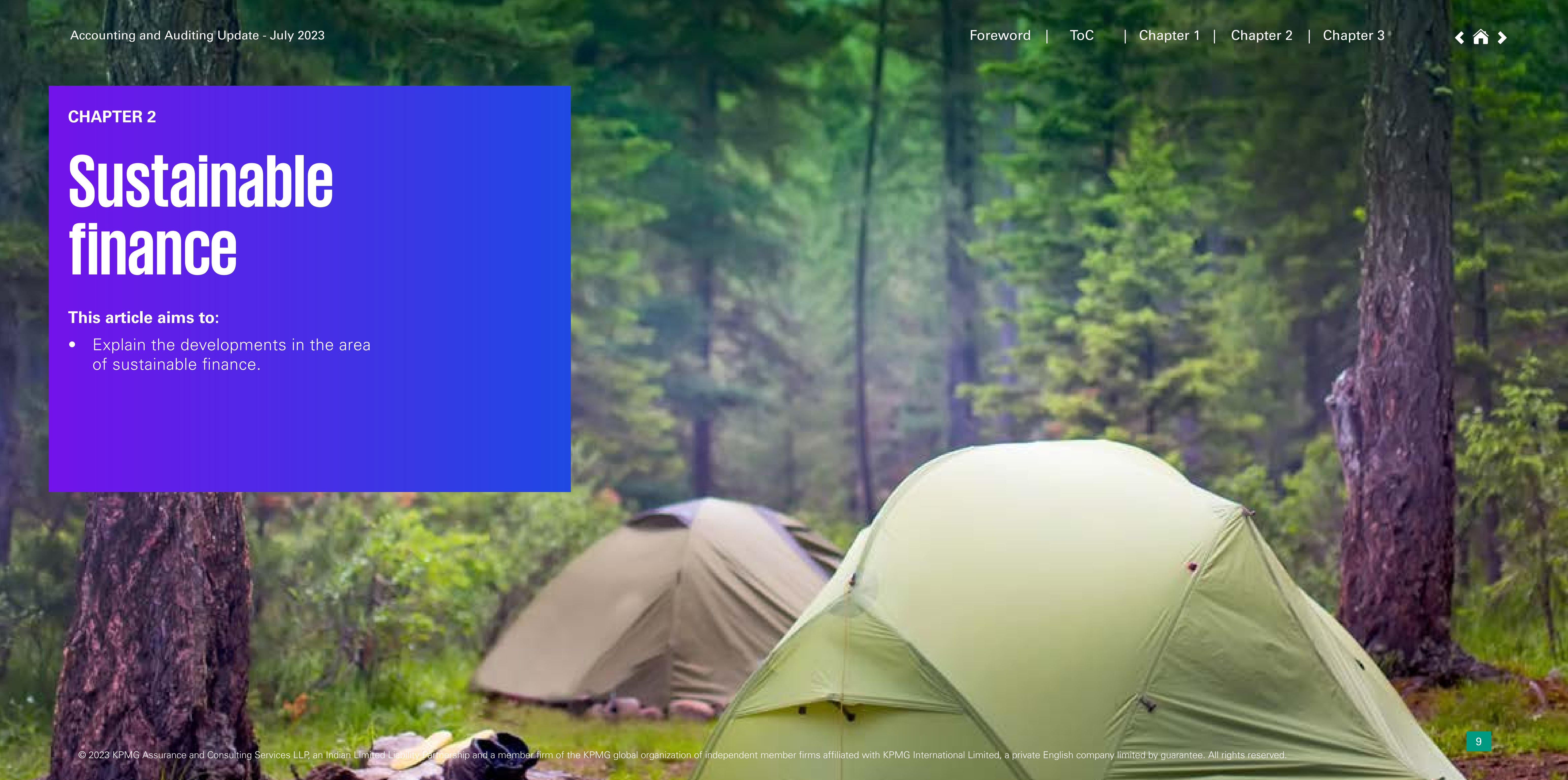

CHAPTER 2

Sustainable finance

This article aims to:

- Explain the developments in the area of sustainable finance.

Sustainable finance supports sustainable economic, social, and environmental development. It is the term used to describe financing and investment decisions that consider Environmental, Social and Governance (ESG) issues. Sustainable finance can be considered an umbrella concept, while ESG is more specific, and focused on environmental, social, and governance. Sustainable financing has become a prominent initiative to address some of the most challenging issues that the world faces today, ranging across climate change, biodiversity, health, financial inclusion, livelihood, women empowerment, and food security. One of the most relevant instruments in sustainable finance is - green bonds.

Background on sustainable finance

Sustainable finance is not a new form of investment. There were socially responsible investors in the mutual fund industry in the US in the 1960s, but they were a minuscule component of the investment community – and in Asia hardly existed. In 1971 Pax World launched the first sustainable mutual fund in the US. The first United Nations Scientific Conference - also known as the First Earth Summit- was held in Stockholm (Sweden) in 1972. The objective of the creation of the framework of the International Finance Corporation of the World Bank (IFC principles) was to reduce the detrimental environmental impacts and risks of business activities.

Sustainable finance has gained momentum after Paris Agreement (2015) and a non-financial crisis like Covid-19. This got further momentum in the recently concluded COP 27.

The financial and non-financial (Covid-19) crisis has restructured the economic and political milieu. Most importantly, awareness of ESG has transformed the landscape of the financial sector. The focus on stability and ethical practice is gaining importance over attractive quantitative returns on investment. Recently more advanced ESG-related products (e.g., green bonds and sustainability-linked loans) have been issued in the market, in response to rising investor demand for such products. Common forms of sustainable finance include green bonds, renewable and sustainable equities, green (ESG) mutual funds, solar bonds, green mortgages, green credit cards, and renewable energy credits.

In 2021-2022, a number of new or revised policy initiatives were established globally having a focus on sustainability. Globally, Europe is the leader in terms of developing a framework for sustainable finance, and ESG integration into different asset classes. The EU Taxonomy for sustainable activities is the first comprehensive science-based classification system designed to help understand whether an economic activity is sustainable. The Sustainable Finance Disclosure Regulation (SFDR) was introduced by the European Commission alongside the Taxonomy Regulation and the Low Carbon Benchmarks Regulation as part of a package of legislative measures arising from the European Commission's Action Plan.

All nations have started following the[1] footprints of Europe and introducing regulations to boost sustainable finance.

Overview of the sustainable finance structure

As mentioned above, the importance of sustainable finance has increased significantly, as a result, organisations, investors, financial intermediaries and other stakeholders are taking into account ESG assessments in their investment decisions.

In this regard, it is important to understand the structure of sustainable finance.

This can be explained through a diagrammatic representation.

(Source: :Organisation for Economic Co-operation and Development (OECD) publication on 'ESG Investing: Practices, Progress and Challenges' and KPMG in India's analysis)

The above diagram depicts:

- Issuers are entities issuing instruments in the financial market, either through public or private channels, with an aim to raise funds towards sustainable development[1].
- ESG ratings are the rating products that are marketed as opinions about an issuer or a security, regarding its ESG profile or characteristics or exposure to the ESG risk, governance risk, social risk, climatic or environmental risks, or impact on society, climate and the environment, that are issued using a defined ranking system of rating categories. Such ratings are provided by ESG Rating Providers (ERPs).[2]
- Index providers convert ratings into market indices by reweighting market portfolios[1].
- Asset managers develop investment products with the help of ESG ratings. This is done to either take portfolio composition decisions or to contribute to the portfolio managers' own ESG ratings[1]. Institutional investors incorporate ESG ratings for portfolio management.[1]
- End users are the subscribers to the instruments.
- Statutory authorities are the regulatory and oversight bodies, market regulators etc. who develop a regulatory framework to ensure issuers are held accountable for their ESG impact and ensure investors have access to the information they need to make informed investment decisions.
- Standard setters lay down the disclosure and measurement requirements for sustainable investing[1].

1. OECD publication on 'ESG Investing: Practices, Progress and Challenges'
2. As per the master circular issued by the Securities Exchange Board of India (SEBI) on ERPs. Circular No. SEBI/HO/DDHS/POD2/P/CIR/2023/ 121 dated 12 July 2023

Challenges in ESG ratings and methodologies

ESG ratings are based on the relevant criteria for each factor of E, S, and G. Rating providers use metrics and sub-metrics to determine the overall ESG score. According to OECD's publication on 'ESG Investing: Practices, Progress and Challenges'[1], investors are facing challenges due to the lack in consistent and comparable information amongst ESG investing products. This is because different ERPs use different methodologies resulting in ESG rating variance. Further, different ERPs rank different aspects of the sustainability of the companies they assess. Also, as per SEBI's consultation paper on 'ESG Disclosure, Ratings and Investment', issued on 20 February 2023, it was observed that emerging markets have different set of environmental and social challenges. Therefore, it becomes critical for ERPs to consider these factors while assessing a company's ESG risks/opportunities and impact.

Thus, there is a need for a consistent set of metrics for assigning ESG ratings. For this purpose, regulatory bodies should establish a set of metrics for the purpose of assigning ratings to ensure consistency.

India landscape

Developments for sustainable finance is taking shape globally and in India also there is continued government focus and policy initiatives on sustainability. The Sustainable Finance Group (SFG) in the Department of Regulation (DoR), Reserve Bank of India (RBI), carried out a survey in January 2022 to assess the status of climate risk and sustainable finance in leading scheduled commercial banks. The responses indicate that although banks have begun taking steps in the area of climate risk and sustainable finance, there remains need for concerted effort and further action in this regard. On the basis of the survey, RBI issued a Discussion Paper on Climate Risk and Sustainable Finance (discussion paper). The discussion paper discusses a need to prepare a strategy based on global best practices on mitigating the adverse impacts of climate change, learnings from participation in standard-setting bodies and other international fora.

Based on the feedback received from various stakeholders, RBI issued a press release dated 8 February 2023 on the 'Statement on Developmental and Regulatory Policies'. One of the guidelines proposed in the press release was on developing an overall green finance ecosystem including a broad framework for acceptance of green deposits.

Consequently, on 11 April 2023, RBI issued a Framework for Acceptance of Green Deposits (the framework). The framework is effective from 1 June 2023.

Recently, a number of ESG funds have been launched in India. As ESG investing becomes mainstream, there is a need to provide adequate regulatory support, and consistent, comparable and decision useful scheme disclosures to make informed investment decision and to prevent greenwashing.

In this area, the Securities and Exchange Board of India (SEBI) had prescribed disclosure norms for ESG schemes of mutual funds to the Association of Mutual Funds in India (AMFI) as stated in the Master Circular on Mutual Funds[3] (the Master Circular). In May 2022, SEBI constituted an ESG Advisory Committee (EAC) which, *inter alia*, provided recommendations for expanding the disclosure norms for ESG funds through public consultations. Subsequently, the SEBI (Mutual Funds) Regulations, 1996 (MF Regulations) were amended on 27 June 2023 to *inter-alia* specify that the funds under ESG schemes should be invested in the manner as specified by SEBI periodically.

Accordingly, on 20 July 2023, SEBI issued a circular to implement measures to facilitate green financing with a thrust on enhanced disclosures and mitigation of green washing risk.

Through the circular, SEBI has introduced a separate sub-category for ESG investments under the thematic category of equity schemes.

Next steps

The market is still at a nascent stage, and commercial banks and investors both institutional and retail will have to play a vital role in the accomplishment of sustainable finance products in India, as the Indian economy grapples with achieving the long-term net-zero objectives.

Pre-requisites for strengthen the progress made so far on sustainable finance policy setting process are as follows:

1. Strong comparability of ESG ratings and investing approaches
2. Good quality data to be used for investment decisions
3. Improvement in ESG disclosures by companies with use of science-based targets and disclosures of annual progress in quantitative and comparable format
4. Greater international cooperation to ensure ESG and climate transition related practices strengthen investor confidence and market integrity.

3. As available under the 'Policy related letters/Emails issued by SEBI' in the Master Circular on Mutual Funds No. SEBI/HO/IMD/IMD-PoD-1/P/CIR/2023/74 dated May 19, 2023. The letters sent to AMFI were dated 8 February 2022 and 21 June 2022