

## ESG Risk for MSMEs - A sustainable approach to Credit Risk Management

### ESG RISK FOR MSMES : BANKS/FI'S AND GOVERNMENT'S RESPONSE

Over the past few decades, financial risks have been associated with unethical practices and lack of governance. Poor ESG practices can lead to financial losses, reputational damage, and regulatory penalties. It is for this reason that various precautionary measures are being taken:

1. Banks and financial institutions are urged to integrate ESG factors into credit risk management alongside traditional financial metrics.
  - A sustainable approach to credit risk management implies incorporating environmental, social, and governance (ESG) factors into the risk assessment and management processes.
  - A sustainable approach to credit risk management involves integrating ESG factors into the standard credit risk assessment process.
2. Global regulators, including the OECD, Basel III, and the European Banking Authority, emphasize ESG adoption in financial systems.
  - According to World Economic Forum's Global Risk Report 2021, Environmental, Social & Governance (ESG) risks accounts for four of the top five risks.
  - Collevocchio Declaration on Financial Institutions advised FIs to adopt its 6 principles which reflect civil society's expectations of the role and responsibilities of BFSI sector in fostering sustainability.
  - Basel III reforms require systematic management of ESG risks.
  - The European Banking Authority (EBA) created roadmaps to allow institutions to bring in objectives and timelines to assess the materiality of ESG and to understand appropriate approach for the banking frameworks.
3. In India, SEBI mandates ESG disclosures, while RBI promotes renewable energy financing under priority sector lending.
  - The Securities and Exchange Board of India (SEBI) has mandated all listed companies in India make ESG disclosures for their value chain, including both upstream and downstream partners and contribute at least 75% of their revenues (by value).
- Reserve Bank of India also encouraged banks to extend finance towards renewable energy by categorising 'Renewable Energy' in its Priority Sector Lending mandate and increasing loan limits for renewable energy eligible projects.
4. Research, such as CRISIL's ESG scores, indicates a positive link between ESG performance and financial returns.
  - The report suggested that 70% of academic studies on ESG have positive relationship between ESG scores and financial returns like profitability, valuation & equity returns.
5. India has set ambitious targets: 500 GW renewable energy by 2030 and net zero emissions by 2070, requiring strong financial alignment.
6. RBI's draft disclosure framework (2024) requires banks and financial institutions to report on governance, strategy, risk management, and climate-related metrics.
7. A phased implementation plan will gradually enforce ESG disclosures across banks, NBFCs, and cooperative institutions.
8. For MSMEs, adopting sustainable practices is now a strategic necessity, supported by initiatives of Ministry of MSME and like MSE-SPICE to promote circular economy solutions.

*Having understood the need, gravity and the goals to achieve question now arises that how we shall be implementing it and what are the critical KPIs to achieve it. Let us first see the KPIs and then we shall be closing our session with suggestive methodology for Banks/FIs to take care of ESG risk.*

### KPIs FOR ESG RISK

To measure the social and environmental impact of a credit portfolio, organizations use ESG (Environmental, Social, and Governance) metrics and KPIs. These metrics provide quantifiable measures of a company's performance in these areas, allowing for tracking progress and understanding the impact of credit decisions.

### ENVIRONMENTAL (E) METRICS AND KPIs

- **Carbon Footprint:** Measures the total greenhouse gas emissions directly and indirectly associated with the portfolio, including emissions from lending activities, energy consumption, and transportation.

- **Energy Consumption:** Tracks energy usage within the portfolio, including electricity, fuel, and other energy sources, to identify opportunities for efficiency and sustainability.
- **Water Usage:** Monitors water consumption across the portfolio, including industrial processes, agriculture, and other activities, to assess water resource impact.
- **Waste Management:** Tracks waste generation, recycling rates, and landfill disposal within the portfolio, evaluating waste reduction and resource recovery efforts.
- **Renewable Energy:** Measures the proportion of renewable energy sources used within the portfolio, indicating commitment to sustainable energy practices.
- **Resource Efficiency:** Monitors the efficiency of resource utilization, such as energy, water, and materials, to identify opportunities for optimization and reduction of environmental impact.

### SOCIAL (S) METRICS AND KPIS

- **Employee Satisfaction:** Tracks employee morale, turnover rates, and engagement levels, reflecting the impact of social policies and practices within the organization.
- **Diversity and Inclusion:** Measures the representation of different groups within the workforce and the extent to which diverse perspectives are valued, reflecting social equity and inclusion.
- **Human Rights:** Monitors adherence to human rights standards, including fair labour practices, freedom of association, and safety of employees.
- **Community Relations:** Tracks community engagement, volunteerism, and social impact initiatives within the portfolio, evaluating the impact on local communities.
- **Customer Satisfaction:** Measures customer feedback and satisfaction with products and services, reflecting the social impact of business practices.

### GOVERNANCE (G) METRICS AND KPIS

- **Transparency:** Measures the level of transparency in financial reporting, corporate governance, and risk management practices, ensuring accountability and accountability.
- **Board Diversity:** Tracks the representation of different groups within the board of directors, promoting diverse perspectives and decision-making.
- **Executive Compensation:** Monitors executive compensation policies, ensuring fairness and alignment with company objectives.
- **Anti-Corruption Measures:** Tracks the effectiveness of anti-corruption programs and compliance with ethical conduct guidelines.

- **Regulatory Compliance:** Monitors adherence to all applicable regulations and laws, ensuring responsible and legal operations.

### HOW BANKS/FIS WILL TAKE CARE OF ESG RISK

The common thread running through risk categories banks are used to dealing with (i.e. credit and counterparty risks, market risks, liquidity risks, operational risks, etc.) is that they all concern the impacts of the risk on the institution itself. However, with ESG risks, risk management must consider new perspectives, for example, not only the impact ESG risks have on the organization, but also the potential impact of stakeholders on the bank and vice versa the risks to which the bank is exposing its stakeholders and the environment due to its business activities.

This approach recognises that credit risk is not just about individual borrowers, but also about broader social and environmental context.

**Key Components of the same are –**

1. Incorporation of ESG factors into credit risk assessment
2. Ensuring lending practices are fair, transparent and aligned to borrowers' need
3. Robust risk management framework to identify, assess, and mitigate credit risks
4. Strong engagement with stakeholders – borrowers, regulators and communities to understand their needs and concerns

### KEY CHALLENGES AND GOOD PRACTICES

**Six key challenges can – if properly tackled - move financial institutions towards not only compliance to ESG regulation, but also to long-term value creation:**

- A) Striking the right balance: anticipating adequately to relevant risks**

Seeing past the ESG label and getting to the issues - The hard work of breaking down E, S and G for a specific company is the starting point to any successful ESG approach. When defining its material ESG risks a bank can break down each sub-category into a concrete area of focus.

Having a clear understanding of the specific issues that are material will help financial institutions focus their time, energy and resources on fewer, yet more impactful, issues.

- B) Translating the ESG strategy into the organization's ecosystem and Integrating ESG in the credit or investment cycle**

Once a banker has understood which ESG issues to focus on, questions of 'how' and 'where' to address

them remain. Banker/FI should incorporate ESG factors throughout their credit or investment cycle: from loan origination to completion or renewal. By incorporating ESG factors in credit worthiness assessments, for instance, financier can anticipate ESG risks well before lending.

**C) Adapting stakeholder management and spreading ESG knowledge in-house**

Training lending teams on effective ESG engagement with a diversity of companies - The skills of the people in this process are the real key to success, therefore financiers should ensure that investment managers and teams can access training on how to effectively engage corporates on ESG.

**D) Collecting, managing and using ESG data for risk modelling**

Data collection is essential for financiers to successfully identify and assess ESG risks and integrate ESG into risk modelling.

For instance, information on clients' greenhouse gas emissions or the locations of their production facilities allows financiers to assess the exposure to physical and transition risks. Information on clients' supply chain structure, including exposure to geographies with higher human rights risks or poor governance can give financiers a picture of their exposure to social and governance risks. Collecting this information is, however, resource-intensive and may require financiers to contact individual clients. Investment portfolios may be sizeable; information can be difficult to obtain or there is a need for data interpretation. Where possible, financiers can use their existing Client Due Diligence/Know Your Customer (KYC) to collect and process the data.

**E) Delivering and communicating on ESG commitments**

Every financial institution may at some point need to show why and how they have taken care of their ESG risks and if they managed to harness ESG opportunities.

**F) Embedding ESG in existing risk practices - Integrating ESG in Risk Management Framework**

Financial institutions can make themselves future-proof by integrating ESG risks in every stage of the risk management framework. This ensures that ESG risks are holistically integrated in existing risk practices. For instance, under risk monitoring, financial institutions should frequently engage with sustainability experts to stay informed on (policy) developments. For ESG risk identification, investors should consider whether their investments are concentrated in specific industries or regions. Climate stress testing can be used for ESG risk assessment. And finally, ESG risk can be mitigated by means of exclusion policies or adapted risk premiums.

## ROLE OF DATA AND AI IN IT

Artificial Intelligence (AI) and machine learning (ML) are revolutionizing the way banks assess ESG risks by enabling them to process vast amounts of unstructured data, detect patterns, and predict potential risks with greater accuracy. By integrating AI into ESG risk assessment, banks can gain more precise insights into how these factors affect their financial health, improve their decision-making processes, and enhance their ability to align investments with sustainability goals

*Lastly, it is pertinent to emphasize that how Data and AI plays an important role in achieving the same.*

## AI ALLOWS FOR

**Enhanced Data Processing:** With AI, banks can quickly analyze a range of ESG data sources—such as annual reports, news articles, social media, and regulatory filings—to identify potential risks that may not be immediately obvious through traditional methods.

**Predictive Insights:** AI tools, such as predictive analytics and machine learning algorithms, enable banks to forecast emerging ESG risks, helping them stay ahead of future challenges, such as regulatory changes or shifts in public opinion.

**Real-Time Monitoring:** AI offers the capability to continuously monitor ESG metrics and flag potential issues in real time, allowing treasury managers to adjust portfolios or take action before risks materialize.

**Artificial Intelligence (AI):** AI can be used to enhance the analysis and integration of ESG metrics into risk assessment models within banks. By incorporating AI-driven technologies, banks can efficiently process large sets of ESG data, identify potential risks, and make more informed financial decisions. AI tools such as machine learning and natural language processing help in assessing ESG-related factors that impact long-term financial stability, credit risk, and market performance. Advanced AI techniques are used to refine risk models and foster sustainable practices.

This will enable banks to not only mitigate potential risks but also to align with global sustainability goals while improving overall financial resilience.

Adopting this comprehensive evaluation methodology not only safeguards Bank/FI against potential risks but also enhances their reputation and competitiveness. It provides a clear path for sustainable and responsible business practices that contribute positively to society and the environment.

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