The dust around ESG is finally settling

September 2021

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(6 min read)

Environment, Social and Governance (ESG) took the capital markets by storm in 2020, leaving in its wake the swirling dust of myriad concepts and questions that investors, asset owners and companies were left grappling with. This development calls for ***build back better*** on the back of the data that emerged in correlation to the financial performance of ESG parameters, which resulted in an increase of fund allocation towards ESG across the globe. While more than half the investment that went to funds in Europe were steered towards ESG products[1], India itself attracted INR3,686 crore in 2020-21 towards ESG funds, a whopping 76 per cent jump from the preceding year[2].

A slew of ESG mutual funds were launched in India last year. As per reports, this trend is expected to continue with estimates of global ESG assets being pegged at ~USD53 trillion by 2025, representing about a third of global assets under management (AUM)[3]. However, the stellar year has also brought out concerns around 'greenwashing.' When investment into sustainable funds saw an unprecedented rush, the market also saw the opportunity to launch new 'sustainable' or 'ESG' products in a bid to attract the growing fund pool. In such a scenario, the concerns are not entirely unfounded.

The regulatory bodies are trying to catch up with this new development and we will soon see the dust settling around the regulations they introduce. According to Global Sustainable Investment alliance, sustainable investments in Europe contracted by USD2 trillion following the introduction of anti-greenwashing rules[4]. EU Sustainable Finance Disclosure Regulation (SFDR) came into effect on 10 March

2021. This is one of the many requirements under the larger umbrella of EU Sustainable Finance Regulations. The aim of SFDR is to bring in a binding and transparent framework in relation to sustainability risks and harmonisation of what qualifies as Sustainable Finance. It mandates Financial Market Participants (FMPs), which includes asset managers, pension funds, investment firms, banks, insurance companies, etc., to disclose information on their sustainability practices (entity level) and their financial products (product level). Geographies outside EU will also be impacted indirectly as the product-level information will have to come through the investment side. Integration of sustainability risks in the portfolio is key. Investors will seek more specific and standardised ESG disclosures from the companies in which they have invested.

Standardisation call for discussions around ESG disclosures are also gathering momentum. An international corporate reporting entity was formed in June 2021 to deliver a coherent corporate reporting system working closely with IFRS and other leading framework setters and standard providers around the world. In August 2019, two international business forums collaborated with the four major accounting firms to develop a set of universal metrices supporting 'stakeholder capitalism'[5].

Standardised reporting on ESG is also gathering momentum in India. In May 2021, the Securities and Exchange Board of India (SEBI) launched the Business Responsibility and Sustainability Reporting (BRSR) format[6]. The BRSR will be applicable to the top 1,000 listed entities, as per market capitalisation. It will be voluntary for FY21-22 and will be mandatory from FY22-23. The BRSR framework requires companies to look at an entity's material ESG risks and opportunities. They will be required to disclose the financial implications as well as the company's plans to mitigate or adapt to the risks. BRSR also prescribes ESG metrices that companies need to report which will serve as an important step for standardisation and will improve comparability.

While we are seeing some traction around standardisation of ESG disclosures, the variance in ESG ratings is another area of consideration. Since 2020, when several rating agencies made their ESG ratings public for companies, a significant disparity has been seen in the ratings provided to the same company. The growth in the ESG market has also resulted in the emergence of new ESG rating agencies, which has further added to the complexity in decoding these ESG scores. Since June 2021, we have two new ESG rating agencies in India itself. While the divergence in ESG ratings can be largely attributed to the individual methodologies and weightages adopted by different rating agencies, another factor is possibly the lack of data which results in use of proxies. With increasing regulations (current and impending) around disclosures, ideally, this disparity in ratings should get addressed.

The dust must settle and there are several streams of work, both in the regulatory and voluntary mechanisms, which are progressing to ensure this stability. ESG materiality muddle - with heightened discussions around single materiality and double materiality - is another subject that is now taking center stage. Even this disquietude will give way to balance. The positive momentum around addressing the regulatory void and building refinement in topics will help bring more clarity on ESG.

For more information, check out our thought paper named ESG Value Realisation and ESG: The Board's Perspective

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[1] ESG Fund Assets Hit Record USD1.4 Trillion in Europe Last Year Read, Bloomberg Quint, 16 June 2021

[2] Inflows of sustainable funds surge 76% to Rs 3,686 cr in FY21, The Economic times | Markets, 22 April 2021

[3] ESG assets may hit $53 trillion by 2025, a third of global AUM, Bloomberg Professional Services, 23 February 2021

[4] European ESG Assets Shrank by $2 Trillion After Greenwash Rules, Bloomberg Green, 19 July 2021

[5] Global Business Leaders Support ESG Convergence by Committing to Stakeholder Capitalism Metrics, World Economic Forum, 26 January 2021

[6] SEBI issues Circular on "Business Responsibility and Sustainability Reporting by listed entities", Securities and Exchange Board of India, 10 May 2021