



## Why Banks need to embed Environmental, Social, and Governance (ESG) factors into their Strategy?

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The ESG standards are increasingly critical to a bank's operations and reputation. We dive into their history, advantages and the ways to implement them.

Banks play a critical role in driving a country's economic progress and running the financial sector. The banking system promotes economic growth by channelling funds into investments and increasing resource allocative efficiency. Thus, an efficient Indian Banking System is a necessary prerequisite for the country's development. Serving as a hub for savers and investors, these institutions form the foundation of India's financial system.

The history of the Indian Banking System can be traced back to the early nineteenth century when State Bank of India, was the first bank to be established in 1806. Today, Reserve Bank of India (RBI), established in 1935, governs and controls the country's banking sector which includes commercial banks, cooperative banks and development banks.

Over the years, banking in India has undergone tremendous transformations. Starting with the economic reforms of 1991 which included liberalisation, privatisation, and globalisation, the size of India's economy in terms of GDP at market prices has increased by almost fifteen times. On the other hand, household financial savings have expanded by sixteen times and the gross domestic savings by almost seventeen times during the same period. The substantial diversification in the economy opened up

an integration channel with the global economy. As the real economy was dynamic, the Indian banking system became flexible and competitive to cope with multiple objectives and demands made on it by various constituents.

From the perspective of financial inclusion, there was a pressing need to extend the reach of financial services to the excluded segments of society. In 2022, the banking structure of India has both the need and scope for further growth in size, shape, and strength when it comes to matching and following international banking norms as required.

As we are all aware, banking in India has moved from ledger based banking to computerization and now to digitalization. The financial crisis between mid-2007 and early-2009 fuelled the global banking scenario. Later on, the impact of COVID-19 pandemic severely impacted the world economy. Apart from the adverse effects on the economy from worldwide lockdowns, the pandemic imparted a lot of lessons which led to the formation of new ways of banking. As the world economy has started returning to robust growth, familiar risks are making their way back into the system along with new ones. These need to be dealt with systematically and sustainably.

The reality of climate change can no longer be denied. The significant systemic risks it poses to the global financial system has been routinely discussed by regulators and environmentalists over the years.

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COVID-19 has now confirmed that the threat of overlooking the planet and people's health is real and has drastic consequences on the future. There is no industry that can afford to separate themselves from this context in which it functions, be it environmental, social, or government regulations and requirements. Climate change is a big source of financial risks, one which Indian banks must prepare themselves for.

Environmental, Social, and Governance (ESG) refers to the three key factors that determine the long term and ethical impact of a business or investment. In 2013, Indian Companies Act made it mandatory for all the firms to disclose the amount they spent on corporate social responsibility from April, 2014. Similarly, new norms for ESG were introduced by the Securities Exchange Board of India (SEBI) in 2020 for the top listed firms by market capitalization. Even in the Indian mutual funds industry, ESG funds are gaining popularity and large corporations are adopting this concept to attract private equity. In short, ESG has become the trusted indicator for sustainability. When banks invest using these criterias, stakeholders view them as socially and environmentally conscious institutions-the kind they are.

COVID-19 not only upended the global value chain and economy, but also caused a fundamental shift in mindset of businesses and entities towards a people and planet centric approach. It has made the link between economic stability, environmental and social issues apparent, along with their combined impact on a company's bottom line. This is where the importance of the financial system comes in. As they serve as the backbone for businesses, banks need to step up and act responsibly by embedding ESG factors into their day-to-day operations and strategies.

In banking terms, the importance of ESG is due to its associated opportunities and risks for financial

institutions. Not only do ESG considerations make sense for the environment, sustainable operations are closely linked with better economic performance. Moreover, it has become the measure of resilience and sustainability of an organisation. The factors are used to make strategic goals for the future, ensure operational executions and also, conveying sustainable business practices to stakeholders and customers.

Overall, there are several compelling reasons for embedding ESG standards and practices across all functions in the banking industry. Other than being essential for sustainable economic development, it proves useful for the organisation from the local bank branch to C-suite management. In order to achieve a holistic transformation of banks, ESG factors prove to be the most effective and efficient approach. A majority of the global banks have integrated these standards into their product designs, corporate strategies and risk management processes.

All in all, there are three trends which may help to position ESG standards as the indicator of good banking practices:

**Climate Change:** This can be restricted by increasing funding towards the de-carbonization of economic activity. It has the potential to open up new revenue streams for banks in the future.

**Reputational:** In such cases where banks and businesses do not measure up to their ESG pledges, they can be accused of greenwashing. Case in point: one of the major automobile manufacturer admitted to cheating emissions tests by fitting vehicles with a 'defect' device which altered engine performance to reduce emission levels when tested, all the while their engines were emitting almost 40 times the allowed limit for nitrogen oxide pollutants.

**Regulation:** Government policies will require financial institutes to measure and disclose ESG risks in their loan portfolio and banking activity.

There are several ways banks can embed ESG into their own business strategies. Ahead are the three categories they fit into:

### **I. Sustainable Finance**

Sustainable Finance can be defined as furthering economic growth while reducing pressure on the environment. It also takes social and corporate governance aspects like inequality, human rights, management structures and executive remuneration into account. Moreover, it also focuses on environmental factors such as climate mitigation and adaptation, conservation of biodiversity and circular economy. In short, it refers to business and investment decisions which take ESG factors into consideration along with financial returns.

In the middle of the 2010, the global interest in sustainable finance had increased. This was partly in accordance with the Paris Climate Accords i.e. the Paris Agreement signed by 195 countries in 2015. All the countries including India have made a commitment to ensure economic growth is achieved in a climate-friendly manner and an overall reduction of greenhouse gas emissions.

Banks include ESG in their lending portfolio's sustainability strategy as a mainstream component to enhance it. By embedding ESG in their own business, banks can improve their lending portfolios and accommodate sustainable projects. A way this can happen is when banks prioritize loans and other lending instruments for companies with sustainability and ESG as a strategic commitment. Responsible lending in the banking industry sends a strong message to the businesses and corporates looking for capital access.

Green Loans, Social Bonds or Sustainability Linked Bonds are sustainable finance instruments which are tailor-made to help support ESG initiatives. Globally, the total green issuance surpassed \$269.5 billion USD in 2020, \$517.4 billion USD in 2021<sup>1</sup> and shows a growing trend in 2022 and beyond, according to Climate Bonds Market Intelligence. A total of 835 green bonds have been issued globally since the start of this year raising \$245 billion, a number derived from the analysis by global law firm 'Linklaters'. The sustainable bond market is predicted to exceed the \$1 trillion mark this year.

### **II. Operational Efficiency**

Agility, resilience, productivity and eco-sustainability are redefining operational excellence. Business globalisation along with the worldwide pandemic intensified the operational requirements to maintain competitiveness and growth. Within the Indian banking system, digital system implementation will be a differentiating factor. It will improve operational efficiency and will promote excellence by improving operational agility and minimising resource consumption and waste.

Operational excellence journey must address sustainable waste reduction as part of a complete solution for corporate clients. Waste reduction in industrial economic and economic terms is essential for today's competitive environment. Initiatives like these are called lean management, operational excellence, sustainability strategy or other similar terms.

In the present scenario, it is difficult for banks to manage both efficiency and operational agility due to the disturbance in domestic and international operations. The use of digital platforms with fintech will make the journey comfortable and can be optimised by plugging in any value leaks through the operational cycle.

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<sup>1</sup>Source: <https://www.climatebonds.net/>

Eco-sustainability requires commitments in order to improve operational efficiency which includes performance, asset reliability, and quality compliance. Visibility across all levels into Key Performance Indicators (KPIs) on an operational level, and insightful and interactive reports enable team collaboration and shared best-practices across different functions. This can be done with the help of advanced analytics, market learning, and artificial intelligence to help uncover hidden improvement opportunities and optimize operational conditions.

Global and local brands have started tackling ESG issues. This renewed focus on climate change and environment has given rise to new measures by big banks like J. P. Morgan, Wells Fargo, and Bank of America to enhance their commitments to ESG standards. One such example is J. P. Morgan. It set up a new Green Economic Specialized Industry Team to provide dedicated banking services and expertise to companies that produce eco-friendly products, services or focus on environmental conservation. Bank of America aims to deploy and mobilize \$1 trillion through its Environmental Business Initiative by 2030 to smooth the transition to a low-carbon economy.

There are a number of ways banks can pursue operational efficiencies to align their ESG strategy; ultimately creating a cumulative effect through the sustainable ecosystem.

### **III. Responsible Investing**

Also known as Sustainable Investing or ESG Investing, Responsible Investing is the strongest catalyst which drives the ESG ecosystem for large institutional investors. It is a way of investing in companies based on their commitment to ESG factors.

The increased awareness regarding climate change, corporate misconduct, and social inequality which has led ESG to become key factors in the reputation

and success of businesses and corporations. This presents an opportunity for banks and financial institutes to drive growth and differentiate to meet the needs of clients.

In light of the three strategies stated above, investors need to be aware of the ESG framework in India. This can be broken down into three: Corporate Social Responsibility (CSR), Social Stock Exchange of India, and Business Responsibility and Sustainability Report (BRSR).

Under the Companies Act, 2013, certain profitable companies are required to spend a minimum of 2% of their three-year annual average net profit towards CSR initiatives in a financial year. The Government requires full disclosure by companies towards these spending in order to increase overall transparency in the future.

Social Stock Exchange (SSE) was an idea floated by Finance Minister, Nirmala Sitharaman in her 2019-20, Budget Speech. It serves private and non-profit sectors by providing them with greater capital and additional avenues to raise funds. The Securities and Exchange Board of India (SEBI) has said that SSE will be a separate segment of the existing stock exchanges. This novel concept gained momentum during the pandemic and spotlighted the need for social capitals for organisations working for social welfare. On the basis of recommendations proposed by working group and technical group constituted by the regulator, framework for SSE has been developed as per which a separate segment of the existing stock exchanges will be developed.

The Business Responsibility and Sustainability Report (BRSR) framework is the result of the Paris Agreement of 2015 and United Nations' Sustainable Development Goals (SDGs) for 2030. SEBI demands BRSR for the top 1000 listed entities in India. The

framework merges the financial performance of a listed company with its ESG performance which helps regulators, investors, and stakeholders in assessing the business stability, growth, and sustainability. The BRSR report consists of three sections for disclosure:

**General Disclosure:** It specifies details of the listed entity, products, services, operations, employees, CSR details, and others.

**Management & Process Disclosure:** This helps entities demonstrate the structures, policies, and processes that are put in place towards regulatory compliance.

**Principle-Wise Performance Disclosure:** These govern the manner in which a business conducts itself with respect to environment and social matters. The collected information is categorised under essential determinants and leadership indicators.

Commercial banks faced many challenges like digitalization, new competitors, low interest rates, regulations, and others. This might make it appealing to restrain ESG issues with regards to large-scale transformation projects. But it is important to remember that a bank's wealth and asset management functions have the potential to enhance the long term sustainable performance of the portfolios.

Financial institutions and banks that align themselves to the needs of the nation while being conscious of the impact of its operations are more likely to generate long-term sustainable returns for all stakeholders. This is why embedding ESG factors into a bank's culture and system is the need of the hour.

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