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Webinar on "Current Preparedness of the Indian Banking Sector around ESG and Climate Risk Management" by Ms. Namita Vikas, Founder and Managing Director, auctusESG LLP

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ABSTRACT

The webinar focused on the current preparedness of the Indian banking sector around ESG and climate risk management. The discussion included global and national trends on this front, in the regulatory space and the market domain. It gave an indication of the current integration of business sustainability and climate-smart practices within the products and processes of leading Indian banks. Case study approach was also employed to discuss a few relevant examples from within India as well as from across the globe.

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About the Speaker

Namita Vikas is currently the Founder and Managing Director of auctusESG LLP, a global firm providing strategic advisory and enablement on sustainable finance, climate transition, ESG, and climate risk management. An award-winning senior business leader with over 30 years of diverse global experience in sustainable finance, ESG, and climate strategy across banking and technology. In her previous leadership role with a large Indian private bank, she led the maiden issuance of a green bond, launched many innovative first-of-its-kind sustainable finance products. She was also instrumental in raising over USD 1 billion in green capital from marquee global DFIs.

Since 2020, following her passion to accelerate global sustainable finance and climate transition, at auctusESG, she has steered marquee global projects awarded by international governments, UN agencies, and global DFIs, in emerging markets like Latin America, Central Asia, Southeast Asia, India, and Africa.

Namita continues to be a member of several expert committees on Sustainable Finance and ESG, including those by the Government of India, and the International Organization for Standardization (ISO). Currently, she serves on the global advisory board of Climate Bonds Initiative, UK, the Finance Industry Advisory Board of the International Energy Agency (IEA), and Digital Green, USA.

Setting The Context

- No country today is immune to the impacts of climate change. Unchecked climate change will push over 132 million people back into poverty over the next ten years, undoing all the hard earned developmental gains that we've had so far.

- Globally, in the recent past, there has been an increased focus on climate responsibilities, especially by financial institutions, since they are public trust institutions and play a very central role in an economy. They have to be very mindful of how they deploy the capital and therefore, there has been a hard focus on financial institutions, particularly from the regulatory standpoint. India too has witnessed a cascading effect because of these international pressures . Boardrooms, management corridors and employee base across banking and corporate sectors have now started talking about ESG and climate risks.

Climate Risk = Financial Risk

Climate crisis is becoming a financial crisis.

It is very important to understand that climate change already has financial consequences for financial institutions. If we take the example of the U.S. insurance sector not being able to bear the rising costs of climate risks, is now restricting certain coverages. Restricting coverages implies pulling out of some areas, making it impossible for businesses to get insurance covers. Risk patterns are occurring simultaneously given the underlying connection between ESG, climate risks and financial risks. A report that was released by the U.S Financial Stability Oversight Council (FSOC) sought to identify and respond to vulnerabilities in the American Financial System. It can be seen how climate change has led to abrupt and unpredictable shocks to the global economic or financial conditions. This is bound to diminish the ability of financial systems to provide services including the provision of liquidity or availability of credit.

Climate risks, also ESG risks are likely to affect households, communities, companies, and governments, leading to damages of property, interruption in business activities, negative impacts on companies or household incomes, ultimately altering the value of assets and liabilities.

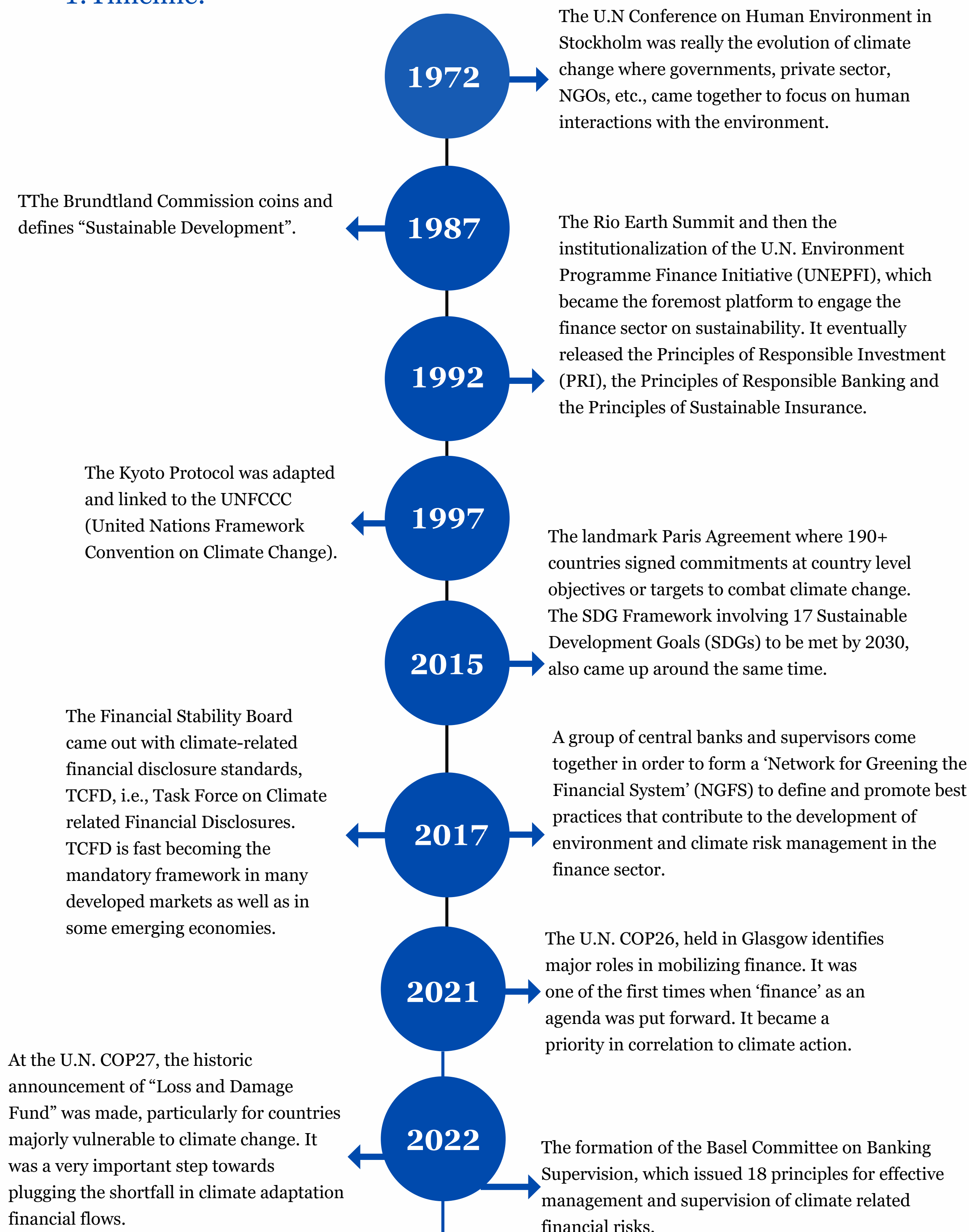
For example, the rising sea levels and the higher incidences of extreme weather events are causing losses for homeowners and diminishing the property values, leading to greater risks in mortgage portfolios. Many a times, such factors are not taken into consideration by lenders and as a result of such outcomes, the financial sector as a whole is likely to experience increasing credit and market risks associated with loss of income, changes in asset values, liquidity risks, operational risks, and at times, legal fines. All of these are likely to be amplified through correlated exposures and the outcomes can cause financial institutions to withdraw credit provisions.

There's a possibility that these effects create a feedback loop where drawing credit can further lead to barriers in adapting to or mitigating climate change, resulting in greater impacts on the broader economy.

Salient Points Discussed

Global Developments

1. Timeline:



2. Market Trends:

In 2021, the Glasgow Financial Alliance for Net Zero was formed and supported by 550 member financial institutions across 50 countries to set very meaningful decarbonization commitments and to accelerate the transition to a net zero global economy.
Apart from that, there are many other global initiatives like the RE100 and the Climate Action 100, which have brought the world's influential businesses to consider driving a very ambitious agenda as far as climate is concerned.
It was Larry Fink, the BlackRock CEO, who set the stage ablaze when he went public in his 2020 Annual Report calling for capital reallocation towards sustainable and ESG strategies on account of the growing climate risks. That event really set the momentum in the investor community.

3. Regulatory Guidance:

The principles of effective climate risk management and supervision which was released by the Basel Committee on banking supervision in June 2022, made the finance sector to really sit up and acknowledge climate risks. Given that the Reserve Bank of India (RBI) takes a greater interest in managing climate risks, a likely alignment of Indian banks and financial institutions to the Basel Committee Principles in some way if not entirely, is a possibility. There are 18 principles, 12 for banks and 6 for supervisors. The Basel Committee Principles will seek to provide guidance on effective management of climate risks, and cover areas like corporate governance, internal controls framework, capital and liquid adequacy and risk management processes.

The European Union (EU) Taxonomy has really picked up pace and is a common classification system for low carbon resilient and resource efficiency activities that businesses align with, to achieve sustainability goals. It is applicable across all businesses. The EU Carbon Border Adjustment Mechanism (CBAM) is one such example, which is a policy mandate aimed at reducing carbon emissions by ensuring that imported goods are subject to the same costs as products produced within the EU.
The CBAM will be implemented in phases from October 2023. Both the EU taxonomy and the CBAM have started to impact European companies as well as the foreign entities which are engaging with the European markets. India has also taken note of it and there are discussions around how India is going to get covered (especially the steel and cement sector) under the CBAM.

The Sustainable Finance Disclosure Regulation (SFDR) applies to financial firms like asset managers, banks, financial advisors, pension funds, insurers, etc. SFDR is a set of rules that aim to make the sustainability profile of funds more comparable and better understood by end investors.

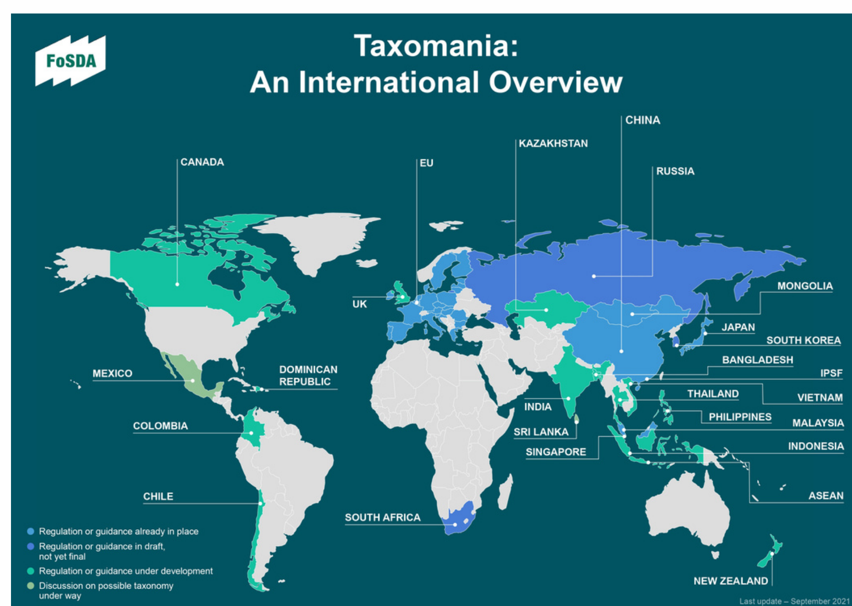
The United Kingdom is the first G20 country to have mandated the Task Force on Climate-related Financial Disclosures (TCFD).

The U.S. Securities and Exchange Commission (SEC) has announced the creation of a climate and ESG task force to identify any material gaps or misstatements in issue or disclosures of climate risks under their existing rules.

The regulations are really aiming to enhance the role of financial systems to manage risks and to mobilize capital for green or low carbon investments. The examples of such regulations in India are the Business Responsibility and Sustainability Reporting (BRSR) guidelines, the Green Deposit guidelines which the RBI issued, the rules for ESG rating agencies, etc.

4. *Taxomania*:*

Taxonomies are a kind of a comprehensive classification system, a clear guidance as to whether an asset can be considered sustainable or not, and how it is key in achieving the net zero targets.



Source: https://futureofsustainabledata.com/taxomania-an-international-overview/

The map above highlights that there's immense traction across geographies for taxonomy. In fact, in India, the Ministry of Finance did get a draft of the Sustainable Finance Taxonomy, and they should soon be releasing it. Securities and Exchange Board of India (SEBI) has already put out the revised Green Bonds guidelines. The regulations are working in a way wherein all the regulators are looking to prevent greenwashing to some degree.

*A term used by Future of Sustainable Data Alliance (FoSDA) in one of their workstreams on Taxonomies.

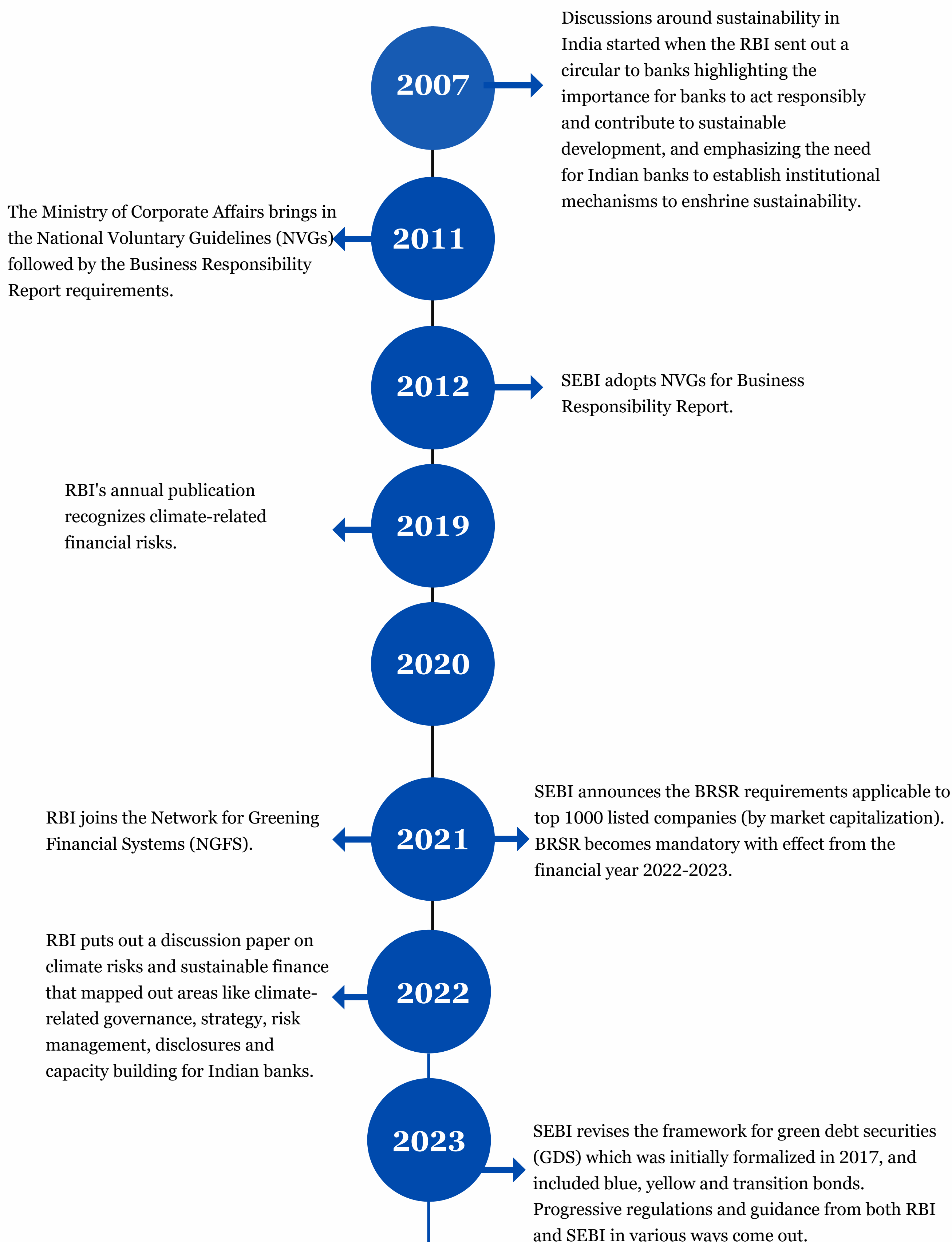
5. Rise of Sustainable Finance:

As of today, sustainable debt has recorded a cumulative issuance of $3.9 trillion since 2006. Green bonds form a majority of this total as climate concerns have been on the fore for a decade now. Green, Social and Sustainability Bonds (GSS) provide investors with an ability to finance environmental and socially impactful projects while securing about the same risk or return profile of conventional bonds. By 2022, GSS issuances had crossed $850 billion, out of which 50% was green bond issuances. The majority of the bonds in the **social and sustainability** categories are issued by government-backed entities or developmental banks, while over 50% of the **green bonds** are issued by the private sector, some of which have been led by financial corporations.

The ESG oriented investing assets reached about $35.3 trillion in 2020, from $13.6 trillion in 2012. The recent forecast suggests that the ESG oriented assets could exceed $53 trillion by 2025, representing more than a third of the projected total Assets Under Management (AUM).

Indian Developments

1. Timeline:



2. Sustainable Finance Instruments in India:

The sustainable debt market in India has been gaining momentum. In the Asia-Pacific (APAC) region, India is the sixth largest issuer of green, social, sustainability, and sustainability linked bonds. As of 2021, the cumulative volume of GSS bonds has been about $19 billion, out of which almost $18 billion were issued in the form of green bonds mainly by renewable energy companies. Despite India's successful sovereign green bond issuance, the overall market is really muted right now. Corporate issuances are seen but are concentrated very much within the renewable energy sector. Commercial banks need to step up for scale to come in. The extra cost of green finance, or the lack of demand, or dearth of investors in the green bond space may have kept the banks at bay.

On the equity side, there are about 10 ESG equity funds. Assets Under Management would be about INR 10,200 crores. It is predicted that the ESG themed investment is going to surge, will account for almost 30 percent of the overall fund volume, and reach over $270 billion by 2030. Announcements by SEBI on ESG rating norms and transition bonds guidelines are bound to widen the investable universe for ESG.

3. Integration of Sustainable Finance and ESG in Banking Products:

Wholesale Liabilities:

Since 2015, EXIM Bank, YES Bank, AXIS Bank, IDBI, SBI have all issued **green bonds**.

Sustainability linked loans which are structured very similar to green bonds are general purpose loans that incentivize borrowers achievement of predetermined sustainability targets against a particular matrix.

Retail Liabilities:

Green fixed deposits are designed for retail customers whose deposits are used as proceeds to finance green projects. The recent green deposit framework by RBI serves as a guideline to bring in standardization and a level playing field within this segment.

Wholesale Assets:

Green term loans are for emission reduction projects such as captive renewable energy, energy efficiency, green buildings, construction, or transition to low carbon projects.

The developed markets have also seen products like **green guarantees and standby letters of credit** wherein banks are providing guarantees on underlying projects that contribute positively to the environment.

Retail Assets:

Green car loans and the **green home loans** are typically for purchase of electric vehicles and green homes.

While it has been seen that the green and sustainable products are fast picking up in the Indian banking sector, there's still a lot of potential for more innovation in the space.

4. Initiatives within the Indian Banking Sector:

Banks in India have started to look at ESG from a policy perspective. Banks like SBI, IndusInd, RBL, ICICI, or even smaller banks like Karur Vysya bank, have ESG policies, or E and S policies.

For example, Federal Bank received a 'Certificate of Achievement' from International Finance Corporation (IFC) as it disbursed about U.S.$332.9 million worth of climate loans, the largest amount of climate loans in South Asia for the fiscal year 2022. IndusInd Bank bagged the award for 'India's Best Bank for ESG 2022' by Asia Money for a very dedicated sustainable banking unit with a focus on ESG in business risk and operations.

This means that an ESG filter is applied across commercial lending, microfinance, sustainable finance and governance matters within the Indian banking sector.

Key Takeaways

- All countries around the world are introducing increasingly stringent climate policies and ambitious Net Zero targets.

- New policies are shaping the market.

- Impacts of climate change are witnessed globally with rapid action to reduce emissions. We are looking at a big climate crisis which is going to impact economic and financial parameters.

- Indian banks are at different stages of adopting ESG policies. However, translating ESG policies into integration within lending models and implementation is crucial.

Landscape Assessment of Preparedness for ESG and Climate Risks amongst Indian Banks

In January of 2022, RBI conducted a study amongst Indian Banks to assess the state of climate risks and sustainable finance. The survey findings indicated that while participating banks had begun recognizing climate risks, a lot remained to be done to measure, monitor and integrate such risks. There's a lot of concern but there's no competence in terms of the ability to do this. The majority of public and private sector banks did not have oversight mechanisms and responsibilities for governance within ESG.

In the area of risk management, while most banks did recognize the urgency, integrating climate risks into the risk management framework was still at bay.

Data processes, methodologies and capacities were also cited as insufficient.

Overall, foreign banks fared better than public and private sector Indian banks and the survey clearly brought out gaps across social pillars of climate risk management that is governance, strategy and risk management.

UK-PACT Landscape Assessment:

AuctusESG in late 2021, along with Overseas Development Institute (ODI) and Climate Bonds Initiative (CBI), undertook a landscape assessment of ESG and climate preparedness amongst Indian banks. It was a one-on-one survey with ten participating institutions.

In the context of **oversight of ESG issues**, four institutions out of ten indicated that the Board of Directors had direct oversight of ESG and climate issues. Board level committees with oversight included CSR, audit and ESG committee. Participating institutions saw the relevance of ESG oversight into mainstream business decision making. A few cases had ESG under the CSR committee. However, given the lack of any kind of regulatory guidance, most banks were yet to establish any kind of dedicated ESG committees.

For **training**, there were only two institutions that indicated that they had made some provisions for ESG and climate training.

In the area of **executive compensation**, four institutions found no link between ESG performance and compensation.

Six institutions made provisions in hiring to strengthen **representation of key social groups** such as women, people with disabilities, people from socially disadvantaged groups or people from rural areas.

In the context of **risk management**, a sharp shortfall was seen in ESG and climate risk management practices. Out of the ten institutions, less than half systematically identified, quantified and used ESG and climate risks to guide financial decisions.

About 50% did not have **standalone frameworks for assessing some combination of ESG and climate risks**. Two institutions attributed this to lack of standard methodologies. As these were leading institutions that were surveyed, the findings speak of the broader culture of ESG integration in risk and credit considerations.

From a **strategy standpoint**, seven institutions indicated that ESG and climate considerations were integrated into their business strategies. The major motivations were reducing repetitional risk and strengthening the brand, portfolio diversification, new business opportunities, safeguarding against credit risks and non-performing assets, and unlocking new or low cost capital from very focused green funds.

ESG and climate related disclosures faced two main challenges:

- lack of capacity to analyze and report
- the lack of data, data collection tools and understanding of the frameworks

With the BRSR in place, there will be more transparency, more training and capacity building in these areas.

Key Takeaways from Survey Findings

- Both the surveys indicate that currently there is limited uptake of ESG and climate risks, when it comes to integration, despite recognition that ESG risks are critical.

- The situation may have marginally changed since the time that these surveys were undertaken. More and more institutions have been talking about ESG and climate risks and there's so much being covered lately, given the concerns of the Board of Directors or the management.

- In some cases, regulator representatives like the Indian Banks Association or the Indian Institution of Banking and Finance, have started to educate banks on these aspects.

- However, most banks have indicated that they are waiting to see the regulatory guidance before they formulate any of their policies.

Case Studies

MALAYSIA

Bank Pembangunan Malaysia Berhad (BPMB) is a leading development financial institution in Malaysia. Through its green financial services and products, BPMB has significantly promoted sustainable finance in the country. The purpose and the strategic transformation plan of the bank aligns with that of Malaysia as a country. There's a significant correlation with the country's goals since there will be a cascading effect from the country to business entities. The bank has also embedded ESG and climate aspects in both risks and opportunities within its business model.

Highly ranked projects through the **MIND** (Measuring Impact on National Development) framework get higher priority of lending by BPMB.

On the climate risks front, the bank has evolved its own climate change risk framework, adapted from the Climate Change Principles-based Taxonomy (CCPT) that was released by their own central bank, Bank Negara. Bank Negara had already put out certain guidelines in terms of what banks need to do. BPMB adopts the three lines of defense model as suggested by Basel which implies risk oversight, right from loan origination to disbursement, and to internal audits.

On the governance front, BPMB Board and the Sharia Committee oversee banking regulations and sustainable practices. In fact, the Sharia committee is also responsible for implementing Sharia conscious governance practices into risk management, leadership and reporting standards.

On the opportunity side, the lending model very much focuses on impact and as a result, there is a strong focus on infrastructure development and support to small businesses. Therefore, in 2021, the bank approved green financing of over $104 million to these kinds of businesses.

BPMB is also a signatory to the U.N principles of responsible banking and also uses Integrated Risk Reporting Framework for its particular disclosures. It has a AAA rating from Malaysian as well as other agencies.

INDIA

Axis Bank* has come up the curve very fast in the last couple of years on ESG, climate risks and opportunities.

On the ESG risk management side, it includes various aspects like ESG policy, including ESG and climate risks in their internal capital adequacy processes, assessment, and capacity building.

Its Annual Sustainability Report discloses mapping of the bank's programmes across various UN SDGs. The bank also taps opportunities to innovate on sustainable financing products. Recently, it signed a $150 million deal with Asian Development Bank to finance Micro, Small & Medium Enterprises (MSMEs) for participating in trade through environmentally and socially sustainable supply chains. Under this particular facility, ADB provides a partial guarantee to Axis Bank for lending towards supply chain products.

The bank has also set up targets, such as incremental financing of about INR 30,000 crores under their wholesale banking to sectors with positive social and environmental outcomes (by 2026), generating a five percent of retail electric two-wheeler loan portfolio (by 2024), scaling down exposure to carbon intensive sectors and incremental disbursement of about INR 10, 000 crores (by 2024).

In 2021, Axis Bank successfully priced its US $600 million issuance of Sustainable Additional Tier 1 (AT1) notes in the overseas markets.

Lastly, from a governance standpoint, it has a standalone ESG Committee of the Board which is chaired by an independent Director. The bank has also been participating in global ESG ratings like Morgan Stanley Capital International (MSCI), Dow Jones Sustainability Index (DJSI), FTSE4Good, and Carbon Disclosure Project (CDP).

Axis Bank uses Integrated Reporting Framework and Global Reporting Initiative (GRI) standards when it comes to its disclosures.

Indian banks are in a very good position to adapt to the changing regulations, to analyze impacts from international regulations, to future proof itself for the regulations that the country is going to bring about. The banks need to build more capacity within their internal teams and move very quickly to take all this into stride.

*Data based on public secondary research.

Q&A Session

Q: Only certain private banks have been a part of this initiative, whereas the larger banks have typically stayed away from it. When do you think the larger banks, especially some of the nationalized banks will start moving into this type of mindset?

A: It is very important to understand that the banking sector is highly regulated as far as India is concerned. Banks follow regulations and do everything within the periphery of the regulations. Private banks happen to adapt to some of these parameters owing to international pressure or investors' demands. On the other hand, public sector banks have taken it into their stride. One such example is the State Bank of India. SBI may not have an ESG committee at the moment but it does have green loans and it has done very well from the product side. Most of the banks are waiting for the regulation since they want clear guidance in terms of what they need to do. While India does look at international regulations, it also has an Indian way of doing things. We need to also consider the local impact and therefore the Indian banks are waiting to see what kind of regulation is going to emerge. All banks would have to align once there is some regulation in place. For example, there were so many ESG rating agencies mushrooming in India until SEBI stepped in with a regulatory framework for all the ESG rating providers (ERPs).

Q: What is the current transition finance environment in India and the potential scope of it in the near future?

A: The scope for transition finance in India is immense. India requires around U.S. $8 trillion to move to a low carbon economy and there are different numbers mushrooming every day. On an annual basis, we require U.S. $3.2 million. There is tremendous opportunity as far as transition finance is concerned. Having said that, if we look at portfolios of banks and start asset tagging, there would be a number of capital flows that have gone towards transition finance, but they could have gone under the category of "General Purpose Loans". There is no category saying "Transition Finance" that is being tracked at the moment. Once we start tracking that, we would know what kind of portfolios banks already have and that the potential is huge. Transition Finance is finance that flows through 'brown' sectors to make it 'greener'. If you look at hard-to-abate sectors, there's so much potential for transition finance. It is unclassified at the moment and once the classification is done, banks would start looking at lending more to those.

Q: Have the equity markets rewarded financial institutions that have shown more ESG and climate risk consciousness? What is your sense of evidence on this in India, or globally?

A: The moment Larry Fink (CEO, BlackRock) announced that BlackRock was

going to make ESG and climate risks a part of their investment strategy, all the other funds started to align. Globally, there are funds coming together under different umbrellas to look at ESG. The European funds have to align with the EU taxonomy and the cascading effects of that will be seen in India. If we look at the MSCI ESG index, it has outperformed the MSCI regular index. We can safely conclude that there is merit in adopting ESG and climate risks consciousness, and with all the international pressure, especially from investors, it has become ever more important.

The whole picture has changed in the last few years and there's a lot of mainstreaming taking place as far as ESG is concerned. The evidence of how ESG funds are performing vis-a-vis regular funds is certain indices such as the MSCI. ESG can be expensive right now, I agree. However, in the case of the Indian sovereign green bond which was issued, there is a '**greenium**'. In certain products, the issuers get a 'greenium', an ESG premium. The market is currently evolving and investors are waiting and keeping a watch on this space. ESG is expensive but it is really more about what your investment philosophy is.

Q: The Indian government continues to focus on the coal industry in pursuit of growing its GDP. In fact, in the Glasgow Committee, India was one of the few countries to stand out and refuse to sign on the 'phasing out' of coal. Given that, do we see Indian banks adopting a different taxonomy as far as ESG is concerned as compared to the rest of the world?

A: India is going to peak in 2050. Naturally, it would depend on coal. Now, the question is, "How do we balance economic growth and sustainability?". India is also looking at investing so much more in renewable energy. There are many banks who are unwilling to finance coal. As we go into the next five years, we might resort to only the public sector banks or the infrastructure development banks to finance the government's requirements for coal. The coal investments currently are limited to the public sector. India has to align with the global commitments and therefore, as a strategy, it really needs to look at how it's going to finance its coal for the next decade.

Q: ESG needs a champion in each country. How do you perceive the risk coming from some of the hardline political parties who might not be supportive of ESG? Isn't that a real risk capable of pushing back implementation of effective ESG policies?

A: Political risk is always there. The important point is how real the climate crisis is and how it is affecting voters. If we take the example of the California wildfires, it is a reality. Even if we deny the climate crisis, people (voters) will ultimately get affected by it. There is a link between the two, no matter how much we deny it. The on-ground reality indicates the presence of homelessness, loss of property, loss of money, etc., leading to an ever increasing burden on the government to create certain disaster reduction budgets that they have to plan out for climate related incidents.

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