EVOLVEMENT OF ESG INVESTMENTS IN INDIA

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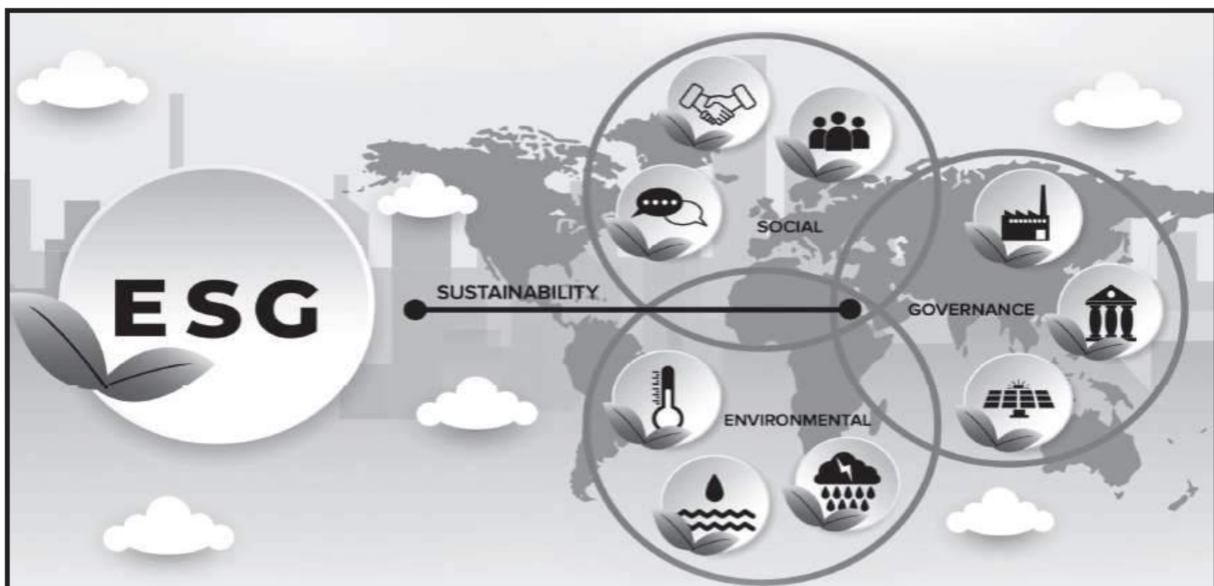

What is ESG?

ESG refers to Environmental, Social and Governance factors that mainly include issues related to climate change, global health, and environment which covers a wide spectrum of issues that originally does not belong to corporate world but has a great impact on various economic sectors. With growing issues and alertness demand for ESG is increasing to control and combat various issues by adopting ESG measures.

The abbreviation ESG was first introduced in 2004 by the United Nations, which stands for Environmental, Social and Governance which came out with the message which tells that in order to win one should care for its surroundings, which means that every organization should take various measures to protect the environment, social, and governance factors while making investment choices to have an optimistic impact on society.

Since then, ESG is the globally adapted mission to make positive changes in the world and has seen significant developments in the ESG Investing landscape globally as investors are becoming more aware of the fact that competitive financial returns can be generated along with social and environmental progress.

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ESG Investing

ESG investing means investing money into companies that strive to make positive changes in society by investing in environmental, social, and governance issues. Ratings of ESG depend on companies that score well in terms of environmental and social responsibility as determined by third parties and research groups. Considering the following factors investors can identify opportunities and mitigate risk by evaluating companies through ESG Report here are three criteria used to evaluate companies for ESG investing:-

1. Environmental factors are evaluated by contemplating the company's carbon footprint, toxic chemicals engaged in its manufacturing process, and sustainability efforts are determined by the material they used.
2. Social factors are reviewed by considering the company's social impact which includes everything from equality, racial diversity even includes employee welfare policies. It also includes companies' social work in the wider sense beyond its limitation.
3. Governance factors are reviewed by considering how the company's board of directors and management drive positive changes which include everything from governance practices, diversity in leadership, and its relationship with shareholders.

ESG Reporting

ESG reporting discloses a company's operations usually dealing in three sectors-: environmental, social, and governance. It helps companies to disclose better qualitative reports to provide good investment offers to their investors. ESG reporting helps investors to identify companies that possess greater risk by comparing their environmental, social, or governmental practices.

ESG reporting helps to identify risks and possibly reduce cost to make improvements as per the need by adopting the ESG reporting framework. Basic ESG reporting will soon be mandatory all over the world. Institutional investors believe that companies which prioritize ESG initiatives provides better opportunities for long-term returns.

How to do ESG reporting

1. Selecting sectors, companies, or practices built on certain ESG criteria.
2. By comparing definite ESG performance relative to industry associates.
3. Screening of investments against generally accepted minimum ESG standards.
4. By including ESG factors into financial analysis.
5. By solving specific social or environmental problems.
6. Influencing company behavior about ESG practices and policies through direct corporate behaviour.

Business Responsibility and Sustainability Reporting

ESG compliance is now important for any organization looking to progress, or to grow in the coming decades. Various companies are taking action to disclose sustainability reporting by following standards and frameworks to present their ESG framework which indirectly targets more investments.

Disclosure of ESG data is the first step towards reporting framework, Companies and investors usually adopts two key reporting frameworks: the Sustainability Accounting Standards Board (SASB), and Task Force Climate-related Financial Disclosures (TCFD), which provides a set of standards to make sustainability information across a wide range of issues.

Evolution of Reporting Standard

The evolution of Reporting standard can be seen as an attempt to bring improvements in environmental, social, and governance practices to help companies and investors. For this Sustainability Accounting Standards Board (SASB), (a non-profit organization in 2011 to help businesses and investors develop a common language about the financial impacts of sustainability prospects) has developed reporting standards by combining sustainability and financial information along with regulation given by the various Security Exchanges.

Several initiatives are formed to align the leading sustainability reporting for providing comprehensive guidance to companies on how to gather data efficiently through the right medium just to provide true data for various investors. This directly leads to more valuable information and creates less confusion among companies and investors.

Reporting Standard Frameworks in which ESG Reporting can be done are as follows:

1. Global Reporting Initiative (GRI)
2. Sustainability Accounting Standards Board (SASB)
3. International Integrated Reporting Council (IIRC)
4. Task Force for Climate-Related Financial Disclosure (TCFD)
5. Climate Disclosure Standards Board (CDSB)

Standard framework	*Proportion of issuers that use the standard framework*
Task Force on Climate-related Financial Disclosures (TCFD)	66.7%
Sustainability Accounting Standards Board Standards (SASB)	68.3%
Global Reporting Initiative (GRI)	75.0%
Carbon Disclosure Project (CDP)	75.0%
United Nations Sustainable Development Goals (UN SDGs)	58.3%
Principles for Responsible Investment (PRI)	15.0%

Stakeholder Capitalism

Stakeholder capitalism means to cater stakeholders' needs and to build meaningful, decisions that establish a continuous dialogue between stakeholders both internally and externally, there has been a gradual evolution in the global reporting landscape of ESG. The evolving reporting landscape demands increased data collection, enhanced performance, forecasting financial and non-financial statements, and board-level demonstration to impact and measure ESG reporting.

Stakeholders are individuals or groups which are impacted by the activities of the businesses now or in the future. Typically, stakeholders include investors, shareholders, employees, customers, communities, value chain members and other business partners, regulators, civil society actors, and media. These people work together to achieve the best outcome by balancing the social, environmental, and economic impacts of business.

Rising to ESG Challenge

ESG Investing in Asia has been comparatively low despite of various global drivers due to the low rate of investors investing in the environment but can also attribute to the following:

- **Traditional Approach**

  Private investors in Asia typically differentiate investment and social activities as two separate and distinct approaches. Philanthropy and various foundations have flourished and delivered significant impact but there still remains some resistance to such investment decisions and financial performance. Investors

usually focus on profits and financial performance solely despite evidence that integrating ESG policies provides long-term profit.

- **Unawareness towards ESG developments**

  ESG factors are constantly evolving and differs according to various industries. This makes it difficult for investors to find suitable strategies for them. According to some researcher it is observed that due to lack of human resources and less expertise in this area result to failure in ESG adaption. They are discouraged by the range of responsibilities that ESG Investing demands. After considering these complications some owners think that they should stick to philanthropy only, while ESG Investing may seem a bit challenging as investors learn from their peers, and as they experiment and gain more experience, they are likely to find their suitable approach.

- **Governance**

  ESG has a broad scope and impacts numerous risk types and business lines. Because of this, leadership needs to take the initiative to set company-wide ESG governance standards. Usually, Board includes senior executives and Risk Committees. While the CFO is typically responsible for ESG investments, cost of capital, and reporting, He should select specific areas to facilitate a comprehensive approach. This may include reputation risk, regulatory change management, and governance processes. In addition, the board has to priorities climate risk management by reviewing products, talent, culture, and external partnerships for sustainability and aligning risk and opportunities.

- **Identifying Strategy and Framework**

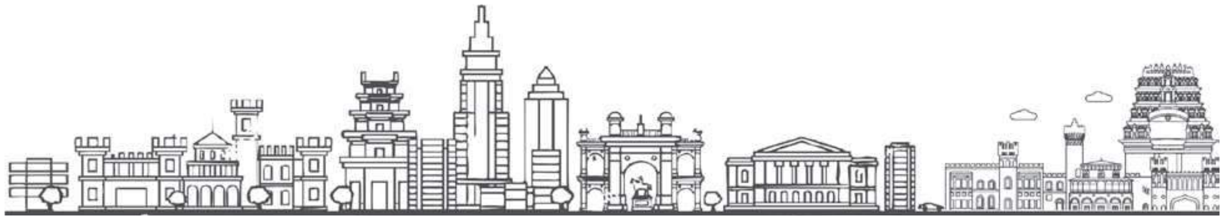
  Firms have to identify gaps and opportunities for improved management and have to integrate a risk management framework to identify types and define risk appetite. Additionally, through ESG, firms could impact existing products, services and launch new offerings. A risk readiness approach can be used to analyze ESG maturity against peers and help to provide a roadmap towards integrated sustainability operating model.

- **ESG Data Accessibility**

  ESG data is not readily available, since not all companies are disclosing their ESG data and measurement methodologies and they differ in comparison across various firms. Additionally, not all data disclosed is relevant or useful in making credit or investment decisions. While the ESG convergence of standards helps firms to be proactive in developing and implementing ESG data and reporting strategies while still keeping an eye out for changes.

- **Disclosures**

  Disclosure plays a key role in allowing investors, and the public in general, to understand and assess the risks and returns of ESG factors and their potential impact on long-term value. The main focus of various institutional investors remains on climate-related disclosures. Many investors seek disclosure on environmental information such as carbon emissions, energy, and natural resource use, and waste and pollution management. Thus regulators, supervisors, and exchanges are moving towards making ESG disclosures, such as TCFD, SASB, and World Economic Forum mandatory. Companies should consider tools or processes to monitor and scan through emerging regulations on a real-time basis and assess against current frameworks.



ESG Approaches

- **Negative Screening**

  Negative screening is the most well-known and perhaps the most common ESG strategy. If a firm's or industry's practices which run counter to values to screen it out investment portfolio. It's like boycotting investment capital even negative screening can help to influence and change things for the better. Negative screening does not necessarily generate superior returns. But the profit motive isn't the only motive. Asset owners like all of us have goals that extend beyond profit and would trade a few extra carbon points for a smaller carbon footprint or another ESG-associated benefit.

- **Climate Change**

  ESG investing without addressing climate change is impossible to address. This is the primary ESG challenge and is always a top priority according to the worldwide survey. Of course, such issues are not easily solved and their asset owners have tried various methods to counteract them, but certain changes have emerged. Investors can't predict something that can be measured due to variation in climate-change and for this reason metrics are being developed. The UN model, for example, adopted a sophisticated model to assess the wide impacts of various emissions.

The Financial Stability Board, Task Force on Climate-Related Financial Disclosures (TCFD) has a host of worthwhile recommendations and has helped ESG's evolution in relation to climate change.

- **Diversity and Inclusion**

  The benefits of diversity in the workplace and in investing have been demonstrated by numerous studies which shows that diversity of gender and ethnicity, among other factors yields tangible positive results. Yet whether in the boardroom or the C-suite, actual personnel demographics have failed to catch up to the science. Key decision-makers remain predominantly male, for example, and often do not reflect the make-up, ethnic or otherwise, of the larger population. And compensation gaps, even in the same job, are common. Addressing these shortfalls has become a central focus of ESG investing.

- **ESG Indexation**

  Since ESG index funds have been available and have the widespread embrace by asset owners but are inevitable meanwhile investors put their capital to work at the crossroads of diversity and smart beta indexing, emerging as a cornerstone investor. It turns out, right now only about 190 companies out of the largest 1,000 publicly traded US companies meet the ESG diversity standards.

- **Active Ownership**

  Shareholder democracy is another critical instrument in the asset owners' ESG toolbox. As owners and potential owners of company stocks, they can leverage their real or potential equity to influence that company's policies. The Council of Institutional Investors (CII) has explored and shaped how asset owners engage with the boards and management of the companies. Its influence is considerable. Companies and society as a whole are well served by clearly articulated corporate governance principles like ESG.

  While active ownership comes with a price in terms of both time and resources, the efforts are worthwhile, particularly in the ESG context.

- **ESG Integration**

  At a broad level, it refers to "the explicit and systematic inclusion of ESG factors in investment analysis and investment decisions," according to Guidance, published by PRI and CFA Institute. "It is a holistic approach to investment analysis, where material ESG factors and traditional financial factors are identified and assessed to form an investment decision."

  ESG integration means to influence investment analysis at every level, from security selection to asset allocation, and beyond. Integration further helps in investment analysis and decision-making processes which leads to better-informed investment decisions. It acts as an early sign or warning for risks that are not yet reflected in asset values.

  Practicing ESG integration leads to more comprehensive assessments and evaluations, resulting in the early discovery of investment opportunities; and provides exercising ownership rights through voting and engagement to create additional long-term value, while also taking responsibility as an asset owner. Integration goes well beyond screening and engagement, and implies the use of ESG information to all stages of the investment process, including the investment case and the valuation models used in investment decisions,"

- **Roadmap to best-in-class ESG practices**

  ESG Roadmap and resources to the industry are comprised of best practices that private market investors

should consider implementing in their organization to advance ESG efforts to promote the sharing of initiatives and resources at a global level. ESG roadmap intends to provide a directory to provide guidance which highlights ESG related resources and provide necessary actions that may be taken to integrate ESG considerations into one's investment program. It is crafted with input from Institutional Limited Partners Association (ILPA) members and industry third parties. This initiative is intended to encourage best practices and recommend resources to companies.

When defining your ESG road map, focus on these three main areas:

1. Set policies and processes for governance using a preventive context to get commitment from the supplier side at the start of the relationship.

2. Engage suppliers and hold those relationships close to make sure their practices are thoroughly assessed based on your ESG performance criteria. Organizational unification will ensure supplier alignment, as well as performance goal-setting.

3. Work closely with all stakeholders to keep them informed, and work with coalitions that are focused on sustainable development.

It's important to have a transparent view into supplier activity and focus on ESG when developing a procurement strategy today. ESG-related risks due to globalization and problematic labor practices around the world make this a necessity.

- **ESG Governance & Integration**

Integrating ESG factors into investment or business decisions is no longer an option, but a growing imperative. Done right, the integration of ESG factors into investment decision processes can drive long-term value creation, integrate Asian businesses into international networks, and encourage sustainable business practices across the region.

The structural integration of information on Environmental, Social and Governance (ESG) factors into the investment decision-making process. Sustainable investors believe that sustainability can have a material impact on companies' performance. Factoring in financially relevant sustainability information thus leads to better investment decisions.

As a wide variety of sustainability information is available, investors first determine which ESG information is financially relevant. The second step is to analyze the impact of these material factors on the individual company and any competitive advantages or disadvantages that arise. The third step is to translate this impact into adjustments to the valuation models used for equities.

There is no right or wrong way to do it all professional investors will approach it differently, and use different criteria, based on what their clients or beneficiaries want.

Seven steps to ESG integration

1. Defining investment as it will define your sustainability investing strategy.
2. Embedding it in the organization, and then seeing the multiplier effect.
3. Creating an integrated framework,
4. Having access to leading research, from companies
5. Integrating ESG, where each investment process requires its own approach;

6. Using active ownership to enhance performance and take responsibility
7. Finally, there is raising the bar, as global challenges continue to shape markets.

ESG criteria can greatly help investors avoid companies that might pose a greater financial risk due to their environmental or other practices and may be liable for regulatory sanctions. For instance, oil spill of Volkswagen's emissions scandal had a significant impact on stock prices and resulted in huge losses.

- **Global ESG frameworks**

ESG frameworks provide logic to analyze various ESG sub-categories and give them weights based on their relevance and importance to eventually determine a percentile of ESG compliance accordingly.

1. *The Global Reporting Initiative (GRI)*

   The GRI is the most widely used framework. The framework was established in 1997 however was recently updated apart from environmental practice to include human rights practices, governance, and social responsibilities.

2. *United Nations Sustainable Development Goals (SDGs)*

   With an aim to achieve Sustainable development by 2030, United Nations member states established SDG in 2015. There are broader level sustainable goals provided within the framework at the country and society level but may have less impact on the industry level indicators.

3. *Task Force on Climate-related Financial Disclosures (TCFD)*

   G20 Financial Stability Board established TCFD to develop a framework that will enable entities to assess climate risk and take necessary action to counter it. TCFD aims to establish transparent ESG metrics to make world economies better prepared for climate change.

4. *The Sustainability Accounting Standards Board (SASB)*

   SASB has published ESG standards in 2018 explaining underlying financial metrics and their implementation. SASB ESG framework is best suited to analyze financial performance based on the ESG practices followed by an entity.

5. *Morgan Stanley Capital International (MSCI)*

   A privately created ESG framework by Morgan Stanley specifically to identify ESG risk in the investment decisions taken by the firm. ESG risks are determined through a scoring system covering data points across industry sectors and ratings range from CCC (laggard) to AAA (leader).

Conclusion

ESG investing is still in its infancy and a novelty to many investors, and how it will evolve in the years ahead is far from clear. But while its future is unwritten, there are varied approaches to ESG, the world's largest asset owners have already rendered their judgment: Whatever it looks like, ESG is the future of investing.

In short, boards should consider taking responsibility for ESG and ensure they have the right people to do so. They should consider developing protocols to identify factors that are important and integrate them into their decision process and compensation plans. They should also make sure reporting is adequate and be mindful of potential liability. Companies from all industries should be proactive in assessing their ESG reporting practices and consider implementing well-recognized standard frameworks.

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