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ESG Newsletter

01

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VOLUME 3

Dear Members,

We are happy to share the Third NewsLetter on Environmental, Social, and Governance.

Every aspect of ESG plays a crucial role in the effort to increase the focus of an organisation on ethical and sustainable practices. Some common ESG criteria that are used by investors and companies are:
Environmental- Energy consumption and efficiency, **Social-** Fair pay for employees, including a living wage, **Governance-** Company leadership and management.

Environmental, Social, and Governance or ESG is a framework that is used to assess the business practices and performance of an organisation on sustainability and ethical issues. The term ESG became popular in 2004 by "Who Cares Wins" after a report was published by a group of 18 banks and investment firms that were recognised by the United Nations.

ESG programme helps the stakeholders to understand how an organisation is managing risks as well as opportunities related to ESG criteria or ESG factors.
Recently the Securities and Exchange Board of India through its master circular dated 12/07/2023 has amended its Credit Rating Agencies Regulations to facilitate the registration of Environmental, Social, and Governance Rating Providers. A company that's not a credit rating agency but has adequate net worth, as required under the regulations, can seek registration as an ESG rating provider.

According to the amended regulations, only a company incorporated with the prime objective of ESG rating can seek registration as an ESG rating provider. It may seek registration in two categories.

Category I is for experienced applicants. A company applying under this category shall be a subsidiary of an intermediary already registered with the board and shall have a minimum experience of Five years in ESG Ratings.

Category II rating providers, however, only need Rs 20 lakh to register themselves with SEBI. It shall maintain a net worth of Rs 10 lakh at all times. It shall have two employees specialising in governance, social responsibility, sustainability, and data analytics. Once a certificate of registration is granted, these companies shall not engage in any activities except ESG rating. It shall further abide by the code of conduct provided for ESG Rating providers.

Further considering the increasing need for green financing and to improve transparency, with a particular focus on mitigation of risks of mis-selling and greenwashing SEBI in its Circular SEBI/HO/IMD/IMD-I–PoD1/P/CIR/2023/125 dated 20/07/2023 has permitted the Mutual funds to launch multiple ESG schemes with different strategies.

SEBI has also issued circular dated 12/07/2023 BRSR Core–Framework for assurance and ESG disclosures for value chain. According to this Frame work the listed company should include in its Annual Report the Disclosure of Value Chain as per BRSR core.
For this purpose, value chain shall encompass the top upstream and downstream partners of a listed entity, cumulatively comprising 75% of its purchases / sales (by value) respectively.

SEBI also made amendments in Regulation 34 of sub regulation 2 of clause (f) in Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Second Amendment) Regulations, 2023 on 14th June 2023 wherein the Small and Medium Entities which is listed on SME exchanges may disclose voluntarily the Business Responsibility and Sustainability Report or may voluntarily obtain the assurance of the Business Responsibility and Sustainability Report Core, for themselves or for their value chain, as the case may be.

This Newsletter covers articles on Environment, Social and Governance as well as the recent development with respect to Environment, Social and Governance.

ADV CS MAMTA BINANI
ALSO ESG CONSULTANT
+91 98310 99551
mamtabinani@gmail.com

CS G SRIRAM
QUALIFIED SOCIAL AUDITOR
SENIOR PARTNER
MAMTA BINANI & ASSOCIATES
+91 99946 69266
mamtabinaniandassociates@gmail.com

How ESG landscape can help companies innovate and drive change

As Environment Social, Governance (ESG) regulations evolve rapidly across the world, companies across sectors are being pushed towards greater accountability and transparency. As this momentum grows, it can be expected that the ESG landscape will become increasingly complex, with companies being evaluated on diverse parameters ranging anywhere from worker well-being to climate change and biodiversity impacts.

Aside from regulation, a range of voluntary reporting frameworks and rating agencies have burgeoned, each having developed their individual requirements and evaluation criteria in relative isolation. Given investor pressure, a lot of corporates today, are thus focused on navigating and faring well across this complex maze of disclosures. Consequently, while conversations on benchmarking are recurrent, there is limited dialogue on clearly defining a vision and aspirations regarding what the sum of the parts should look like, and how they can strategically reinvent themselves to get there.

Key drivers of ESG transformation

Be it consumers or investors, the demographics are changing and so are preferences, offering greater scope for innovation of products and services. For example, there is growing demand for climate friendly or lower Greenhouse Gas emission product alternatives, and eventually we may see a sizeable greenium developing for several products while it exists only for a few today. Driven by this motivation, diversification or reinvention would also render a company more resilient to market disruptions or shocks. Hence, a value centric approach today, is a win-win for companies as well as nature.

Access to finance is also increasingly becoming dependent on ESG performance. In the last few years, several ESG focused collaborations and venture funds have been launched, with PE funds preparing their own ESG focused strategies. ESG indexes for the stock market have, on an average, shown higher growth than traditional indices since their inception. In terms of employee retention, studies have shown that millennials prefer to work for organisations that share a common vision and resonate with their values when it comes to environmental sustainability or impact on society. So greater ESG focus today can deliver positives on many fronts. On the other hand, poor ESG practices can lead to significant losses in revenue and reputation, and there are several examples of companies with poor governance mechanisms that have found it challenging to recover from those fails.

The future of ESG in India

As Business Responsibility and Sustainability Reporting (BRSR) expands in terms of breadth of coverage and sectors over time, there will be increasing pressure on companies to disclose their ESG strategies and impacts more comprehensively. More recently, the Securities and Exchange Board of India (SEBI) approved the regulatory framework that introduces BRSR core and brings assurance into the ambit, which will also be applicable to the value chain of the obligated companies. As these requirements are phased in, it could allay many of the greenwashing and credibility concerns that plague stakeholders today. A host of regulations have been introduced globally as well that will directly or indirectly impact our markets which includes the EU Corporate Sustainability Reporting Directive (CSRD) and Carbon Border Adjustment Mechanism (CBAM). The ISSB which aims to attain convergence of sustainability disclosure standards could also be a game changer for reporting.

Digital could also be a big enabler in not just informing but also driving transformation as well as disclosure. The demand today for bottom-up data is huge, not just across a company's own operations but also across their supply chains. There are plenty of performance metrics that could be material to an organisation, and as assurance is systematically introduced in the disclosure regime, the focus on measurement and monitoring of these metrics will multiply. It's only with the aid of digital tools can such data be captured efficiently and utilised effectively to power an organisation's strategy and implementation. In the medium term, it would be a sensible move for companies to embed ESG reporting into core ERPs, just the way financial reporting requirements are integrated.

Several global financial institutions are also focused on building their data analytics capacities by deploying data mining and machine learning techniques to collect and assess ESG data. A growing number of manufacturing industries are now deploying AI and the Internet of Things (IoT) to optimise their processes and enhance energy efficiency. Remote-sensing technology and AI are proving to be a critical enabler of decarbonisation and resilience even for the agricultural sector, providing timely and actionable insights to farmers as well as agri-businesses.

What is ESG, how is it supporting companies' efforts toward sustainability

What is ESG?

Environmental, Social, and Governance or ESG is a framework that is used to assess the business practices and performance of an organisation on sustainability and ethical issues. The term ESG became popular in 2004 by "Who Cares Wins" after a report was published by a group of 18 banks and investment firms that were recognised by the United Nations.

ESG programme helps the stakeholders to understand how an organisation is managing risks as well as opportunities related to ESG criteria or ESG factors.

Role of ESG programme?

According to a report by TechTarget, while sustainability and corporate governance are usually considered non-financial performance indicators, the role of an ESG programme is to ascertain accountability along with the implementation of the systems to manage the impact of an organisation. For instance, how it treats its employees, stakeholders, and suppliers and its carbon footprints.

ESG Criteria

Every aspect of ESG plays a crucial role in the effort to increase the focus of an organisation on ethical and sustainable practices. Some common ESG criteria that are used by investors and companies are:

Environmental- Energy consumption and efficiency

Social- Fair pay for employees, including a living wage

Governance- Company leadership and management

CSR Vs ESG

While CSR refers to the organisation's policies, values, and practices that address social and environmental issues, ESG is an umbrella term, used primarily by investors to assess an organisation's impact on society.

ESG funds and recent Sebi guidelines

According to Sambitosh Mohapatra, ESG Leader, PwC India, the Securities Exchange Board of India (Sebi) has mandated the Top-1000 listed companies by market capitalisation to report their ESG data as per the requirements of the Business Responsibility and Sustainability Reporting (BRSR) starting from FY 2023.

"The BRSR seeks disclosures on specific key performance indicators against the nine thematic principles and guidelines of the National Guidelines on Responsible Business Conduct (NGRBC)," he said.

According to a recent CNBC TV report, the market regulator Sebi announced a few measures with the intention of boosting ESG-based investing in India via mutual funds. Sebi has also mandated asset management companies (AMCs) to provide disclosures on votes cast on resolutions of ESG issues. This move by Sebi is also favourable for the investor community that is keen to invest in green, sustainable, and impact funds.

Status of ESG implementation in India

While talking about the status of ESG implementation in India, Nawneet Vibhaw, Partner, Shardul Amarchand Mangaldas & Co said, "The last financial year (2022-23) was the first year for mandatory ESG reporting by the top 1,000 companies in India. It may still sound like a nascent stage for ESG implementation in India but the reality is that in this short span of 2-3 years, the regulator(s) have done a phenomenal job to ensure its effective implementation."

He further said that the regulators have been quick to identify some of the loopholes and are taking well-thought steps to plug them at the earliest.

"Sufficient awareness has been created regarding ESG reporting and its importance for various stakeholders and not just the top 1,000 companies but even those beyond are working sincerely to ensure that they are compliant on all relevant parameters and even exceed the regulatory and investor expectations," he added.

Is ESG here to stay? Fear of 'Greenwashing'

According to Mohapatra, "The primary reason for ESG to stay is the strengthened scientific evidence for unsustainable consumption and its impact on the economic and financial systems. Emerging ESG risks such as climate change, biodiversity, water, waste, and human rights do have a negative impact on the society and economy."

Mohapatra further said, "Governments, regulatory authorities, capital markets, and corporates are adopting measures to mitigate these risks and leverage opportunities. Thus ESG has become a hallmark of a responsible brand with which investors find meaning and consumers a reason to be associated with. ESG has now become outcome-oriented since it has a direct impact on valuations, brand goodwill, license to operate, capital access, and capital allocation in the market."

Challenges faced by companies during ESG implementation

Monish G. Chatrath, Managing Partner, MGC Global Risk Advisory LLP. listed out some of the challenges that companies face during the implementation of ESG. "Limited awareness, inadequate resources to integrate ESG considerations into business practices, varying data, and emerging regulations with guidelines are some challenges being faced by organisations today," he said.

Money-market managers rebrand almost $1 trn of funds in form of ESG

Money market funds targeting European clients have quietly been reclassifying their legal status to market themselves as promoters of ESG, with close to $1 trillion of highly liquid client assets now registered as such.

The designation in question is known as Article 8, which under European Union rules means a financial product "promotes" environmental, social and good governance goals. Asset managers have been attaching it to funds that specialize in ultra-short-term assets at a pace that's transformed the market since European ESG investing rules were first enforced in 2021.

Money market funds registered as Article 8 currently have $986 billion of client assets, up about 43% since August, according to data compiled by Bloomberg. BlackRock Inc., Amundi SA, and the asset management arms of BNP Paribas SA and Goldman Sachs Group Inc. were the four biggest players, the data show.

Europe has a "fairly broad" definition of Article 8, and it's clear that market participants and even regulatory authorities have different interpretations, Minyue Wang, director at Fitch Ratings, said in an interview. Against that backdrop, money-market funds can "promote" ESG characteristics as much as other asset classes, she said.

The development feeds into a broader debate over what ESG should and shouldn't be. In Europe, there are calls for a fundamental review of the region's ESG investing rulebook, the Sustainable Finance Disclosure Regulation, as continual waves of fund reclassifications leave investors bewildered.

Bloomberg Intelligence estimates that in total, money-market funds with $1.6 trillion of client assets have registered under some form of ESG label. It's "become the trend du jour," said Adeline Diab, director of ESG Research for Bloomberg Intelligence.

A spokesperson for BNP Paribas Asset Management said its decision to categorize money-market funds as Article 8 follows "strict ESG guidelines and constraints, including that each fund must have an ESG score that is better than that of its investment universe."

Spokespeople for Goldman Sachs Asset Management and Amundi declined to comment. BlackRock hasn't yet responded to a request for comment.

The total market for Article 8 has swelled to roughly $5.8 trillion, according to Bloomberg data that includes funds of funds and money-market funds. That's in part as fund distributors put pressure on asset managers to deliver products that cater to demand for ESG from investment clients.

But analysts at Jefferies International Ltd. and Commerzbank AG said the Article 8 market may be headed for a period of upheaval, in light of planned regulatory changes. Europe's markets watchdog wants to introduce minimum thresholds for the kinds of investment products that can be sold as ESG and sustainable, which might dramatically change the landscape, they say.

Money market funds contain highly liquid investment products, meaning they're often considered an attractive substitute for cash deposits. Asset managers tend to fill them with short-term treasury securities or commercial paper issued by corporations, often banks.

Such investment vehicles have grown in popularity since last month's banking crisis, as highly liquid funds became a preferred alternative for depositors reacting to the collapse of Silicon Valley Bank and Signature Bank. Even before those shocks, corporations and consumers were opting to shift cash into money-market funds, which generally offer higher returns than bank deposits. Concern about the US banking sector was a "prominent" driver of cash flows to money market funds in March, Fitch's Wang said.

Tracking SFDR Upgrades and Downgrades

The embrace of ESG by money market funds coincides with a slowdown in the wider market for sustainable investing. Globally, ESG funds drew $29 billion in net new money last quarter, down from almost $38 billion in the previous quarter, Morningstar Inc. said on Tuesday. ESG fund launches in Europe slumped by almost two-thirds, meaning the "cool-down in new sustainable product development was entirely driven by a significant reduction of new sustainable fund launches in Europe," it said.

Society first. ESG investing is here to stay

The Covid pandemic and growing anxiety about the adverse impact of global warming has increased public interest in Environment, Social and Governance (ESG) investing.

ESG investing strategies have been broadly summarised by the Global Sustainable Investment Alliance (GSIA) under seven broad themes: impact investing; best-in-class screening; sustainability-themed investing; norms-based screening; corporate engagement; negative screening; and ESG integration.

As of 2020, per GSIA, these strategies were used to manage assets of over $35 trillion, and according to a Bloomberg study, global ESG assets are on track to exceed $53 trillion by FY 2025.

However, the growing popularity of ESG investing has recently faced increasing criticism.

Questions have also been raised about the underwhelming performance of many ESG funds in the past year, especially when benchmarked with funds that were happy to invest in ESG-unfriendly fossil fuel companies that saw record profits in the wake of the Russia-Ukraine war.

We discuss three major critiques of ESG investing and why they should not impede its sustained growth.

Critique 1: ESG is subjective and difficult to measure, the criteria for investing are confusing, and this distracts from a pure returns focus.

There is considerable merit to the argument that ESG is hard to measure. ESG rating providers typically track several hundred parameters under each of E, S and G, and these are neither identical nor do they lend themselves to comparable scoring.

Yet, ESG investing strategies — all the seven identified above by GSIA — play a valuable role in offering investors options around how their assets might be managed. From funds that target impact in areas like healthcare, to funds that focus on backing companies that are successfully reducing their greenhouse gas footprint, to activist funds that force the pace of change in reluctant company managements, a plethora of choices are getting created for investors.

The onus of explaining and defending the benefits of each such strategy would obviously fall on the respective fund manager. Just as there is a spectrum of public market investment choices, ranging across bullish and bearish strategies, likewise, there is a spectrum of ESG outcomes promised by different fund managers, and it is up to investors to select the fund strategy that offers the most meaningful outcome to them. The outcome sought may or may not be predicated on financial returns, and this is clearly a choice entirely in the hands of the investors.

Critique 2: Critics question whether better ESG performance necessarily leads to better financial returns. They point to the underperformance of many ESG funds when benchmarked with market returns. This is a fair critique, and the fund managers of such ESG funds need to explain what may have gone wrong with their strategies. It is simultaneously worth noting that in markets like India, even though the ESG focus is relatively nascent, the MSCI India ESG Leaders Index has outperformed the benchmark index over various periods, including from inception, and over the past 10 and five years. (See chart)

For many fund managers, the ESG performance of companies actually offers a proxy measure for prudent risk management. A company that does a better job of managing risks relating to various ESG parameters including environmental impact, employee engagement, community support and good governance, is likely to be better able to navigate through black swan events like Covid and other looming challenges like climate change.

Critique 3: ESG investing is a gimmick.

For many critics, ESG investing represents a form of virtue signalling and is essentially a gimmick.

However, a few bad apples cannot be the basis for rejecting an effort in the direction of improving ESG performance.

We have seen the perils of short-term thinking which led to the Great Financial Crisis. ESG investing, by focusing on certain defined ESG metrics, usually with a preference for long-term sustainable growth, can be a force for good.

As climate change worsens and more sustainability-linked challenges emerge, stakeholders will increasingly look towards reporting and disclosure frameworks for information on the issues that matter to them. ESG investing strategies will consequently resonate with many stakeholders.

In India too, we are seeing regulatory pressure moving the needle on this front. SEBI is tasking ESG funds to improve their corporate engagement and stewardship protocols.

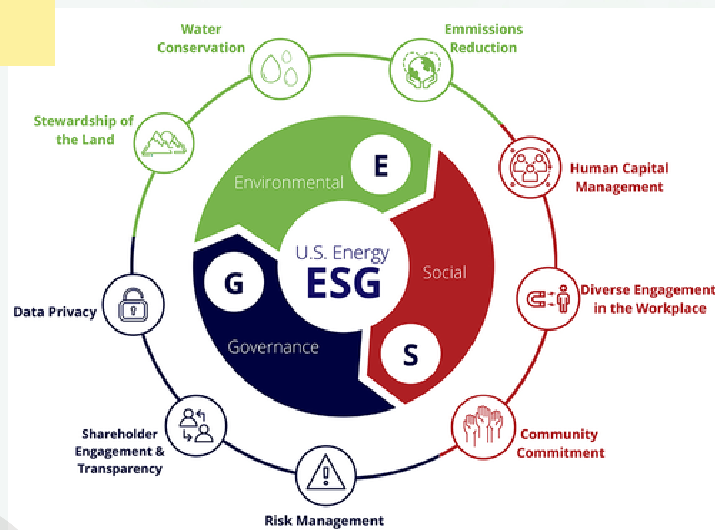
Telling The ESG Story: From Strategy to Reporting

What has the ESG story been like from strategy to reporting? KPMG Presents The Blueprint 'Business in The New Normal' as part of KPMG ESG Conclave 2023. The theme for the event was Thought |Action| Impact.

In a panel discussion moderated by Gautam Srinivasan, business leaders, eminent personalities from the investment community, and the enablement aspect gathered together to share their insights on this. Kalpana Morparia, Independent Director, and Dr. V S Parthasarathy, Independent Director joined to share their business leaders' perspectives considering their years of experience. Amit Tandon, Founder & MD at IIAS, and Rama Patel, Director at CRISIL shared the investment communities' views and Sai Venkateshwaran, Partner of KPMG in India provided the solutions outlook for this discussion.

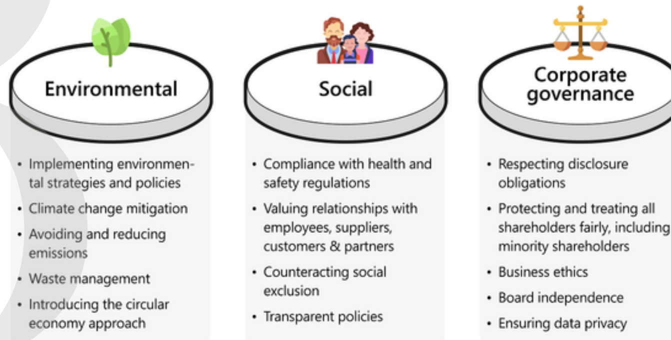
Speaking of profits, the conversation flowed into what the investor community's interests are when it comes to ESG issues. Do they really believe that a company that looks at ESG seriously is a great investment prospect in the long term? Sharing his thoughts Amit said, "As far as investors are concerned there's a very clear realization that ESG impacts each industry differently. Therefore, the big challenge for them is that there's a huge amount of data out there, but how do you get the comparability? There are certain themes that kind of run through the entire process. First, is there a recognition by investors that the risk-adjusted return for companies that are following ESG processes are going to be a little better than those who have given a short shift to sustainability and stewardship. The second factor is that the systemic risk is lower. By that, I mean that the volatility in terms of performance and, therefore, in terms of the stock performance is significantly lower. To sum up, investors realize both systemic risk and tail risk are lower for companies that kind of adhere to strong ESG principles."

Is ESG preference going to play a strong role for companies? Sharing her insights, Rama Patel said, "Several studies have been done in terms of what is the long-term sustainable return generation capabilities of ESG-conscious companies compared to their counterparts. Empirically on a long-term basis, there are studies that show that the performance of ESG-conscious companies has outpaced their peers. The concept of ESG is not something new. Yes, the acronym and focus are new. Over the last couple of years, we have seen the kind of supply-side disruptions that things have created for real companies. Investors have seen how it has impacted business performance. So, it would not be a far-reaching statement to say that very clearly sustainable practices are something that would gather focus in terms of what even companies are looking at. We are seeing even the ESG-focused funds growing and I think it is going to continue gathering pace."



Moving from the strategy to the reporting stage, the discussion flowed into how the reporting landscape is still very fragmented. So how should companies clearly articulate the key ESG work that they are doing? and how should they focus on what do and share and how to clear the path ahead in line with how the enterprise is moving? Sharing his thoughts Mr Sai said, "Companies are embracing ESG reporting and of course, there is the regulatory reporting that's coming in. But that's only addressing one little part of it. I think there is a lot that at least the more progressive companies are doing in terms of adopting various global frameworks together with independent assurance and looking at what is relevant in their context to communicate to their investors. However, one key element that we are missing in the Indian context is that companies still haven't got to an integrated view to look at issues like impact of climate change on financial performance, both in the short and medium term."

Limited knowledge of ESG issues can be a big challenge. Companies still see ESG as an ancillary rather than a core part of their business function. However, this limited knowledge may just be a boon!



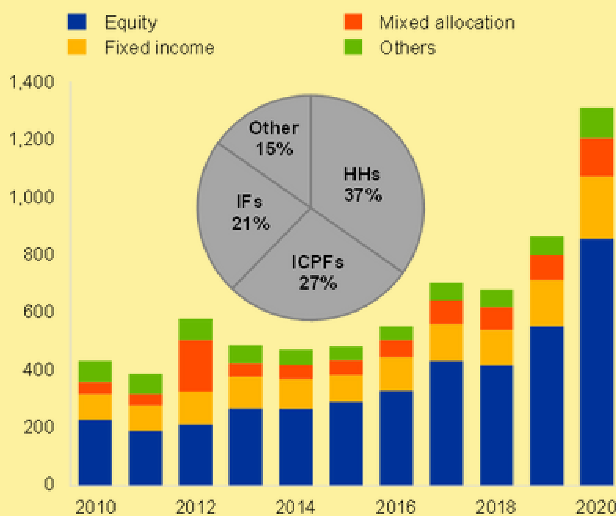
Wall Street darlings, ESG funds may be on the way out

NEW DELHI: Environmental, social, and governance-focused funds, which were once deemed the darlings of Wall Street, may be on the way out, media reports said. They're currently weathering a "perfect storm of negative sentiment," said Robert Jenkins, head of global research at Lipper, a financial data provider, CNN reported. Despite the gloomy forecast, Jenkins remains optimistic. He sees this as a natural phase of the market's evolution. A new, more efficient system is taking shape that incorporates ESG standards into the bedrock of stock valuations, he said.

ESG investing as a separate entity could be on its way out, but the approach was wrong to begin with, said Jenkins. Instead, it should be integrated into the fundamental analysis of every investor. Total assets under management in ESG funds fell by about $163.2 billion globally during the first quarter of 2023 from the year before, CNN reported. In March alone, total assets under management in the responsible investments fund market fell by $6.8 billion. It's not that the funds are underperforming, either. The average overall return for these funds was 2.2 per cent in March - outperforming the 12-month moving average return for the wider market by 2.8 percentage points.

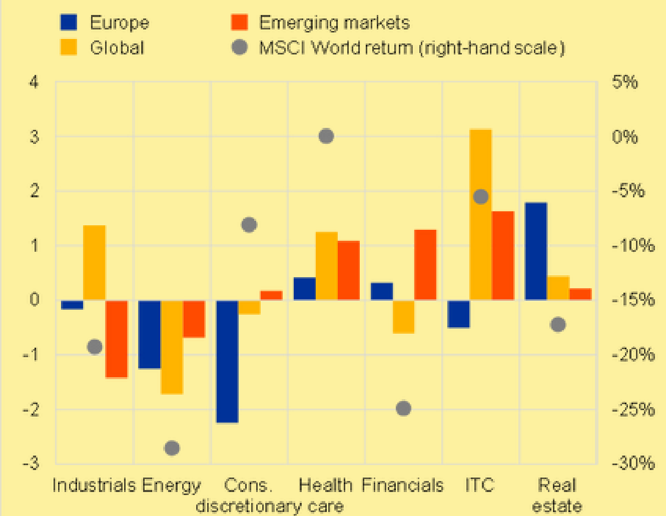
Assets of global ESG funds by asset class, and distribution of holdings across euro area sectors

(holdings in pie chart: Q2 2020, market values in USD billions)



Difference in sectoral exposure of ESG and non-ESG equity funds

(Q1 2020, share of total equity and percentage points)



Instead, a confluence of political, geopolitical and market events has severely damaged interest in ESG investing, CNN reported. Russia's ongoing war in Ukraine forced traders to reconsider investing in energy and weapons stocks.

Responsible investing funds also came up against mighty economic headwinds last year. These funds' outsized investments in tech stocks and lack of energy stocks (which was the only positive sector in 2022), led to noticeable losses last year, CNN reported.

"I think ESG was overly trendy and it got caught up in itself," said Jenkins. "I was going to conferences two to three years ago, and I remember walking out and thinking 'these guys aren't saying anything new or different. They're all saying the same thing," CNN reported.

Companies jumped on to the bandwagon and greenwashing, a marketing tactic to appear environmentally conscious in investments, became prevalent. That, in turn, hurt the movement's reputation. ESG won't be as glamorous as it was before, but it won't be a politically explosive term either, CNN reported. "It's actually going to fade a little bit from its marquee nature, it's just going to be a part of sound business strategy and management," said Jenkins. "They're just going to be put alongside all the other fundamental analytics that we're so used to hearing about, your earnings-per-share and your GAAP accounting. ESG ratings will just become part of that toolkit for investment managers."