ESG Framework for Responsible Banking

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***Abstract*: We are in the age where human activities have profound impacts on the environment. This is affecting the biodiversity, natural resources and also the climate. As per the WWF Living Planet Report- 2012, the humanity's ecological footprint exceeded the Earth's regenerative capacity by 50%. This is expected to exceed by 100% by the year 2030 under existing business and development activities induced by us. So, it has a meaning that we need two planets by the year 2030 to meet our needs. ESG investing approach involves incorporation of ESG factors into investment approaches and decision-making. This holistic approach is referred by many names such as socially responsible investing, ethical investing, sustainable investing, triple bottom- line investing, green investing etc. But all these differing names focus on long-term value creation. This also covers a wide range of issues including how corporations respond to climate change, constraints posed, established health & safety management systems, management of supply chains, workers/employee satisfaction policies, established governance structures and many others.**

***Index Terms*: ESG Framework, Responsible Banking, Ethical Investing**

We are in the age where human activities have profound impacts on the environment. This is affecting the biodiversity, natural resources and also the climate. As per the WWF Living Planet Report- 2012, the humanity's ecological footprint exceeded the Earth's regenerative capacity by 50%. This is expected to exceed by 100% by the year 2030 under existing business and development activities induced by us. So, it has a meaning that we need two planets by the year 2030 to meet our needs. But, so far we don't have the answer: '*Where is the planet 'B'?*'

Definitely, we need to restrain our ambitious and hazardous activities that require exploitation of natural resources, which we have named as development activities. Since, Mother Nature has its own limitation for supply of resources, we need to rethink, re-orient and evolve new systems, methodologies and avenues of development.

Banks are the one of the major drivers of growth and development of any society. As a responsible corporate citizen, banks need to understand that the Earth's regenerative capacity has limitations. The inhabitants of the Earth need to regenerate resources without damaging the precious natural resources. Similarly, banks should also align their activities in this direction. Consuming without regenerating the resources is just like consuming capital as opposed to generating. This form of development cannot be sustainable for long. Business-as-usual cannot be a viable option for longer period of time. This requires banks to integrate ESG framework in their policies and activities. ESG- (Environmental, Social and Governance) is a term and concept first proposed in June 2004 by the UN Global Compact's "Who Cares Wins". This initiative focuses mainstream investors and analysts on the materiality of and relationship between environmental, social and governance concerns. Environmental concerns include Greenhouse gas (GHG) emissions, biodiversity loss, pollution and contamination, carbon regulation exposure, renewable energy and similar issues. Social concerns include labour practices, community displacement, human rights, health and safety, financial inclusion etc. Governance concerns include corruption and bribery, reputation, management effectiveness etc.

There is an urgent need to acknowledge and take meaningful action on significant ESG challenges such as climate change, population growth and resource scarcity. These ESG challenges have deep connotation for businesses and the economy. It is also going to impact society at large, representing both risks and opportunities. These ESG challenges or "sustainability mega forces" must be taken care of, if long-term economic and social growth and stability are to be maintained.

The present anthropogenic era poses many risks for a sustainable development. This in turn presents a significant risk for banking activities also, as the success of banking industry is related to the development activities. This risk can occur due to extreme exploitation of natural resources resulting into changed weather patterns impacting agricultural produce or even infrastructure developments. Just for instance, with depleting water level, water intensive industries can face a forced shutdown. Government may also come up with certain regulations which would adversely affect the production activities in various sectors that consume the scarce natural resources. There is also potential for reputational risk impacting brand value, which could be critical for banks funding themselves with retail deposits.

But, there is a silver lining. This scenario is not limited to risks but also offers various opportunities for all of us including banks. Development of sustainable infrastructure, renewable energy projects and energy efficient activities are few of the opportunities that the present anthropogenic era has to offer.

There is a need to factor ESG concerns along with traditional financial approaches, in all of the investment decisions of the banks and the corporate decision process to help build a sustainable society. This will ensure to develop global long-term financial stability

and economic development. There is a need for significant change in the attitudes and actions of the banking sector to promote more responsible and sustainable business practices. This has also been opined by the UN, OECD, G20 and certain regulators also.

These ESG challenges are very much relevant to the banks play the role of financial intermediaries and as capital raising agents. Banks are significant players for societal and economic development. As such promotion of sustainable business practices is also very important. If the banks fail to do the same, it is quite likely that the banks will end up facilitating practices which have significant negative environmental and social impacts. They will also miss the opportunity to create new products and services that capitalize on ESG issues.

All the banks need to understand that incidents relating to negative ESG outcomes caused by their lending, client relationships and advisory decisions can affect them back. These incidents may also cause reputational damage to their brand image. There may be other direct potential financial impacts such as:

• Increased NPAs due to credit/ default issues;
• Increased risk of litigation due to inadequate disclosure on ESG risks for equity and debt issuance activities;
• Higher cost of capital related to:
— Higher return expectations from Equity and debt holders due to perceived poor risk management ability and quality of loan portfolio;
— Chances of depositors' shift to other organizations, due to their ESG concerns, thereby resulting into loss of a low cost source of funds/ capital for banks.

Investing the ESG way: Socially Responsible Investing to Drive Sustainable Development

ESG investing approach involves incorporation of ESG factors into investment approaches and decision-making. This holistic approach is referred by many names such as socially responsible investing (SRI), ethical investing, sustainable investing, triple bottom- line investing, green investing etc. But all these differing names focus on long-term value creation. This also covers a wide range of issues including how corporations respond to climate change, constraints posed, established health & safety management systems, management of supply chains, workers/employee satisfaction policies, established governance structures and many others. Some of the popular definitions are:

- **United Nations Principles of Responsible Investing** (UNPRI) refers responsible investing as **an investment decision that incorporates 'ESG' factors. These will help in better management of risk and generate long term sustainable returns. UNPRI** is an international network of investors having an AUM of more than USD 80 trillion.

- Global Sustainable Investment Alliance (GSIA) defines sustainable investing as **an approach that plays an important role in selection of portfolio and its management with reference to ESG factors.** It is an international collaboration of world's seven largest sustainable investment membership organizations.

There are various factors that form the basis of an informed ESG investment decision. These factors also complement traditional investment analysis by assessing the non financial risks. These parameters vary upon various factors like size of the company, industry, geography/ country and type of investment. Rating agencies like, **Moody's** reflects ESG risk in its ratings which accounts for qualitative and quantitative ESG factors and considering them in its wholesome analysis of credit drivers.

Investments based on the analysis of ESG performance of companies can be called as 'smart' as this approach looks beyond the traditional analysis of the financial statements of the company. This approach addresses wide spectrum of issues that are traditionally not a part of financial decision, and investment approach, yet may result into financial relevance any moment of time.

Banks are becoming concerned day by day for ESG risks. In our country, few banks already have a documented policy to address these concerns. For example, State Bank of India (SBI) has developed a Board-approved Sustainability and Business Responsibility Policy. This policy acts as a central guiding principle for all business functions and aims to entrench an integrated environmental, social and governance (ESG) risks with respect to SBI's operations.

This policy has been prepared taking a reference to the National Voluntary Guidelines (NVG) on Social, Environmental and Economic Responsibilities of Businesses. NVG is published by the Ministry of Corporate Affairs and deals with the management approach towards sustainable development. This policy helps the Bank in aligning its business decisions and sustainability initiatives to the global Sustainable Development Goals (SDGs). SBI takes the lead role being the only public sector bank to publish a sustainability report in India, comprehensively capturing the Bank's vision of contributing to a sustainably growing economy and practicing responsible finance. The sustainability report of SBI for the year 2019-20 has been titled as 'Responsible Finance – Sustainable Growth'. This report reinforces the commitment of this big financial giant in its efforts to support responsible economic growth and enable the transition to a low-carbon economy. According to this report, Bank demonstrates its continuous endeavour to create value for its stakeholders, and its performance across environmental, social, and governance aspects. SBI has aligned its key initiatives with specific SDG targets. This is in tune with the target set by our country to achieve SDGs by the year 2030.

The banking system has always been one of the major financiers of any economy. The concept of Responsible Banking can be promoted by leveraging on their strengths to finance the future that is sustainable, green and aligned to the Paris Agreement as well as Sustainable Development Goals (SDGs).

As per World Investment Report 2014, UNCTAD (United Nations Conference on Trade and Development), it is estimated that the Global Goals which include, basic infrastructure (roads, rail and ports; power stations; water and sanitation), food security (agriculture and rural development), climate change mitigation and adaptation, health, and education require an annual mobilization of around USD 5 to 7 trillion by 2030. For India, the annual estimate stands at around USD 960 billion – out of which the current shortfall is of USD 565 billion.

It is apparent that there is a financing gap so far as achievement of SDGs are concerned. However, the response to address the climate change and development needs is going to provide a huge set of emerging sectors like green energy, green buildings, e-mobility, waste management, urban water, climate-smart agriculture etc. These sectors will definitely give a proper thrust to the Indian economy towards becoming a sustainable and futuristic economy.

In the last few years, we have also seen a steep growth in Green Bond Market. Few banks, like Yes Bank and HSBC have also introduced a very innovative first of its kind green retail product called the "Green Future Deposit". Besides these, there are a range of sustainable financial products and mechanisms such as Sustainability linked loans that provide pricing advantage to greener sectors.

Banks are taking the responsibility for development of smarter and sustainable future, however, a common framework to guide them in aligning their business to SDGs and the Paris Agreement have been lacking. One such has been taken by the United Nations Environment Programme Finance Initiative (UNEP FI) which officially launched the 'Principles for Responsible Banking' – the first global framework for enabling banks to align with the objectives of the SDGs and the Paris Agreement on September 22nd, 2019.

In the light of this global movement, the Indian economy is well geared for the future with support from banks that have an inclusive, equitable and sustainable philosophy of Responsible Banking. Sustainability is now not limited to doing less harm, it is about doing more good.

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