ESG in the BFSI Sector

Whitepaper by Breathe ESG
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Index

Executive Summary

This whitepaper provides a comprehensive analysis of the potential of Environmental, Social, and Governance (ESG) considerations in the Banking, Financial Services, and Insurance (BFSI) industry in India.

The following document is a consolidation of the awareness, opportunities, risks, regulatory requirements , current practices, future prospects with respect to ESG management in the Indian BFSI industry.

Key Insights:

- *Increased investor focus and regulatory compliance are among the key drivers for BFSI companies to adopt ESG integration into their businesses.*
- *Reducing financed emissions, climate change risk mitigation and embedding ESG requirements into core banking processes emerge as the main trends in the industry.*
- *Sustainable financing through green bonds, green deposits and ESG mutual funds are the future of responsible banking.*

The Indian BFSI industry is at a crucial juncture, with immense potential to be ESG compliant. By incorporating ESG considerations into their core operations, banks can proactively manage climate risks, drive sustainable finance initiatives, and contribute to India's transition to a low-carbon economy.

Introduction

Organizations are prioritising the importance of ESG now more than ever.

In the context of banks and financial institutions it means that they have a responsibility to integrate ESG considerations into their operations, lending practices, and investment strategies.

By incorporating ESG factors, financial institutions can promote sustainable and responsible practices within their own operations and influence positive change in the industries and companies they finance.

According to a survey by Morgan Stanley, 85% of individual investors in the United States are interested in sustainable investing.[1]

1. Morgan Stanley Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice

Introduction

Climate change is in focus in the Reserve Bank of India's latest Report on Currency and Finance (RCF) which highlights the role of fiscal policy in driving energy transition and investments.

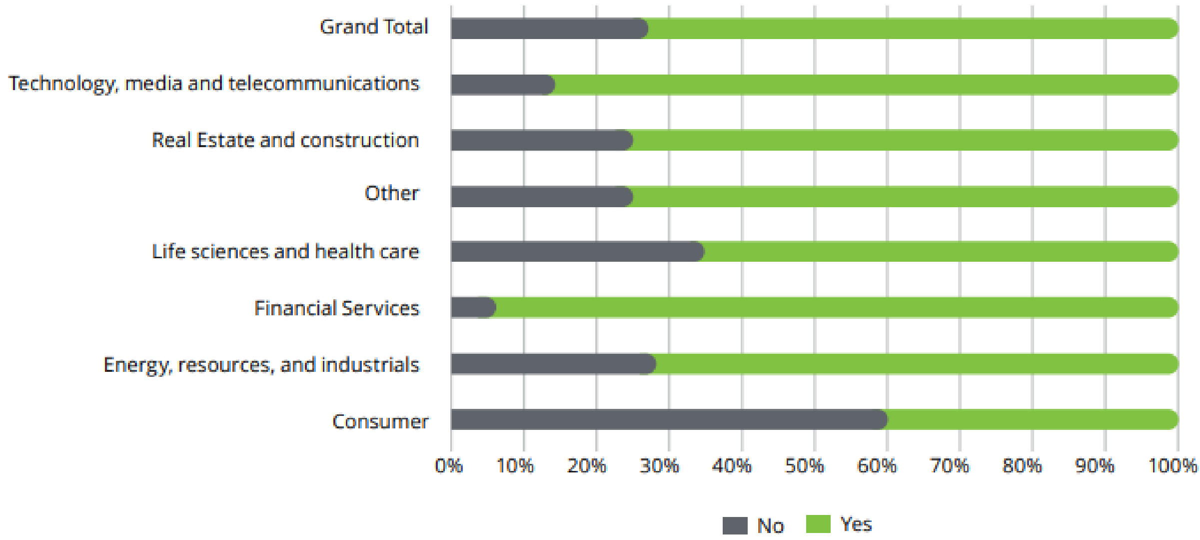
According to the report published by RBI on May 3, 2023:

- **India's net-zero target by 2070 necessitates an annual reduction in energy intensity of GDP by approximately 5%.**
- **Significant enhancement in India's energy mix towards renewables, aiming for 80% by 2070-71.**
- **Estimated green financing requirement for India is at least 2.5% of GDP annually until 2030.**[2]

2. REPORT ON CURRENCY AND FINANCE, RBI May 3, 2023

Increased investor interest

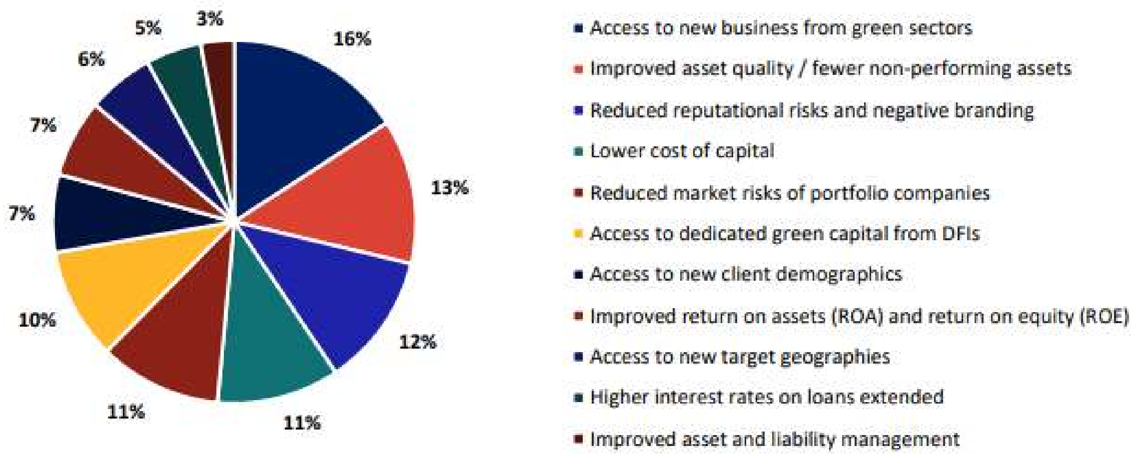
In a survey of 150 Indian organizations, 90% financial services organizations agreed that there is an investor focus on ESG .[3]



Graph 1: Sector wise representation of investor focus on ESG performance

Multiple benefits of ESG management

The UK Government surveyed 154 individuals from the top 10 financial institutions of India and found that 73% believe integrating ESG and climate risk assessments into credit processes will help their institution. The major benefits emerging from this study are represented below. [4]



Graph 2:

3. Deloitte: ESG Preparedness Survey Report, May 2023.
4. UK Pact: ESG and climate risk management in the Indian financial sector-A landscape analysis of 10 leading financial institutions

Reducing Financed Emissions

In recent years, numerous banks have publicly committed to decreasing their financed emissions, aligning with the Paris Agreement's goals.

This commitment is evident in the growing membership of the **Net-Zero Banking Alliance (NZBA)**, which expanded from **43 to 122 banks** within a little over a year, accounting for 40% of global banking assets.[5]

In India, **Federal Bank** and **Suryoday Small Finance Bank** have an e**xclusion policy** that prohibits lending for **the construction of new coal power plants or the extension of an existing coal power plant.**

Additionally, **Federal Bank** has committed **not to finance oil and gas exploration activities.**[6]

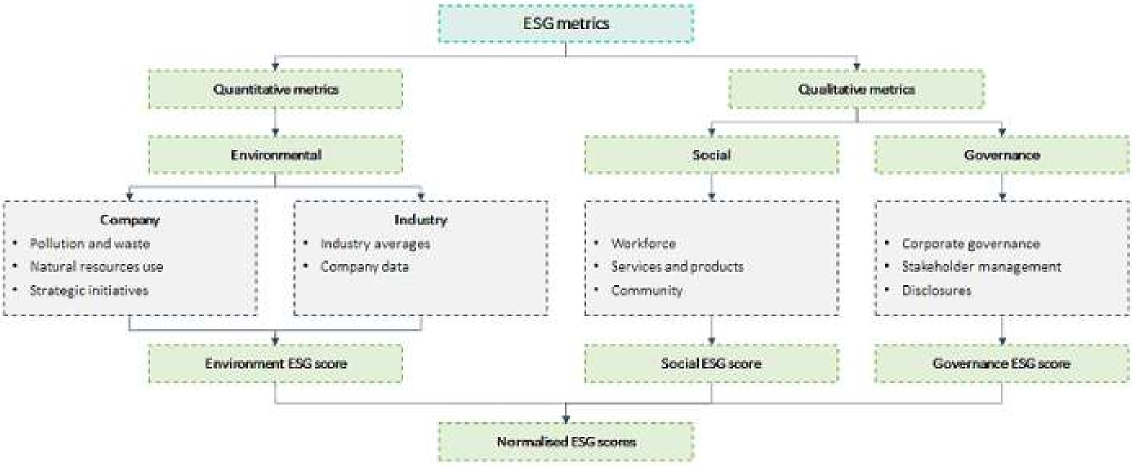
GHG Accounting : Emission Categories

Scope 1	Direct greenhouse gas emissions that result from sources that are owned or controlled by a company, such as emissions from combustion of fossil fuels in boilers, furnaces, and vehicles.
Scope 2	Indirect greenhouse gas emissions that result from the consumption of purchased electricity, heat, or steam by a company.
Scope 3	Indirect greenhouse gas emissions that result from a company's value chain, including emissions from its suppliers, customers, and other third-party activities related to its business operations.

5. Net-Zero Banking Alliance, Industry-led, UN-convened
6.Climate Risk Horizons: Unprepared, March 2022.

Embedding ESG requirements into core banking processes

Credit analysts and credit rating agencies generally assess debt issuers' operating performance using a range of traditional analysis methods such as profitability, liquidity, and solvency ratios



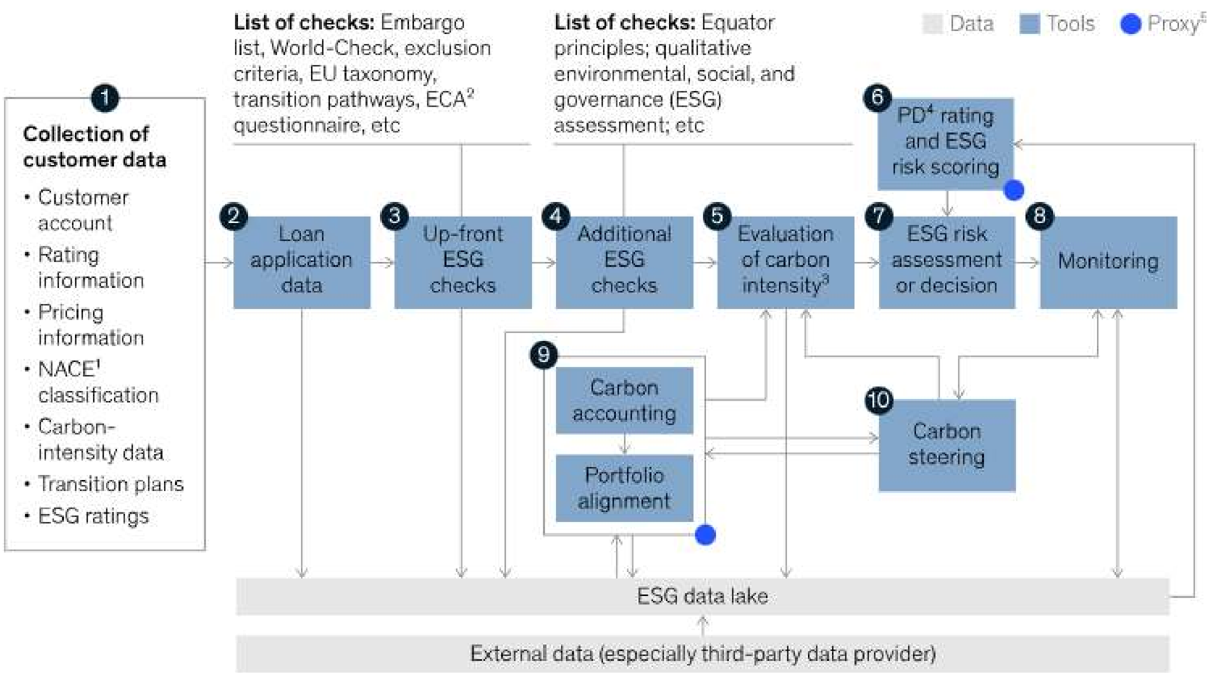
A rational approach to do this involves using a **scoring methodology** to overlay an ESG view within the credit appraisal process. The scorecard intends to assess a borrower on several parameters within each ESG pillar, using both quantitative and qualitative techniques for risk assessment.

The figure above indicates the structure that could be used within such an ESG scorecard. Based on the ease of availability of input data, a disclosure adjustment/modifier can also be assigned

Image Source: Deloitte, The Role of ESG in the Credit Appraisal Process

Embedding ESG requirements into core banking processes

Multiple steps must be considered when integrating environmental, social, and governance data into the credit approval process.



The design of ESG technical solutions involves constant trade-offs between short-term needs and the long-term vision. Instead, banks should apply a use case-driven approach to introduce new ESG capabilities in the right sequence at the right time.

Leaders can identify and prioritize **specific ESG use cases, create clearly defined stage gates, and collect metrics** to track success during interim phases. Collection of ESG data from customers and pooling it together so that the data base can be tapped into at each stage of the credit appraisal process is one way to approach this integration as depicted in the chart above.

Image Source: Mckinsey, ESG data governance: A growing imperative for banks

Climate change risk assessment

In January 2022, the RBI surveyed 34 scheduled commercial banks on climate risk and sustainable finance.

The survey showed that 8 out of 12 public sector banks and 9 out of 16 private sector banks consider climate risks as material threats.[7]

A report by Climate Risk Horizons ranked **YES Bank, IndusInd Bank, HDFC Bank and Axis Bank** at the top for considering the climate issue in their business decisions while public sector giant **SBI** was **ranked 6th.**[8]

The primary observation is that the private sector organizations are more proactively responding to climate risks, while the public sector institutions need to catch up.

7. Report of the Survey on Climate Risk and Sustainable Finance, RBI
8. Climate Risk Horizons: Unprepared, March 2022.

ESG Risks and Challenges in the BFSI Sector

ESG risk assessments are crucial for banks in India. They enable banks to identify and manage environmental, social, and governance risks, ensuring financial stability and regulatory compliance. Addressing ESG challenges enhances stakeholder trust and attracts socially conscious stakeholders. Embracing sustainable practices positions banks to capitalize on opportunities in the growing sustainable finance market, supporting India's transition to a greener economy.

ESG Risks	**Description**
Regulatory Risks	Risks arising from new laws and regulations related to ESG issues. Increased compliance costs and potential legal penalties for non-compliance. Heightened regulatory scrutiny leading to additional costs and operational challenges for banks.
Physical Risks	Risks from increasing frequency and severity of climate-related events, damaging assets, disrupting supply chains, and impacting borrower creditworthiness.
Reputational Risks	Scrutiny from consumers, investors, and the public regarding ESG performance. Potential loss of customers to competitors seen as more responsible. Decreased demand for shares and potential damage to a bank's public image.
Financial Risks	Risks translating into direct financial implications for banks. Higher default rates from financing projects or companies with poor ESG practices. Decrease in share value due to failure in incorporating ESG principles. Operational and liability costs associated with poor ESG performance.

Future Prospects of ESG Compliance

Sustainable finance is expected to flourish in India, with private equity and venture capital firms projected to hit a market size of $125 billion by 2026. This remarkable growth will play a vital role in driving economic and social transformation in the country.

- **Green Deposits**: Introduction of guidelines by the **Reserve Bank of India** for banks and NBFCs to accept "green deposits" **aimed at financing** energy efficiency, clean transportation, climate change adaptation, sustainable water and waste management, green buildings, and biodiversity conservation.
- **ESG Mutual Funds**: Introduction of an ESG category of mutual funds by the **Securities and Exchange Board of India (SEBI)**, allowing asset management companies to launch multiple ESG funds. Improved reporting and transparency will enhance investor confidence.
- **Government and Private Sector Collaboration:** Anticipation of government action on green financing, including tax breaks for low-carbon technologies and policy support for green financing instruments. Emphasis on private sector organizations adopting internal carbon pricing and promoting investments in green technologies and solutions.
- **Sovereign Green Bonds:** India recently launched its inaugural sovereign green bond with the first tranche valued at **INR 80 billion (equivalent to $972 million).** Following this success, the Government of India made an exciting announcement on February 9, 2023, stating the issuance of an additional **INR 80 billion ($972 million)** in sovereign green bonds. [9]

9. India's sovereign green bonds may enhance financing capacity: Fitch

Case Study: YES BANK

Setting an example for sustainable banking

- Yes Bank achieved the ESG score amongst Indian banks, in the S&P Global Corporate Sustainability Assessment (CSA) 2022, considered as one of the best assessments of an organization's ESG performance.

- The improvement in this score from 2021 shows the bank's diligent efforts towards integrating ESG and climate considerations into all key aspects of its business.

- It is the only Indian bank to be a signatory to UNEP FI Principles for Responsible Banking.

- Yes Bank has also pioneered new financial instruments such as India's first Green Bond in 2015 and India's first Green Fixed Deposit in 2018. [10]

- According to V.E, a division of Moody's ESG Solutions, Yes Bank is ranked among the 100 Best Emerging Market Performers. [11]

10. Yes Bank Achieves Highest S&P Global ESG Score Among Indian Banks.
11. Yes Bank Ranked Among 100 Best Emerging Market Performers By V.E, Part of Moody's ESG Solutions

Bearing the brunt of non-compliance

On 22 November 2022, the Securities Exchange Commissioner (SEC) fined Goldman Sachs Asset Management, L.P (GSAM) $4 million for failing to follow its own ESG guidelines.

There were several failings in policies related to ESG research that GSAM's investment teams used to select and monitor securities.

It was also found that GSAM relied on previous, outdated and non-relevant ESG research to make certain investment decisions.

The company also failed to have any written procedures for ESG research for one product.

Goldman Sachs' case where it failed to comply with its own ESG policies is a lesson for compliance teams.

Regulators are cracking down on tackling ESG non-compliance through enforcement and calls for higher standards of ESG conduct.[12]

12. SEC fines Goldman Sachs for ESG non compliance

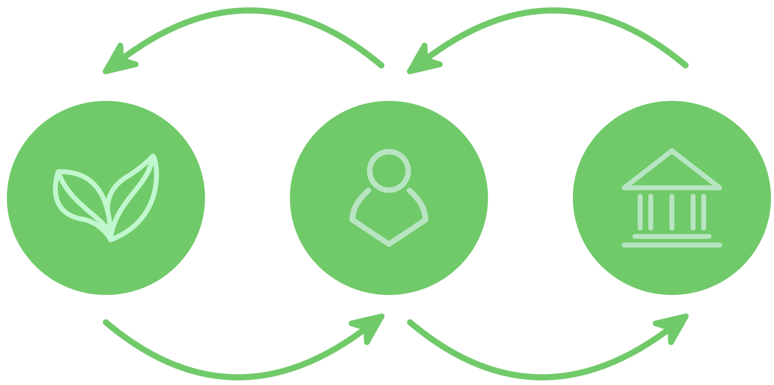
How ESG helps banks conduct business responsibly

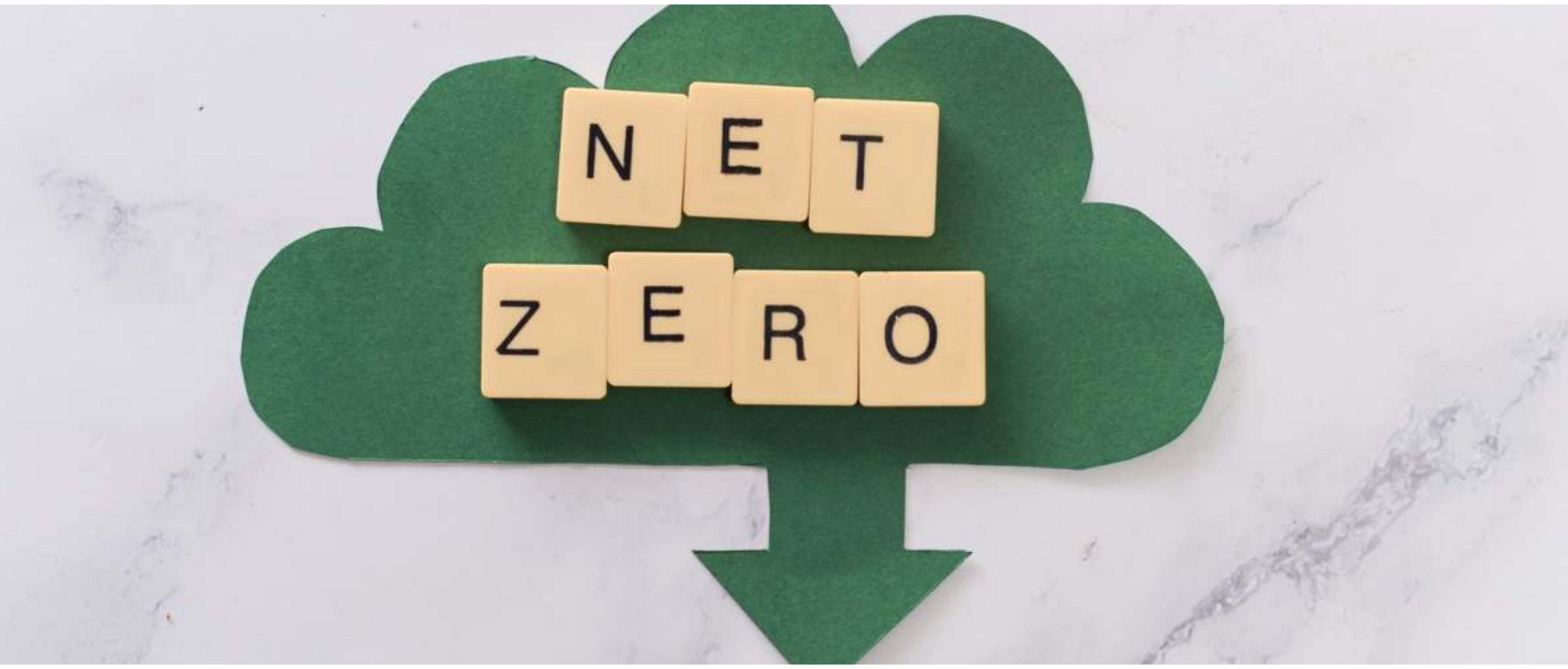
Monumental challenges—including climate change, poverty, and inequality are seemingly becoming ever more urgent. Therefore, it is the need of the hour for business to shift their approach from being purely profit-centric and instead focus on creating a sustainable business strategy to positively impact people, planet and profits.

India's banking sector is uniquely positioned to meet the challenge and has a crucial role to play in tackling climate change and aiding green transition. **But the latest report by Deloiette finds that major banks in the country are unprepared to deal with the climate change crisis.**

ESG factors aid banks in achieving sustainability through environmental impact assessment, risk management, responsible lending practices, and social responsibility.

By integrating ESG principles, banks **build trust, attract clients, enhance their reputation, comply with regulations,** and contribute to a more sustainable financial sector.





How can Breathe ESG help?

Baseline Report
Materiality Assessment
Peer Review and Gap analysis
GHG Accounting and Net Zero Solutions
ESG Reporting
ESG Training and Certification Support
ESG Roadmap and Strategy

Materiality Assessment

Organisations can prioritize ESG issues based on their relevance and impact in consultation with all stakeholders.

Identification of stakeholders: The preliminary step is to identify all internal and external stakeholders
Shortlisting material topics: Shortlisting 15-20 material topics that is immediately relevant to the organisation.
Identify Business Priorities: Identify business priorities through inputs of key management personnels (KMP's)
Conduct Materiality Survey: Understand key stakeholder priorities by sharing a materiality survey
Materiality Matrix: Weight business priorities against stakeholder priorities to create a materiality matrix that will help pave the ESG roadmap.

Baseline report

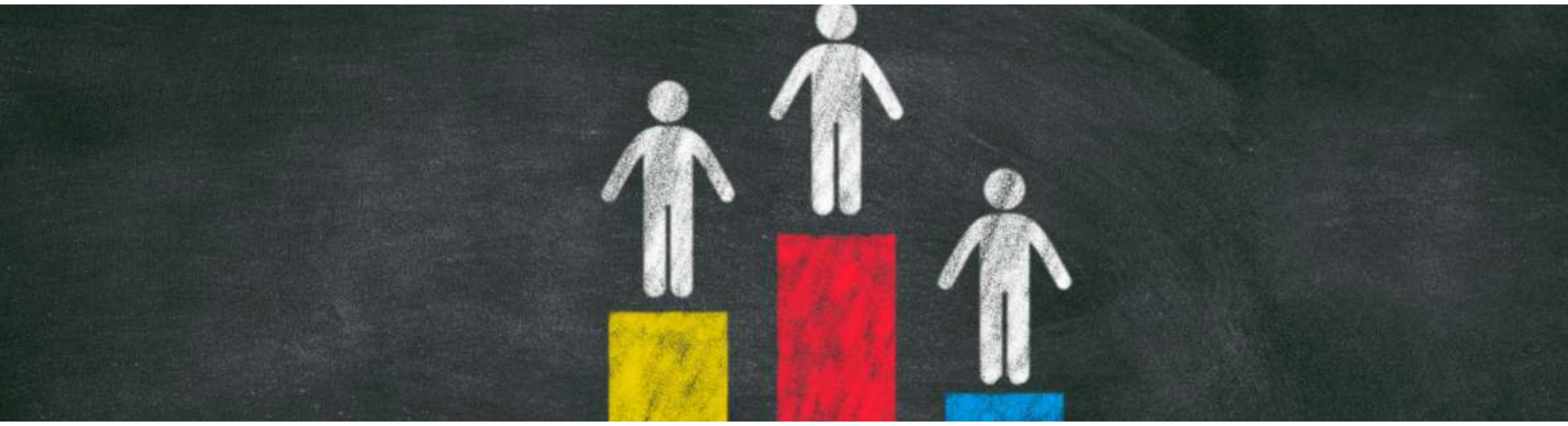
A tailored baseline report enables organisations to assess their current ESG performance and identify specific areas for improvement.

Identification of sustainable topics: Identify the relevant sustainability frameworks and disclosures like Energy consumed, gender diversity and compliance.
Collect data: Collect data on relevant activities within each category, such as the quantity of electricity purchased, the waste generated and water consumed.
Identify Peers: Identify Peers that have disclosed their ESG report that can serve as a benchmark
Determine Gaps and trends: Benchmark the performance against peers as well as internally against other assets, and previous performances to identify gaps in their sustainability performance

GHG Accounting

Implementing robust GHG accounting methodologies and working towards net-zero emissions demonstrates an organisation's commitment to environmental stewardship.

Establish the baseline: Determine the organization's current greenhouse gas (GHG) emissions baseline by conducting a comprehensive GHG inventory and assessment.
Set the target: Establish a net-zero emissions target for the organisation, aligned with Science Based Target initiative (SBTi)
Identify and prioritise actions: Identify and prioritise actions needed to achieve the net-zero target. Including both short-term and long-term actions.
Develop a roadmap: Develop a roadmap that outlines the specific actions, timelines, and responsible parties required to achieve the net-zero target aligned with SBTi.
Monitor and report progress: Establish a monitoring and reporting system to track progress towards the net-zero target and ensure accountability.



Peer review and gap analysis

Offers insights into industry best practices and areas where organisations can improve their ESG performance, promoting continuous improvement and competitiveness.

Peer identification: Identify peers within the industry for comparative analysis,
Setting KPIs: Identifying and setting industry relevant KPI's to collect peer information
Secondary Research: Collecting KPI oriented data from peer public reports and press releases
Benchmarking ESG performance: Benchmark the ESG data of the organisation over the past year against its peers
Gap Analysis: Identify the areas where the sustainability performance of the organisation falls short with respect to its internal benchmarks and peer performance

ESG Reporting

Transparent and comprehensive ESG reporting enhances risk management, strengthens stakeholder trust, and drives sustainable financial performance.

Identifying Reporting Frameworks and Standards: Identify key ESG reporting frameworks and standards for ESG reporting
Onboarding onto the ESGMS Platform: Allow the ESG data to be on boarded onto the ESGMS platform which can be further utilized by the organisation in the future for publishing ESG related data
Creation of draft ESG reports: Draft ESG report for KMP approval
Publishing ESG Reports: Publish ESG reports across frameworks and standards for stakeholder and public viewing

Training support

Providing ESG training and certification support to BFSI professionals equips them with the necessary skills and knowledge to integrate ESG principles into their decision-making.

Key Management Personnel Training: Train KMP's and company directors on ESG practices
Employee Sensitisation: Provide training to the employees of the organisation about the field of ESG
Technical training: Train the staff to use ESG management systems for measuring, monitoring and reporting.
Certification support: Providing end to end support to the organisation to pursue a certification or entry into an index

ESG Roadmap Creation

ESG roadmap creation aligns business strategies with sustainability goals, fosters long-term value creation, and promotes responsible and ethical practices.

Identify and prioritise actions: Identify and prioritise actions needed to achieve the sustainability targets, including both short-term and long-term actions.
Set targets: Establish sustainability targets for the organisation, aligned with UNSDG principles
Develop a roadmap: Develop a roadmap that outlines the specific actions, timelines, and responsible parties required to achieve the organisation's targets
Monitor and report progress: Establish a monitoring and reporting system to track progress towards the target and ensure accountability.

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