

## ESG Risk for MSMEs : Banks/FI's and Government's Response

**“Sustainability Is Here To Stay, Or We May Not Be”**

*To start with, I will put few real-life examples before you. Firstly,*

**Example 1 - BP's Deepwater Horizon Oil Spill:** Back in April 2010, popular gasoline company BP suffered financially when an oil rig of theirs called “Deepwater Horizon” erupted near the Gulf of Mexico – and subsequently impacted the surrounding wildlife and biodiversity. BP ended up paying a hefty cleaning fee after the oil explosion, totalling around \$65 billion dollars for both the fines issued and fees to clean the surrounding areas. BP could have avoided this from happening with ESG risk management, as the governance component wouldn't have allowed for BP to be subject to those exorbitant fines in the first place.

**Example 2 –** In 2010, for example, a series of suicides at Foxconn, **Apple's leading** manufacturing partner in China, shocked the tech industry. The tragedy thrust into the global spotlight an uncomfortable truth: The sleek iPhones and iPads that had become symbols of innovation and progress were produced under highly stressful conditions for workers.

Apple faced a reckoning about the true cost of its products and the extent of its responsibility for the people working in its global supply chain. The Foxconn crisis marked a turning point for how Apple and other businesses worldwide evaluate their ethical footprint. It was a stark example of an ESG risk that became a business priority.

*Thirdly & lastly*

**Example 3 - Wells Fargo Scandal:** Between 2011 and 2016, Wells Fargo employees created approximately 2 million unauthorized accounts, including checking, savings, and credit card accounts, in the names of existing customers without their knowledge or consent. The scandal resulted in significant fines and settlements, totalling over \$3 billion. The scandal resulted in significant fines and settlements from various regulatory bodies and lawsuits. Reuters reported that three former Wells Fargo executives were fined for their role in the scandal. Bank made significant changes to its management, risk, and control frameworks, as well as its culture and policies. Wells Fargo stated that they are committed to rebuilding trust.

This highlights the financial risk associated with unethical practices and lack of governance.

### Road Map

**What does it imply for Banks/ FIs & how above examples related to risk being taken by them:**

**A sustainable approach to credit risk management implies incorporating environmental, social, and**

**governance (ESG) factors into the risk assessment and management processes.** This means considering how a borrower's sustainability practices, and potential risks could impact their ability to repay loans or other obligations. Essentially, it's about ensuring that financial decisions are not only profitable but also aligned with sustainable development goals.

**A sustainable approach to credit risk management involves integrating ESG factors into the standard credit risk assessment process.** This means evaluating a borrower's environmental footprint, social impact, and governance practices, alongside traditional financial metrics like creditworthiness and capacity to repay.

**Understanding how Environmental, Social, and Governance (ESG) risks manifest in real-world scenarios is crucial for companies aiming to mitigate these risks and of course to their lenders also.**

**Environmental risks** often involve direct or indirect damage to the natural environment due to a company's operations. **One clear example is the oil spill incidents** which not only lead to severe environmental degradation but also affect the offending company's reputation and financial stability.

**Social risks** pertain to the relationships between a company and its employees, suppliers, customers, and communities. Issues such as poor labour practices can lead to strikes, legal actions, and **regulatory penalties like the example of Apple.**

**Governance risks** involve the systems of rules, practices, and processes by which a company is directed and controlled. Poor governance can lead to scandals and legal troubles, as seen in **the case of Wal Fargo, where governance failures led to misleading regulatory bodies** and the public, resulting in hefty fines and diminished brand trust.

### What World bodies/ regulator says/ doing?

*Having understood the gravity of the matter, let us see what the regulatory bodies mandates and the steps taken to address it/ encouragement for adoption and adherence.*

**According to World Economic Forum's Global Risk Report 2021, Environmental, Social & Governance (ESG) risks accounts for four of the top five risks.** OECD's report on 'ESG Investing: Practices, Progress and Challenges' state that ESG Investing may improve existing Risk Management practices and may lead to returns that are better than traditional investments.

**Collecchio Declaration on Financial Institutions** advised financial Institutions to adopt its 6 principles which reflect civil society's expectations of the role and responsibilities of the financial services sector in fostering sustainability.

**Basel III reforms** require systematic management of ESG risks. Banks must integrate these risks into their overall risk assessments and financial reports.

**The European Banking Authority (EBA)** has created roadmaps to allow institutions to bring in objectives and timelines to assess the materiality of ESG and is trying to understand the most appropriate approach for the banking frameworks themselves.

**The Securities and Exchange Board of India (SEBI)** has mandated that all listed companies in India make ESG disclosures for their value chain, which must include both upstream and downstream partners and contribute at least 75% of their revenues (by value). With regulators like SEBI demanding companies to report on ESG policies and RBI recommending banks include ESG norms in borrowers' credit evaluations, ESG compliance in India is experiencing significant growth in adoption.

**Reserve Bank of India** has also encouraged banks to extend finance towards renewable energy. RBI has identified 'Renewable Energy' as one of the categories under its Priority Sector Lending mandate. Banks are also investing in Green bonds/funds.

The RBI has increased the loan limits for renewable energy projects eligible under priority sector lending. For example, loans up to ₹35 crore per borrower are eligible for renewable energy projects.

**Eligible Activities:** Renewable energy includes various activities like solar and biomass-based power generators, windmills, micro-hydel plants, and non-conventional energy-based rural electrification.

**This policy helps to ensure that banks are lending to sustainable and environmentally friendly initiatives like renewable energy projects, which contribute to India's overall sustainability goals.**

### What does the data & Research say:

Acknowledging the relevance of ESG factors in decision making of policymakers, corporates and others CRISIL had published ESG Scores in 2021 on select companies. The report suggests that **70% of academic studies on ESG have positive relationship between ESG scores and financial returns like profitability, valuation & equity returns.**

Any impact on the economy at large, whether directly or indirectly exposed to ESG risks, will have a definite impact on banks' performance. Embedding ESG into bank's strategic plans will lead to long term sustainability of the respective bank, environment and society at large.

*Now let us understand that where India stands and steps taken by Indian government and the regulators*

### Where India Stands: Government and Regulatory Bodies

**Govt has set target of achieving 500 GW Renewable Energy by 2030** and has commitment for achieving Net Zero by 2070 and reaching 500 GW of non-fossil fuel-

based capacity by 2030. **Mobilising finance is key to achieving** same and financial institutions need to align their lending policies with India's renewable energy growth strategy.

### Understanding Risks for Banks & FIs:

**Credit Risk:** The increasing frequency and severity of extreme weather events can devalue assets held by banks' customers, disrupt supply chains, affect customers' operations and profitability.

**Market Risk:** Banks may experience declines in valuation and increased investment volatility due to shifts in investor preferences or adverse climate-induced effects on underlying economic activities.

**Liquidity Risk:** There may be increased demand for liquidity to respond to extreme weather events or challenges in liquidating assets due to their negative impact.

**RBI's initiatives in ESG Implementation-** Reserve Bank of India (RBI) has taken several initiatives to implement ESG policies within financial institutions:

*Read this Verbatim -* In the Discussion paper on Climate Risk and Sustainable Finance- RBI asserts that Climate change is increasingly recognized globally as a significant financial risk for financial institutions as well as posing a threat to the safety, soundness, and resilience of individual Regulated Entities (REs), which in turn impacts the stability of the entire financial system. Therefore, it is essential for REs to proactively manage the risks and opportunities arising from climate change and environmental degradation.

**Recognizing the critical impact of climate-related risks on financial stability, RBI has introduced a draft disclosure framework, 2024 for Regulated Entities ("RE").**

### Applicability:

All Scheduled Commercial Banks (SCB), excluding Local Area Banks, Payments Banks, and Regional Rural Banks.

All Tier-IV Primary (Urban) Co-operative Banks (UCBs).

All All-India Financial Institutions (AIFI), (viz. EXIM Bank, National Bank for Agriculture and Rural Development (NABARD), National Bank for Financing Infrastructure and Development (NaBFID), National Housing Bank (NHB), and Small Industries Development Bank of India (SIDBI)).

All Top and Upper Layer Non-Banking Financial Companies (NBFCs).

**Adoption of these guidelines remains voluntary for entities other than those specified in the above-mentioned categories. However, foreign banks must make disclosures specific to their operations in India.**

### Thematic Pillars of Disclosure:

The REs must disclose under the following four key thematic schemes, which include, **Governance, Strategy, Risk Management and Metrics and Targets**. The RBI seeks disclosures on a two-tier level: (a) baseline; and (b) enhanced disclosures. These disclosures highlight accountability and demand a potential shift in the corporate governance process.

| Thematic Pillar            | Description                                                                                                                                                                             | Key Disclosure Requirements                                                                                                                                                                                                                                                                                                   |
|----------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Governance</b>          | Details the governance processes, controls and procedures used to manage climate-related financial risks and opportunities.                                                             | <ul style="list-style-type: none"> <li>Board oversight of climate-related risks and opportunities.</li> <li>Senior Management's role in assessing and managing climate-related risks and opportunities.</li> </ul>                                                                                                            |
| <b>Strategy</b>            | Describes the RE's strategy for managing climate-related financial risks and opportunities, including identification of risks and opportunities over different time horizons.           | <ul style="list-style-type: none"> <li>Identified climate-related risks and opportunities over short, medium, and long term.</li> <li>Impact of these risks and opportunities on business, strategy and financial planning.</li> <li>Resilience of the strategy under different climate scenarios.</li> </ul>                 |
| <b>Risk Management</b>     | Outlines the processes to identify, assess, prioritize, and monitor climate-related financial risks and opportunities and their integration into the overall risk management framework. | <ul style="list-style-type: none"> <li>Policies and processes for identifying, assessing, prioritizing and monitoring climate-related financial risks.</li> <li>Processes used for managing climate-related risks.</li> <li>Integration of climate-related risk management into overall risk management processes.</li> </ul> |
| <b>Metrics and Targets</b> | Details performance metrics related to climate-related financial risks and opportunities, including progress towards climate-related targets.                                           | <ul style="list-style-type: none"> <li>Metrics used to assess climate-related risks and opportunities.</li> <li>Scope 1,<sup>6</sup> Scope 2<sup>7</sup> and Scope 3<sup>8</sup> GHG emissions- Targets for managing climate-related risks and progress against these targets.</li> </ul>                                     |

#### Implementation Plan:

Recognizing the need for a pragmatic and phased approach, RBI has outlined a staggered implementation plan for the framework:

|                                        | Governance, Strategy, and Risk Management | Metrics and Targets |
|----------------------------------------|-------------------------------------------|---------------------|
| SCBs, AIFIs, Top and Upper layer NBFCs | FY 2025-26 onwards                        | FY 2027-28 onwards  |
| Tier IV UCBs                           | FY 2026-27 onwards                        | FY 2028-29 onwards  |

#### Implication for MSME

While ESG principles have traditionally been associated with large conglomerates and Fortune 500 giants, **a new narrative is emerging - one** that champions the role of Small and Medium Enterprises (SMEs) and Micro, Small, and Medium Enterprises (MSMEs) in driving sustainable change.

**For SMEs and MSMEs, it's not just a choice; it's a strategic necessity.**

There is a strong business use case for SMEs and MSMEs to adopt sustainable practices. Big corporations are starting to base their procurement decisions more and more on sustainability factors, including carbon footprint/emissions, sustainable materials, etc. The need for businesses to be more sustainable is crucial in the current environment, which includes growing climate change uncertainties, widespread supply chain disruptions, rising resource scarcity, and a call to action for companies to address their negative environmental and social impacts.

Sustainability is becoming the main differentiator for large buyers to identify suppliers in their value chains. International initiatives like the EU Green Deal, which must be implemented by 2050, and the follow-up EU Circular Economy Action Plan have broad ramifications and will affect supply chains.

The World Bank recognizes Micro, Small, and Medium Enterprises (MSMEs) as crucial for sustainable development, and they are actively involved in supporting their growth and development through various initiatives. These initiatives focus on providing finance, risk-sharing mechanisms, and technical assistance to empower MSMEs and enable them to contribute to the Sustainable Development Goals (SDGs).

**MSE SPICE is a pioneering initiative by the Ministry of Micro, Small and Medium Enterprises (MoMSEs)** dedicated to empowering Micro, Small Enterprises (MSEs) in embracing sustainable practices through the circular solutions.

In the overall global sustainability effort, encouraging circular practices in micro and small enterprises (MSEs) has become a strategic necessity. The introduction of the **MSE - Scheme for Promotion and Investment in Circular Economy (MSE - SPICE)** is a proactive step to harness the potential of MSEs in driving sustainable development. **This is initiated by Ministry of MSME in collaboration with World bank.**

**The primary goal of this scheme is to promote resource efficiency, reduce environmental impact, and enhance the competitiveness of MSEs in India.**

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