Latin America and Asia. Most recently, IFC co-hosted the International Sustainable Banking Conference with Bangladesh Bank in Bangladesh in November 2013 to continue to share best practices with the banking sector in South Asia and elsewhere in the region.

### **Rise in regulatory initiatives**

A recent phenomenon has been an increase in banking regulator-led guidance for the financial sector. This is reflected in the findings of an internal needs assessment commissioned by IFC which revealed that for banks



adopting environmental and social risk management practices, there are often complications brought on by the absence of the enabling environment and regulation to create a level playing field for all institutions. The assessment found that banking regulators are often well positioned to signal and provide guidance and advice to banks and other financial institutions on environmental and social risk management of lending portfolios and to encourage financial innovation in support of environmentally and socially friendly business development and growth.

For example, IFC has worked with the China banking regulator, the China Banking Regulatory Commission (CBRC) over the past six years to support them in transitioning the financial sector towards sustainable practices. CBRC launched the Green Credit Policy in 2007 and the Green Credit Guidelines in 2011 to provide guidance on implementing sustainable banking at three levels: environmental and social risk management; business opportunities and financial innovation; managing banks' own footprint.

### BOX 3: Sustainable Energy Finance

One of the ways IFC works at the nexus of climate change mitigation and finance is through its Sustainable Energy Finance (SEF) programme, which conducts market and sector studies to identify segments with potential for commercial lending at scale. Intensive support is provided to partner banks, leasing companies, and microfinance institutions to help with development of SEF strategies, business models, products, and the internal capacity for marketing and business development. IFC also advises financial intermediaries on building partnerships with equipment suppliers, energy service companies, and vendors so they may increase their market share and provide better service to clients.

The Russian Federation is the largest greenhouse gas emitter in Europe and Central Asia and the world's third-largest energy-consuming country. Yet its market for investments in improving energy efficiency had been developing slowly. IFC's Russia Sustainable Energy Finance Programme, launched in 2005, has worked with local banks to help them develop specialised products for energy efficiency finance. This also included guidance on identifying, assessing and pricing products, and advising banks on marketing campaigns. At the end of the seven-year programme, 14 partner banks had financed 342 projects valued at USD 289 million, with

an expected reduction in greenhouse gas emissions of 559,000 tons of CO<sub>2</sub> a year.

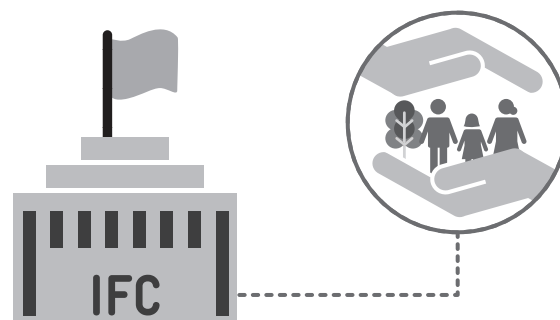
Since 2006, IFC's China Energy Efficiency Finance (CHUEE) Programme has helped key players in China's economy—banks, utility companies, government agencies, and suppliers—collaborate for the first time in creating a sustainable financing model. IFC covers a portion of financial risk through guarantees for loans made by partner banks to climate-friendly energy projects.

CHUEE also helps banks develop pipelines, portfolios and expertise in the sustainable energy finance market and assists in assessing the risks and opportunities of renewable energy and energy efficiency projects. At the end of six years, the three participating banks had provided loans totaling \$783 million, exceeding the project target of \$533 million. This also led to the finance of 178 projects, leading to an estimated 19.3 million metric tonnes of annual greenhouse gas emissions avoided. More significantly in support of the business case, the three banks have gone on to develop sustainable energy finance portfolios outside of the CHUEE programme.

**Source:** Extract from Annual Review 2103, Access to Finance Advisory Services, International Finance Corporation

Examples of other markets where regulators have taken the lead to develop environmental and social risk management guidance for the financial sector include Bangladesh, Brazil, and Nigeria. In addition, initiatives are underway in Indonesia, Peru, Philippines and Vietnam. In some markets, banking associations have assumed the lead to support the development of environmental and social risk management guidance. A leading example of this is the Colombian national banking association, Asobancaria, which together with Colombian financial institutions and national development banks oversaw development of the Green Protocol for the banking sector in Colombia. The Protocol outlines the signatories' commitments to promote sustainability in the financial sector along with a series of actions and goals. Similar industry association-led initiatives are underway in Kenya and Mongolia.

In response to requests made at the First International Green Credit Forum in Beijing in May 2012, IFC launched the Sustainable Banking Network for regulators and associate partners in September 2012. The Network is an informal and free association of banking regulators globally for the purpose of knowledge exchange and learning on sustainable banking and supports the collective learning, networking, and knowledge sharing efforts of banking regulators in this space. As the host of the Network, IFC plays the role of facilitator, organising meetings, supporting the knowledge management platform, facilitating bilateral exchange, and providing technical advice to Network members on policy development.



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# 5

## Responsible Investment: Opportunities and challenges for Indian investors



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### Introduction

Responsible investment (RI) is a term used for a bouquet of strategies employed by financial institutions seeking to generate both financial and sustainable value by incorporating extra-financial factors—defined by environmental, social and governance (ESG) criteria—into investment decision making.

RI is a booming market globally and an increasing number of investors are moving beyond exclusively measuring financial performance of their investments and factoring extra-financial metrics into their investment considerations. At least USD 13.6 trillion worth of assets under management incorporate ESG concerns into their investment selection and management, according to a report issued by the Global Sustainable Investment Alliance.<sup>1</sup> Assets under management by UN-backed Principles for Responsible Investment (PRI) signatories now stands at more than USD 34 trillion, up from USD 4 trillion at the PRI's launch in 2006.

### Indian context

The trend of financial institutions integrating ESG into investment decision making does not extend to India in a major way. Barring a handful of institutions that are signatories to the PRI and UNEP-FI, the

total amount of sustainable assets under management in India is small compared to other emerging markets such as Brazil and South Africa.

TERI-Europe estimates that the total stock of investment in Indian equities where the investment strategy includes a strong focus on ESG considerations is approximately USD 1 billion, which is almost entirely composed of foreign institutional investors. There is a clear lack of interest among key domestic players such as mutual funds and life insurance firms in the Indian market. India's first sustainability-themed mutual fund, Sustainable Development Fund, was launched in 2007 based on the methodology of the S&P ESG India Index but its size today is only USD 2.6 million, due to redemptions and a sharp fall in the stock market.

However, the ESG landscape is gradually growing and an emerging group of investors in India are looking beyond traditional financial returns and integrating ESG into their investment processes. Driving this change are Indian policy makers with the launch of the National Voluntary Guidelines for Social, Environmental and Economic Responsibilities of Businesses (NVG-SEE) and the mandate by Securities and Exchange Board of India (SEBI) to file an annual

Business Responsibility Report (BRR) for the 100 largest publicly-traded firms.

In addition, there are encouraging signs from the private equity sector in terms of ESG integration and banking sector in terms of financial inclusion and responsible lending.

## **An opportunity for domestic investors**

There are several opportunities for investors to generate value through ESG investing.

### **Enhanced financial performance**

An increasing number of investors with long-term perspectives, including global pension funds and insurance companies, see ESG integration as an opportunity to enhance their financial performance. A number of research studies suggest a neutral-to-positive relationship between strong ESG indicators and long-term financial performance. Pooling results from 36 studies, Mercer<sup>2</sup> showed that 30 studies evidenced a neutral to positive relationship between ESG factors and financial performance. Similarly, a study led by RCM<sup>3</sup> showed that investors could have added 1.6 per cent a year to their investment returns over slightly less than five years by allocating funds to portfolios that invest in companies with above-average ESG ratings. A 2012 Harvard Business School study<sup>4</sup> found that USD 1 invested in a portfolio comprised of “high sustainability” companies in 1993 would have been worth USD 22.60 by 2010.

### **Assess company’s true performance**

ESG integration is gaining traction due to its growing importance in assessing a company’s true performance. According to the International Integrated Reporting Council (IIRC),<sup>5</sup> an increasing percentage of an entity’s market value can be attributed to intangible assets and ESG indicators provide ways to measure the performance of these intangible assets. Considering ESG criteria enables investors to gauge good risk management and strategic planning at the company level. Research shows that companies with strong ESG performance have a higher capacity to adapt to change, lower their capital constraints and lower their cost of capital.

### **Take advantage of market inefficiencies**

The investment case in emerging markets, particularly in India, rests most heavily on the concept of inefficient markets, where not all the available information is incorporated in the current stock price. There is a lack of comprehensive research coverage in emerging markets in general and a dearth of ESG-related analysis in particular. Given the higher levels of both risk and return in emerging markets, investors who make an effort to understand the impact of ESG have a better chance of reducing risk and boosting returns. Due to this scarcity of information, fund managers see sustainability criteria as a way to make superior investment decisions. For example, in emerging markets, knowledge of qualitative factors such as the strength of a company’s management and its management of human rights in the supply chain can be a particularly useful way to identify undervalued companies.

### **Effective portfolio risk management**

Applying an investment strategy that considers ESG factors when investing in companies will enable investors to identify ESG risks and determine which companies have more effective risk management and are therefore likely to be more profitable in the long run. Indeed, there is evidence that proper consideration of ESG factors can significantly reduce a portfolio’s risk exposure and enhance portfolio diversification. A study by Allianz and Risklab (2011)<sup>6</sup> suggests that ‘tail risks,’ the risk of unlikely events causing catastrophic damage, can be reduced by nearly 40 per cent by optimising ESG risk exposure in an emerging markets equity portfolio, compared to an ESG-risk-neutral strategy. The study, using various ESG metrics provided by several ESG research providers,<sup>7</sup> concludes that while all portfolios gain from ESG risk management, this benefit is greatest for emerging markets investments.

### **Ability to provide capital at lower costs as compared with mainstream investors**

Responsible investors are able to provide capital at lower costs compared with mainstream investors. This is because they face lower risk in their portfolio owing to appropriate factoring of E&S related risks and therefore have the ability to raise capital at lower costs.

### **Lower reputational risk**

Investors can reduce reputational risks by avoiding investments in companies that do not adopt sustain-

ability practices or are not committed to good corporate governance. Responsible investors who are not cautious of the reputation of their investee companies are well aware of the costs associated with attacks on their own brand image.

### **Gaining alpha through encouraging good corporate governance**

In India, it is generally assumed that regulations are weak, corruption is high, and corporate accountability is unreliable—these concerns may threaten to limit potential growth of such emerging market economies. Good corporate governance is linked with higher company valuation, reduced risk of corporate scandals and corruption, increase in external investments, lower cost of capital, improved competitive performance and stronger stakeholder relationships. Country-level studies have provided evidence of the positive effect of corporate governance practices in emerging markets. In Korea, well-governed companies traded at 160 per cent premium to poorly-governed firms. Brazil-based companies with the best corporate governance ratings had 2004 P/E ratios that were 20 per cent higher than those with the worst governance ratings and companies with above-average governance had 45 per cent higher return on equity (RoE) and 76 per cent higher net margins than those with below-average governance practices. In addition, firms included in the Brazilian Corporate Sustainability Index<sup>8</sup> have been shown to trade at a premium relative to other publicly-traded firms. Gompers, Ishii, and Metrick (2003)<sup>9</sup> find a substantial outperformance of more than eight per cent per annum for firms with the best corporate governance ratings against those with the worst corporate governance ratings.

The importance of corporate governance cannot be ignored. Investors can take the opportunity to encourage good corporate governance in investee companies and observe enhanced returns with fair and transparent management at the company level.

### **Identify opportunities for growth**

In India, population growth and economic development are creating both challenges and large-scale opportunities related to environmental and social equity. Companies providing innovative solutions to these challenges present particularly attractive investment opportunities. Some of these ESG solutions-relat-

ed investment themes include: Social equity (credit and banking, services for the 'base of the pyramid'), health and wellbeing (medicine and health care, food and agriculture), sustainable infrastructure and development (green building, sustainable transportation), environmental protection (pollution prevention, water treatment and waste management) and clean and efficient energy.

### **Means to sustainable development and responsible business practices**

Responsible financial systems can contribute to the goal of sustainable economic development by promoting business innovation and strengthening responsible economic, environmental and social behaviour of businesses. Companies' access to debt or equity in their twin functions as financial service providers and investors. By setting the right incentives through extra-financial lending and investment criteria, the financial sector acts as a 'multiplier' of responsible business practices and sustainable economic development. Responsible finance is a means to the end goal of responsible business.

With recent regulatory measures, investors will have more opportunity to obtain ESG data, include extra-financial factors in their evaluation processes and stay ahead of the curve by differentiating themselves from their competitors.

### **Regulatory push**

The Securities and Exchange Board of India, SEBI, is addressing some extra-financial disclosure issues among Indian corporations. It has mandated ESG disclosures from the top 100 listed companies, in the form of annual Business Responsibility Reports based on the Ministry of Corporate Affairs' (MCA) voluntary guidelines on social, environment and economic responsibilities of businesses (NVGs). Similarly, the Department of Public Enterprise (DPE) has issued guidelines on corporate social responsibility (CSR) and sustainability for central public sector enterprises, which sets the requirements for CSR reporting to assess the overall performance of central public sector enterprises. The Companies Act, 2013 includes CSR as a mandatory agenda item at the

Board level and requires companies to report on their CSR policy, governance and initiatives along with the CSR budget spent. Consequently, investors will have more opportunity to obtain ESG data, include extra-financial factors in their evaluation processes and stay ahead of the curve by differentiating themselves from their competitors.

## Challenges to RI/ESG investing for domestic investors

Given the nascent stage of the ESG integration trend in India, there are several barriers that impede the integration of ESG considerations into investment processes in the country.

### Lack of (quality) information

Although relevant information and data sets have become more mainstream in the developed markets driven by regulation that requires companies to disclose their ESG performance and also thanks to the role played by mainstream data providers (Bloomberg, Thomson Reuters), this is not yet the case for emerging markets, particularly India.

Companies' disclosure of material ESG factors is relatively poor here and companies largely do not address material ESG-related financial risks to their core business—an aspect that concerns the majority of investors. Without this information, investors and other stakeholders are unable to make informed decisions and implement RI strategies. This is further exacerbated as controversial issues are underreported in the public domain due to lower levels of scrutiny from government, civil society organisations and media, which leaves investors unaware of and exposed to associated risks. Furthermore, there is a perception that even the data that does get disclosed is not too reliable.

In an effort to address this lack of quality information, the CII-ITC Centre of Excellence for Sustainable Development is collaborating with Solaron to assess, analyse and rate the sustainability performance of the top 100 companies in India. Other organisations such as the Indian Institute of Corporate Affairs are also seeking to undertake similar studies.

### Lack of understanding and capacity

There is a general lack of capacity to assess sustain-

ability risks that prevents mainstream investors from integrating ESG into their decision making. Companies that do want to provide relevant information to sustainable investment funds and analysts may lack the necessary resources, tools or experience in engaging with such stakeholders. In addition, finance specialists don't seem to fully understand the language of environmental and social impacts. There is a perceived need to increase the capacity of mainstream investment organisations in order to fully integrate ESG criteria and help finance specialists to understand the language of environmental and social impacts and their relationship with longer term economic forces.

Responsible investment awareness, concepts and practices have also not yet penetrated into the main body of India's buy-side and sell-side analyst community. It must also be acknowledged, however, that many international investors and analysts also lag behind in this regard and may rarely, if ever, raise ESG issues when assessing companies.

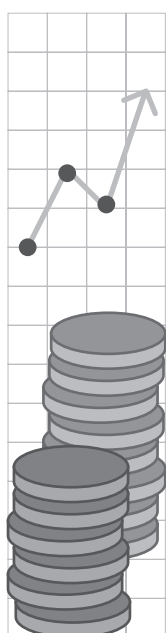
### Direct engagement hindered by existing corporate governance structures

Direct engagement between investors and companies can be very useful for overcoming information gaps, developing mutual understanding, aligning interests, and prompting company action on urgent ESG risks. However, governance models in India greatly differ from common practice in developed markets as companies in India are still largely private family- or state-owned. This poses the risk that minority shareholder interests may not be adequately represented. In this regard, research providers, including Solaron, have been engaging with both corporations and other stakeholders in order to highlight material issues to investors.

The behaviour of investors—both asset owners and investment managers—is frequently short-term in nature. Pressures to report short-term performance to boards, beneficiaries and clients can be strong.

### Lack of commitment and innovation

There is a lack of awareness among domestic institutional investors such as mutual fund and life in-



insurance industries about the need to integrate ESG factors. Even though there are multiple studies that provide evidence that there are better risk-adjusted returns from investing in companies with improved sustainability performance, there is a need to further demonstrate the materiality of extra-financial issues to financial performance, especially to top management. The level of understanding of the relationship between extra-financial and financial performance is abysmally low. This awareness needs to be built before Indian institutional investors can take active ownership in questioning managements on ESG performance, and domestic asset owners need to be encouraged to subscribe to the PRI. Further, even when there is awareness on the business case of extra-financial reporting and risk management, there is a lack of will and commitment. The perception of associated high costs makes banks and investors reluctant to follow these practices.

#### **Little evidence on consumer opinion**

Another gap area is that of surveys/information on public opinion related to environmental awareness and sustainable investment appetites of Indian consumers.

#### **Quarterly capitalism culture**

The behaviour of investors—both asset owners and investment managers—is frequently short-term in nature. Pressures to report short-term performance to boards, beneficiaries and clients can be strong. Asset owners now also face pressures from regulators that may result in more short-term investment strategies. These include performance requirements imposed as a result of under-funding (shortfalls against liabilities) and liquidity rules introduced in response to the financial crisis (which provide disincentives for long-term illiquid investments, including those in areas such as renewable energy infrastructure).

The average holding period of stocks by institutional investment managers has tended to decline, especially due to short-term performance pressures on investors. One of the results of this higher level of turnover in portfolios is that it reduces investment managers' ability and incentive to engage with company management as active shareholders. End investors play a crucial role in this regard by communicating to investment managers their long-term view. However, it is often seen that they themselves take a very short-term view on stocks.

Presently, most compensation structures disproportionately emphasise short-term performance and fail to hold investment managers accountable for the long-term impacts of their actions (given that most sustainability risks and opportunities will be realised over the long term). Investment mandates put in place by asset owners are in many cases structured on the basis of short-term performance targets and monitoring periods which only incentivise asset managers to demand short-term performance from companies. Although short-termism drives high turnovers relative to standard market benchmarks, research has shown that it contributes to asset mispricing and bubbles, and the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns and impeding efforts to strengthen corporate governance.

Global investors who are signatories to responsible investing principles require their fund managers to follow those principles while making investments. However, because the uptake amongst Indian asset owners is shallow, investment managers are not given the mandate to consider ESG into their decisions.

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#### **Misconception of 'fiduciary duty' definition**

Fiduciary duty is a widely contested term with different definitions and legal interpretations in different countries. In many jurisdictions, fiduciary duty is largely considered as imposing obligations on trustees or other fiduciaries to maximise investment returns. This has resulted in ESG risks being neglected in investment practice and a greater emphasis on short-term returns. The policy framework and public debate around reform of the Indian investment system does not appear to address ESG issues or the implications of ESG-related financial risks to fiduciary duties. As fi-

duciary duty interpretation only mandates investment managers to maximise investment returns, most investors believe that incorporating ESG criteria into investment decisions may violate their fiduciary obligations.

## Conclusion and recommendations

The financial sector is increasingly recognised as playing a pivotal role in driving responsible business and investments as it moves away from using financial performance as the only criteria to assess business risk and opportunities and incorporates extra-financial indicators such as ESG. While there have been some welcome policy developments in India with the SEBI mandate, MCA's National Voluntary Guidelines and the changes outlined in the Companies Act emphasising corporate disclosure on a report or explain basis, there is still a long way to go to achieve the levels of ESG integration and engagement noted on an international scale.

In light of the challenges and conclusions of this paper, a number of recommendations to promote RI and overcome the barriers towards RI in India have been identified. These are:

- Companies should be encouraged to report on short and long-term ESG issues that are material, which will help investors assess business prospects and value. Companies can do this by building the report around the company's business model, the context in which it operates and its strategy to address these challenges, all of which should ultimately feed into the business strategy and performance reporting.
- A central platform that effectively collects company sustainability data that is verified and comparable should be established. This platform can leverage on existing databases of service providers.
- Institutions such as Responsible Investment Research Association (RIRA), CII, service providers such as Solaron Sustainability services, cKinetics, relevant management consulting firms, and the handful of high ESG performing financial institutions such as IDFC and SIDBI should play a key role in overcoming the challenges and presenting the business case to investors on how

a company's ESG considerations can affect its financial performance.

- Awareness needs to be raised amongst investors (including among the mutual fund and life insurance industries) through communication channels and training programmes. This can be done by facilitating dialogue with FIIs who are investing in India and have more advanced ESG practices. Market research can also be commissioned to understand investors' and public awareness and attitudes to RI.
- Investors can sign up to the UN-supported Principles for Responsible Investment (PRI)—an initiative that supports its signatories in incorporating ESG issues into their investment decision making. This will also give them access to peer practices for RI investing.
- There is a need for the investment industry to innovate in order to overcome the barriers to RI and contribute to a sustainable society. Financial institutions such as Yes Bank in India have engaged in innovative sustainability solutions through their banking services and could share their lessons and experiences with other Indian peers. Internationally, Deutsche Bank offers various sustainable credit products with a focus on projects in energy efficiency, renewable energies and clean technologies, where they see increasing interest from the overall market.

Another example of a product that will strengthen this process and help investors identify and track ESG leaders is the latest innovative product launched by Solaron. The 'Global ESG Performance Tracker' was developed based on international demand and provides investors with ESG performance trends of their portfolio, an informed assessment of a company's ESG risks and their impact on portfolio performance. This kind of innovative product development will support and encourage the uptake of RI in India.

There are promising signs of change in the field of responsible investing in India. With increasing international investor demand and a regulatory push, domestic investors will be encouraged to implement ESG practices and policies. An interesting area of development is the impact investing market in India



which is gaining increasing momentum. Looking ahead, there is a general consensus that there is a market for banking and investment products in India that addresses the country's pressing social and environmental challenges such as the need for water and renewable energy supplies. Given the new business

possibilities, domestic Indian investors should look at ESG as an opportunity to build new business opportunities, create new markets and enhance financial returns while at the same time contributing to equitable development.



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# 6

## Rating Agencies: How they value ESG performance? Do the markets award ESG disclosure?



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After the announcement of Principles of Responsible Investment (PRI) on April 27, 2006 by the then Secretary General of UN, Kofi Anan, international funds worth USD 34 trillion have now endorsed the same. The backing of such a large fund to the Principles confirms that the integration of environmental, social and corporate governance considerations is now becoming an essential part of global investment business.

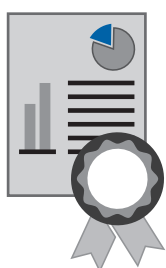
ESG investing, responsible investing, socially responsible investing, socially aware investing, ethical investing, values-based investing, mission-based investing... all describe the same concept. These terms tend to be used interchangeably within the investment industry to describe an approach to investing, which combines the intentions to maximise both financial return and social good. In general, ESG investing favours corporate practices which are environmentally responsible, community-friendly, support workplace diversity and increase product safety and quality.

The origin of ESG investing cannot be traced to any single specific defining moment, as it has shaped over a period of time and drew momentum from a variety of historic developments. The first instance

of ESG investing perhaps can be traced back to 1920s when churches divested the so called 'sin stocks'—alcohol, tobacco and gambling from their portfolio. However, the catalytic factors for ESG investing, in the more recent past, have been the environmental movements of the 1970s and 1980s. As the ability to conduct substantive social and environmental research on companies improved, 'negative' or 'avoidance' screening was supplemented by 'positive' or 'inclusionary' screening—the practice of looking for companies with ESG policies and practices. In this way, more recent ESG investing approaches differ considerably from the old ethics-based approach that by their very nature need to exclude certain types of investment areas.

The real evolution in ESG methodology has come about by:

- The creation of research bodies focusing on the companies that meet ESG and sustainable criteria; and
- The realisation by companies that adoption of ESG policies can be beneficial. Increased transparency by companies and the willingness to have a dialogue with research groups, meant that it be-



came easier to compose research-based rankings together with quantifiable assessments of corporate behaviour and suitability.

This has been a key factor in the development of several ESG indices across the globe.

### ESG and credit rating agencies

ESG as a concept and tool is now fairly well developed and established. However, investors interested in ESG integration, among the various asset classes, have largely focussed on equity. Investors in the debt market have shown very little appetite for ESG issues despite the fact that the size and importance of debt market is huge.<sup>1</sup> As credit ratings agencies (CRAs) primarily focus on the debt market, this may be one of the reasons why their involvement in the ESG space is limited. Moreover, in the current form, credit analysis is fairly quantitative and the focus is on the profitability, liquidity and solvency of the entity and its ability to service the debt. ESG issues are difficult to quantify over the short term and are hard to convert into common financial ratios used for credit analysis. Further, unless ESG issues undermine the company's ability to service its debt obligations either now or in the future, it will not alter the credit rating. Since ESG issues have such a pronounced impact only occasionally, they are therefore mostly overlooked and at best picked up in the credit analysis while assessing the 'quality of management'.

Investors are beginning to integrate ESG issues into fixed income and portfolio investment because integrating ESG risks fits well with the risk-focused behaviour of a bond investor.

Despite these challenges, the focus is gradually shifting and investors are beginning to integrate ESG issues into fixed income and portfolio investment because integrating ESG risks fits well with the risk-focused behaviour of a bond investor. While returns for the equity investors mainly come from the growth, bond investors focus primarily on protecting their capital and avoiding losses. Therefore, if ESG issues pose a material risk to the entity's ability to service the debt, then credit analysis should consider them. Yet, this has not acquired any definite shape in the credit rating

process of the CRAs. Investors extensively use credit ratings provided by CRAs while deciding their investment. However, an investor interested in ESG-screened investment strategies has to currently look beyond CRAs and rely on specialist research providers/agencies to operationalise such a strategy. If the goal is to mainstream ESG issues into the investment decision making process then CRAs will have to play a critical and bigger role in this regard.

However, unlike the financial parameters there is still a lot of disconnect between companies and investors about the financial materiality of various ESG factors. Moreover, as the length and breadth of ESG factors that are financially material is still evolving while investors need to understand that ESG integration into investment analysis is a tool to evaluate risk and return and is not an ethical criteria, companies need to understand that their corporate communication and disclosure for the investment community should be focused on financially material ESG issues.

As the disclosure and communication from companies to the investment community currently lack clear links between ESG, financial performance and how this links to business strategy, there is a long way to go before CRAs can incorporate ESG issues into their credit rating process and investors can feel confident about integrating ESG issues consistently in their investment strategies in the debt market.

However, some trends that are likely to favour ESG investing both in equity and debt market in the future are:

- Globalisation of industry where social and environmental performance becomes a source of differentiation and competitive advantage
- Tightening global, regional, and domestic regulatory pressure such as the Kyoto protocol
- Changing consumer and investor demographics with many younger "greener" consumers and investors
- Growing institutional shareholder activism
- Global population pressure consumption pressure; and
- Pressure from NGOs armed with better information and growing credibility.

### ESG and emerging markets

Although the above discussion is largely representative of what is happening in the advanced economies—mainly the US and Europe, emerging markets, includ-

ing India, are also gaining traction in the ESG space as foreign investment flows into emerging markets rise in significance. Currently, the investment penetration of ESG funds in emerging markets is minuscule compared with the developed economies. However, since ESG-based retail and institutional investors command a substantial size of global investment flows and they often want to align investment strategies with their investment needs, ESG investing is likely to expand even in emerging economies such as India in times to come.

### ESG and market return

There is very little disagreement between companies and investors that ESG issues can have consequences for a company's financial performance, either for better or for the worse in the long term. However, one criticism that has often been levelled at ESG investing is that they entail systematic deterioration of the risk-return trade-off for the investor.

The origin of this criticism can be traced back to Milton Friedman's view during early seventies whereby he stated that there is a fundamental and irreducible contradiction between the concepts of corporate social responsibility and free market-driven shareholder value approach, as internalisation of social costs inevitably leads to a reduction of enterprise value. However, 30 years later, not only the thinking has undergone a fundamental change, a number of studies have demonstrated that focus on ESG issues and shareholder engagement does not harm financial return, and in some cases have improved corporate performance. For example, Orlitzky, Schmidt, and Rynes (2003)<sup>2</sup> found a statistically significant positive association between corporate social performance and corporate financial performance. Bauer, Kees, and Otten (2002)<sup>3</sup> found no significant differences between ESG screened returns and those of unscreened funds. Similarly, Russo

and Fouts (1997)<sup>4</sup> found that companies with better environmental records appear to have better-than-average returns on assets.

In case of India, Banerjee, Gokarn, Pattanayak and Sinha (2010)<sup>5</sup> attempted to answer the question—does the market reward firms that practise good corporate governance (CG)? To examine the relationship between corporate governance and firm level performance, they used the CG score obtained from the S&P ESG India Index<sup>6</sup> as proxy for firm level governance quality, and select financial indicators and Tobin's Q as measures of firm-level performance.

They found a positive and significant relationship between CG score and firm-level performance after controlling for a number of firm-specific and time-specific factors. Better governed firms besides commanding a higher market valuation were found to be less leveraged and had higher interest coverage ratios. They also provided a higher return on net worth and capital employed, and their profit margins were relatively more stable. Their Price-Earnings Ratio (P/E) and yield—the return earned by the shareholders by way of dividend—were also higher in comparison to the firms whose CG score was lower.

Besides these studies, it may also be worthwhile to point out that the MSCI KLD 400 Social Index,<sup>7</sup> based on an ESG Best-in-Class methodology of US stocks, has outperformed the MSCI USA stock index on a total return basis since it went live on April 30, 1990.

All this evidence suggests that for individual and institutional investors addressing financial goals while also encouraging companies to improve their ESG actions is a fiscally prudent and strategically advantageous objective.



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