KPMG

ESG value realisation

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Abbreviations

AIMA	All India Management Association
AMR	Anti-microbial Resistance
AUM	Asset Under Management
CAIA	Chartered Alternative Investment Analyst
CBI	Climate Bond Initiative
CEA	Central Electricity Authority
CO_2e	Carbon Dioxide Equivalent
CSR	Corporate Social Responsibility
DCF	Discounted Cash Flow
DJSI	Dow Jones Sustainability Index
ESG	Environmental Social and Governance
ETF	Exchange Traded Funds
F&B	Food and Beverages
FDI	Foreign Direct Investment
FMCG	Fast Moving Consumer Goods
GDP	Gross Domestic Product
GIIN	Global Impact Investing Network
GSIA	Global Sustainable Investment Alliance
INR	Indian Rupee
LAC	Latin America and the Carribean
LGBTQ	Lesbian, Gay, Bisexual, Transgender and Queer

MSCI	Morgan Stanley Capital International
NDC	National Determined Contributions
NSE	National Stock Exchange
PE	Private Equity
PRI	Principles of Responsible Investments
Q	Quarter
R&D	Research and Development
RI	Responsible Investment
ROE	Return on Equity
ROIC	Return on Invested Capital
S&P	Standard and Poor's
SDGs	Sustainable Development Goals
SDS	Swiss Agency for Development and Cooperation
SEBI	Securities and Exchange Board of India
SFF	Sustainable Development Goals Finance Facility
SSE	Social Stock Exchange
UN	United Nations
UNDP	United National Development Program
USD	United Stated Dollar
WEF	World Economic Forum

Foreword

From pension funds adopting ESG as a risk mitigation measure to insurance companies viewing it as a predictive tool, the perception of portfolio risk has come a long way. A business' performance, which was traditionally linked to pure play financial and economic metrics, is now also taking full cognizance of the potential environmental, social and economic value erosion it can lead to. The demographic of investors is also changing globally, with millennials demonstrating greater consciousness of the environmental and social impacts of their investments.

Every business leader is now aware of the risks and opportunities that ESG brings with it. Not only has this given rise to ESG integration in mainstream financial instruments, but also in various equity-linked and fixed-income instruments which are paving the way for a new world order.

Long-termism is finally taking root. Long-term value creation has become business as usual. The departure of investors from sectors with amplified environmental and social negative impacts is now commonplace. The challenge now lies in quantifying "long-term," given the fact that a host of ESG risks have already started materialising.

'Value realisation' is the next step towards making sense of this. The complex process to realise the 'true' value of ESG practices begins with adopting the right approach towards them. Once implemented, it needs the right set of metrics to measure the impact that it creates. In the larger context, collaboration at various levels with different stakeholders will also pave the way to develop a common language. for communicating impact and value creation.

The era of 'Stakeholder Capitalism' has just begun. Getting on the bandwagon early will only lead to favorable outcomes.

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Executive Summary

The global economy is constantly evolving to keep pace with changes in the capital markets. ESG has gained traction in the past decade, calling for a transformation of business strategies across corporations. Financial institutions stand at the forefront of this transformation, owing to their ability to drive positive impact through investment decisions.

Investors need to account for several ESG considerations, depending on an organisation's business objectives. The impact created by a company affects its earnings and risk profile and consequently, shareholder value. In order to understand the actual impact created by investments, it is imperative to adopt valuation methods that incorporate economic, environmental and social risks and the subsequent cost of internalisation of these risks.

One such valuation method is to quantify externalities in financial terms and link them to the earnings of the organisation. An organisation's true value creation can be assessed when both financial and non-financial impacts are considered. This can only be effective when ESG integration is streamlined across geographies, industries and stakeholder groups. Standardising ESG taxonomy across different asset classes, improved ESG disclosures for enhanced transparency, and active collaboration with stakeholder groups are crucial towards this end.

ESG integration, if leveraged as a value creation tool, will help us drive the sustainable development agenda over the next decade.

01 Defining the dichotomy

The COVID-19 pandemic has brought about unprecedented changes to business and life at large. As companies, leaders, and investors navigate these volatile and uncertain times, an opportunity has emerged to examine how companies with ESG practices have fared.

Global markets are transforming and capital markets are re-strategising their approach to adapt to the disruptive changes in the economy. Fossil fuel-based sectors are finding it hard to acquire new capital and obtain regulatory permissions.

These developments present risks as well as opportunities for businesses. This dual nature of the perception of ESG has increased the popularity of financial instruments that enable the channelisation of funds into responsible and sustainable activities and sectors. Access to new capital will increasingly be linked to a more holistic set of decision points.

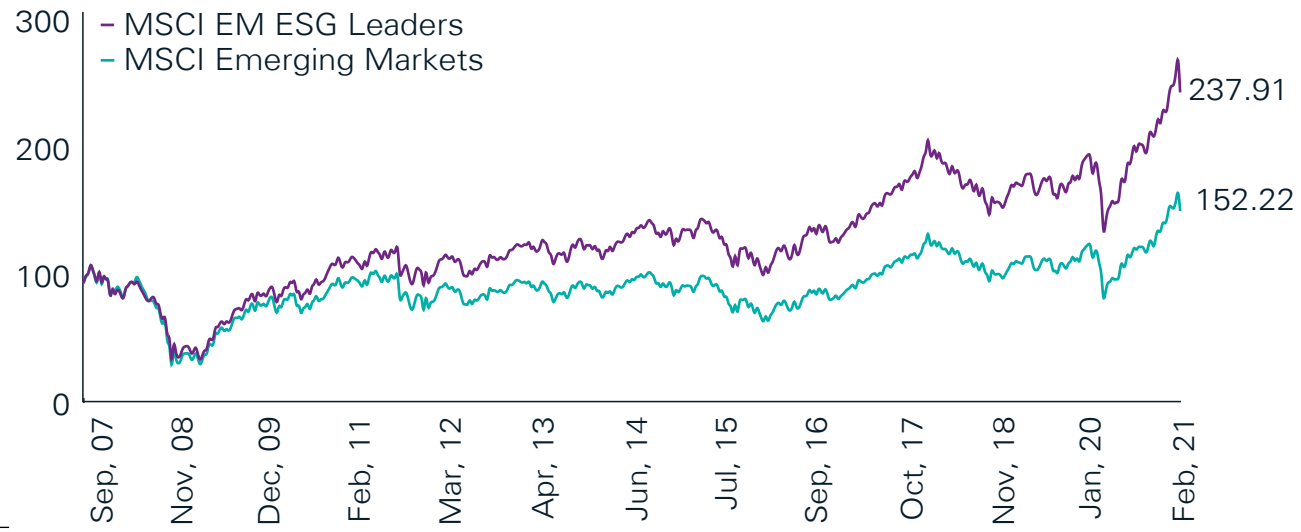
While integrating ESG into the investment approach can lead to enhanced returns, not adopting the right ESG strategy can lead to limiting the portfolio's growth. Choosing the right ESG approach is a complex process in which financial institutions have to look at several considerations before taking investment decisions.

1.1 Introduction

The current pandemic has brought to light the inadequacies and fallacies amongst global institutions to deal with a crisis of such scale and magnitude. It is interesting to see that countries that were considered to be the most prepared to deal with a pandemic are now among the worst hit by COVID-19. With a few exceptions, the pandemic has affected almost every sector of the economy and brought about one of the worst global economic slowdowns in recent times.

A recent study by the Harvard Business School found that an investment of USD1 after 20 years yields USD28 in return for those companies that focus on ESG as against USD14 for those that do not.

Figure 1: MSCI Emerging Markets ESG Index Performance – Cumulative index performance of gross returns (Sep 2007 – February 2021 in USD)[1]



1. MSCI Emerging markets ESG Index Performance, MSCI, February 2021.

If anyone was undecided about ESG being a sound business approach, there's enough empirical data available now demonstrating that ESG portfolios yield better returns over the long term. A closer look at the performance of MSCI emerging markets ESG leaders reveals that they suffered a lesser decline in value during the pandemic and recorded a faster recovery compared to the laggards.[1]

To summarise, boards of companies must acknowledge that ESG is a business imperative rather than a buzzword that can be swept under the carpet for the time being.

1.2. The evolution of ESG

In recent times, the concept of 'Who Cares Wins, in which the ESG terminology was coined and published in 2004 has gained prominence.[2] The world has seen great strides being made in the direction of Responsible Investment (RI) since then. In 2006, when the UN-backed Principles for Responsible Investment (PRI) were launched, 63 investment companies (asset owners, asset managers and service providers) with USD 6.5 trillion in Assets Under Management (AUM) signed a commitment to incorporate ESG issues into their investment decisions. By 2020, the number of signatories had grown to 3,038 and represented USD 103.4 trillion in AUM. A recent report indicates that the pandemic has become a catalyst for ESG investing, and the AUM under ESG may represent close to 44 percent of the global AUM (USD 45 trillion approximately) by the end of 2025.[3]

Taking ESG considerations into account has a direct impact on the overall stability of financial systems. This is because material ESG issues are linked to a company's risk profile which, in turn, act as a driver for sustainable financial performance. The COVID-19 pandemic has created a pathway for industries to become more agile. It is evident that responsible and ethical businesses proved to be more resilient in these times and were less impacted by the pandemic.

The Global Sustainable Investment Alliance (GSIA) monitors growth in sustainable finance in terms of AUM across five regions: Australia, New Zealand, Canada, Europe, Japan and the United States. Each of these regions has a strong focus on investing responsibly, and accounts for a substantial portfolio of assets that are professionally managed. Between 2016 and 2018, Europe, the United States and Japan showed a consistent increase in the total volume of responsibly managed assets.

Table 1: Growth of sustainable investing assets by region in local currency, 2014-18[4]

Region	2014	2016	2018	Growth per period		Compound Annual Growth Rate (CAGR) 2014-2018
				2014-2016	2016-18	
Europe (in EUR)	9,885	11,045	12,306	12%	11%	6%
United States (in USD)	6,572	8,723	11,995	33%	38%	16%
Canada (in CAD)	1,011	1,505	2,132	49%	42%	21%
Australia/New Zealand (in AUD)	203	707	1,033	248%	46%	50%
Japan (in JPY)	840	57,056	2,31,952	6,692%	307%	308%

Global leaders are redefining investment strategies amidst the COVID-19 crisis. The "S" component of ESG has gained prominence and significant investments are expected to be made in this realm. In a recent survey conducted by KPMG, 63 per cent of global leaders claimed that the Social component will be silver-lined over Environment.[5]

2. Who Cares Wins, IFC, June 2004
3. About the PRI, UNPRI, Accessed on March 1, 2021
4. 2018 Global Sustainable Investment Review, GSIA, 2018
5. KPMG 2020 CEO Outlook: COVID-19 Special Edition, KPMG International, September 2020

1.3. One size doesn't fit all – the importance of customising ESG integration for companies

There is an underlying area of concern with respect to the discussion on ESG integration. One prevalent line of thought pertains to standardising the approach towards ESG integration in order to generate comparable quantitative data across financial and non-financial institutions. Therefore, developing guidelines and frameworks to standardise the ESG integration process can be beneficial. This idea bears merit; however, the guidelines and frameworks created should be adaptive and flexible. This will allow different types of companies and financial institutions to implement them in a manner that is relevant to their business and sector.

For an organisation, the journey of ESG integration can be moulded to:

Meet shareholder expectations: An ESG approach works best with tailored solutions that are designed to meet unique investor expectations.

Address sectoral risks: This is especially true for firms focussed on impact investing or sustainability-themed investing.

Manage material issues within the ESG investment: Effective management of appropriate risks can help an organisation enhance business continuity and capitalise on opportunities.

Drive behavioural changes in the industry: Becoming an industry thought leader on matters related to ESG integration comes with advantages like enhancing brand value, improving productivity and cost savings, lowering operational and strategic risks, and reducing regulatory intervention.

The widespread adoption of ESG best practices cannot be achieved in isolation. An ESG strategy needs to be tailored as per the needs of the company. Active participation is required from multiple stakeholders to engender greater effort in achieving the following:

1. Interlinking materiality assessment and ESG integration in investment/lending activities
2. Developing sector-specific guidelines, frameworks and standards
3. Driving the importance of disclosing 'comparable data'
4. Consolidating industry-level data for a geographical location
5. Driving regulation around annual ESG disclosures
6. Designing relevant methodologies for ESG impact assessment
7. Aligning ESG integration with National Determined Contributions (NDCs) and Sustainable Development Goals (SDGs)
8. Valuing/quantifying the positive impacts, outputs and outcomes resulting from responsible investing

1.3.1. Relevance of ESG for financial institutions

The widespread impact of the novel coronavirus is revealing significant vulnerabilities in the value chain. These vulnerabilities have impacted all stakeholders. The current pandemic has led institutional investors around the world to take a closer look at how ESG risks may impact companies within their portfolios. This is because financial institutions have capacity to forward integrate ESG aspects and exercise control on their customers and investing companies. The pandemic has also accelerated the issuance of bonds focussed on COVID-19 relief, amounting to a total value of USD 55 billion by mid-April 2020, which is more than the value of all social bonds issued in 2019. The proceeds of these bonds were used towards healthcare services development, bridging

funding gap of SMEs affected by lockdowns, vaccine development support to pharmaceutical companies, among others. To facilitate the launch of these bonds, stock exchanges like the London, Luxembourg and Nasdaq Nordic stock exchanges have waived fees for bonds aimed at mitigating the impacts of COVID-19.[6]

As global ESG challenges become more evident and relevant with each passing year, investors, asset managers and financial institutions have become more receptive to responsible investments. This is a drastic shift from the earlier view that analysing investment through an ESG lens will have a disruptive or negative impact on the rate of return.

1.3.2. Relevance of ESG for corporates

Environmental, Social and Governance aspects are interwoven in every business. A strong ESG proposition will enable organisations to create value and address stakeholder capitalism issues. Some of the links that can ensure the relevance of ESG incorporation to create value are:

1.4 ESG approaches and principles

Since the concept of ESG investing has garnered popularity, organisations have explored different approaches and principles for making investments. These include:[7]

01 Restriction screening

- Avoiding investments in certain sectors issues based on values or risk-based criteria:
  - Negative screening
  - Positive screening
  - Norms-based screening

02 ESG integration

- Considering ESG criteria alongside financial analysis to identify risks and opportunities throughout the investment process, which may lead to decisions to avoid, include or size certain investments.

03 Thematic investments

- Tilting Investments towards certain themes and sectors positioned to solve global sustainability-related challenges
  - Sustainability-themed investments
  - Sustainable finance

04 Impact investing

- Allocating funds to enterprises that are structured to deliver a specific measurable set of positive social and/or environmental impact, alongside market-rate financial returns

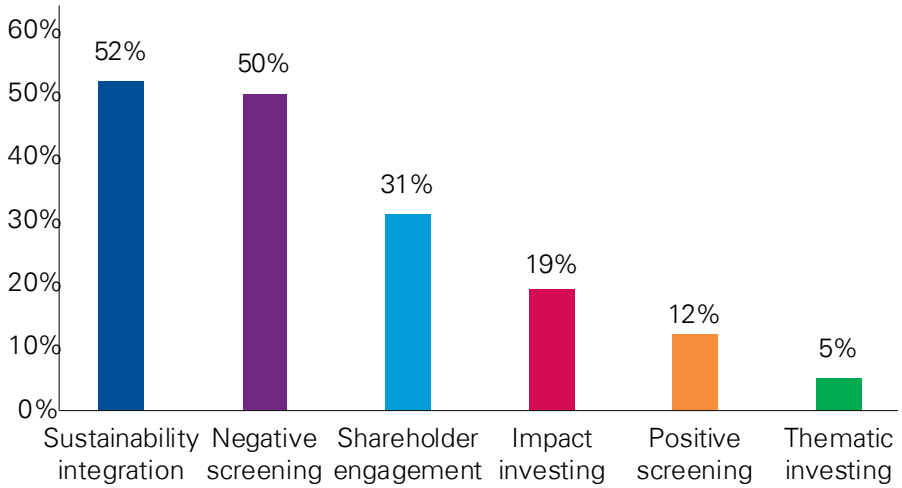
Embracing ESG in companies will boost the bottom line by making operations more sustainable. It helps improve processes and management controls that are primarily non-financial in nature, but have an implication on financial respects.

6. World Investment Report, UNCTAD, June 2020
7. ESG and Sustainable Investing Report 2019, Morgan Stanley

Initially, the global trajectory of ESG strategy tilted primarily towards negative screening and ESG integration. Negative screening is often the starting point for investors eager to integrate ESG considerations into their portfolios. While some negative screening strategies are more complex — such as exclusion of companies with links to animal cruelty, for example — it often comes down to an exclusion of tobacco and weapons manufacturers and perhaps alcohol producers. As this space matures, it seems likely that the negative screening approach might be included in most investment mandates by default.

As per a survey conducted by KPMG International, CREATE-Research, AIMA and CAIA, sustainability integration and negative screening were found to be the top picks of hedge fund managers.[8] Now, the impact investing industry is witnessing an increase in momentum, with over 1,720 organisations across the world currently overseeing USD 715 billion in impact investing assets at the end of 2019.[9]

Figure 4: Sustainable investing assets by strategy



Source: *KPMG-CAIA-AIMA-Create survey 2020*

8. Sustainable investing: fast-forwarding its evolution, KPMG International, CREATE-Research, AIMA and CAIA, February 2020
9. Annual Impact Investor Survey, GIIN, 2020

02

The surety of change – Emergence of a new world order

Investors no longer just look at corporate strategy and risk management reducing exposure to risk-prone sectors to, but also to enable industries with high potential of environmental and social value creation. More and more businesses are focussing on ESG factors to drive their investment decisions. A spurt in ESG-driven funds has seen it evolve from being a value-add to a business imperative.

It is almost certain that the years to come will see the emergence of ESG as an important criterion for making investment decisions. This is expected to change the way businesses manage their impacts and formulate their strategies. This will be further reinforced with the opportunities that ESG brings for a business. While ESG integration has the potential to reduce compliance costs for an organisation, it can also generate better risk-adjusted returns at the fund and portfolio levels.

2.1. ESG in mainstream finance

Globally, the implementation of ESG integration practices is gradually making its way from just being a good practice to being incorporated into mainstream financial analysis. ESG parameters are now being used in investment decision-making processes to manage risk appetite and generate sustainable and strong long-term returns.

For equity investors, ESG has become an integral part of portfolio construction. For financial service institutions, ESG is being integrated in their credit appraisal systems. Meanwhile, ESG has become an important tool for driving value creation through engagement with portfolio companies for private equity firms. Even stock exchanges have started launching ESG indices that apply a 'tilt' based on relative ESG performance of companies, positively impacting the stock prices of ESG leaders and negatively impacting laggards in each sector.

This calls for evolving standardised methodologies for linking ESG issues with conventional financial analyses. Standardised methodologies that attribute financial proxies to ESG parameters in order for them to be monetised are important focus areas for continued research.

2.1.1. Types of investment and their linkage to ESG

The key financial instruments with ESG integration include:

Stocks

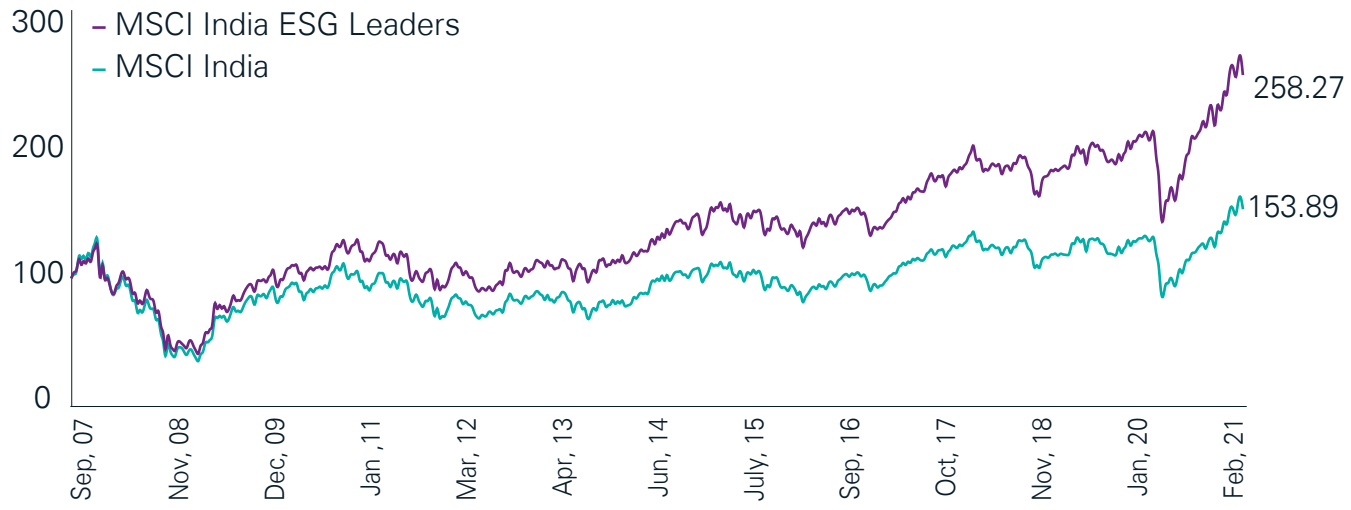
ESG stocks are stock options that have been chosen by investors based on the sustainability performance of the company that they are looking to invest in. Based on historical evidence and the company's sustainability disclosures, investors can decide whether it integrates material ESG issues into its overall business strategy. There are several global and regional indices that track leading companies in the sustainability domain. The inflow of ESG funds is increasing in India, with about USD 507 million in just the first quarter of 2020.[1]

The COVID-19 pandemic is catalysing ESG investing in India. Following the launch of the country's first ESG fund in 2018, seven more have entered the field.

The Nifty100 ESG Sector Leaders Index has outperformed the Nifty 100 Index since inception, with a 12% CAGR return against 10.8% CAGR return for the Nifty 100. In the last three years, the Nifty 100 ESG Sector Leaders Index has returned 8.5% CAGR, compared to 5.2% CAGR for the Nifty 100 Index.[2]

The Nifty100 ESG Sector Leaders Index has been less volatile than the Nifty 100 Index over various time horizons. Since the begining, the Nifty100 ESG Sector Leaders Index has had a annualised volatility of 16.9% vs. 17.3% with its parent index. It has also stayed marginally less volatile between September 30, 2019 and September 30, 2020, with annualised volatility of 29.2% against 30.4% for the NIFTY 100.[2]

Figure 4: MSCI India ESG Leaders Index performance – Cumulative index performance of gross returns (September 2007 – February 2021 in USD)[3]



It is evident from the graph above that MSCI India ESG leaders have consistently performed better than their counterparts over the past decade.

1. Sustainable funds in India attract $500 million during Covid-19 selloff, The Economic Times, May 2020, Accessed on 14 March, 2021
2. Nifty100 ESG Sector Leaders Index, NSE India, October 2020
3. MSCI India ESG Leaders Index (USD), MSCI, February 2021

Fixed-income bonds: Issuing bonds is another way of raising money. Investors from a group of Swedish pension funds first began questioning the availability of funds to finance projects specifically to tackle climate change in 2007. However, discussions on this topic were still very much in the early stages due to the lack of clarity surrounding the interlinkage between finance and climate change. The Swedish investors reached out to the World Bank, which then released the world's first 'green bond' within a year.[4]

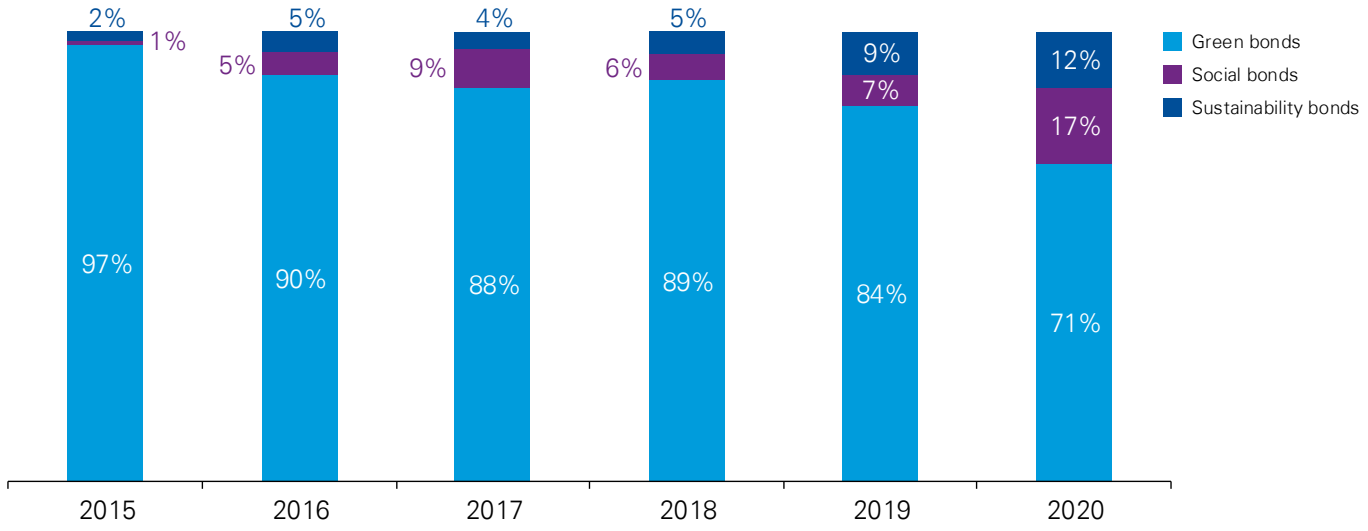
Since then, green bonds have become a new and creative way of mobilising funds for climate projects. Over a decade of green bond issuance, various stakeholders such as government bodies, industry agencies, development experts, economists and academia have come together to collaborate on global financial solutions to tackle climate change.

Within the last decade, various permutations and combinations of green bonds with specific financial objectives in place have flooded the market. Climate bonds, corporate green bonds, municipality green bonds, green covered bonds and sovereign green bonds are the options available to investors. Adding to these, the United Nations Development Programme (UNDP) UNDP introduced Sustainable Development Goal (SDG) Impact Standards for SDG bonds in July 2020. Investors can use these standards to support their assessment of the SDG-enabling attributes of various SDG bonds.[5]

The Global issuance of green bonds in Q3 of 2020 has hit the record of USD 69.4 billion as compared to USD 59.3 billion in 2019.[6] In total, outstanding issues of green bonds in emerging markets since 2012 stood at USD168 billion by the end of 2019. China accounted for USD 142.9 billion of total outstanding issuance, with India adding a further USD 10.9 billion and Brazil USD 5.4 billion.[7]

Social bonds, which finance projects with primarily social objectives, have emerged as a key tool to finance defined social causes. COVID-19 has fueled the social bond market to support healthcare, employment and housing. In 2020, the social bonds outperformed the market, out of the USD 400 billion in sustainable debt issuance in 2019. According to the Climate Bonds Initiative (CBI), social bonds made up approximately USD 20 billion, which is 5 percent of the market. However, USD 32 billion worth of social and sustainability bonds were issued in April 2020.[8]

Social bond 2020 issuance surpassed total issuance in 2019[9]



There has been a proliferation of bonds issued in response to the COVID-19 pandemic. It is pertinent to note that they all demonstrate how the fixed income market is being used as a tool to solve or combat problems, whether climate change or COVID-19.

4. 10 Years of Green Bonds: Creating the Blueprint for Sustainability Across Capital Markets, The World Bank, March 2019
5. UNDP launches standards for bond issuers and private equity funds seeking SDG impact, UNDP
6. Green Bond Market Summary, Q3 2020, Climate Bond Initiative, November 2020.
7. Emerging Market Green Bonds Report 2019, IFC and Amundi, 2020
8. A Pandemic-Driven Surge In Social Bond Issuance Shows The Sustainable Debt Market Is Evolving, S&P Global, June 2020

Mutual funds: Based on investors' risk appetite, ESG parameters can be integrated into a smaller or larger proportion of the mutual fund. A key challenge faced by the industry is that it has been difficult to interlink the rate of return with ESG integration, due to the mix of instruments incorporated in a mutual fund. S&P Global, however, suggests that returns from ESG-focussed exchange-traded funds and mutual funds have also increased, overtaking broader funds' median returns.[10] In India, mutual fund houses are taking an active interest in ESG integration. Various new ESG mutual funds entered the public domain in 2020.[11]

Exchange-Traded Funds (ETFs): Financial

Financial institutions are gearing up for the transfer of wealth to millennials, who are environmentally and socially more conscious and make responsible decisions. This important driver is the reason behind the inevitability of ESG ETFs gaining prominence over the next 10-20 years. Various ETF options available to investors are trying to increase exposure to companies with a superior ESG performance, tracked by organisations like MSCI or the S&P 500 index.

The incorporation of ESG-related concerns into investment decisions and AUMs in ESG mutual funds and ETFs grew from USD 453 billion in 2014 to USD 760 billion in 2018.[12] In India, the concept of ESG ETFs is yet to take hold, but the opportunity to do so will only increase with time.

The linkage between the rate of return on ETF and ESG integration does not have empirical validation due to the lack of historical performance data. However, ESG-related ETFs have proven their resilience during these unprecedent times. ETFs continue to trade efficiently, playing a leading role in price discovery for investors and banks, as they give transparency to the values at which investors are prepared to exchange risk.

Depending on investors' objectives, different types of funds will perform differently. The objectives of these funds range from exclusion of fossil fuel-intensive companies to promotion of diversity, LGBTQ inclusion and women's empowerment. The funds may also give a higher weightage to a specific sector, due to which the calculated rate of return will be higher.

Equity investments

Financial institutions, invest in companies that represent an opportunity for a high rate of return. The approach to ESG integration within the investment cycle will differ, depending on the nature of the investor and investment. Further, depending on the controlling interest that the investor firm has in a company, the extent of ESG integration will also vary. Where the investor has a majority controlling interest, the robustness of the ESG integration process and the engagement with portfolio companies will differ.

A case in point is that of ESG-driven Private Equity (PE) companies that use ESG strategies to evaluate potential investments by assessing the material risks and opportunities. PE firms can identify relevant ESG best practices that can be integrated with the company's management decisions to drive value creation. When it is time to exit, these best practices would be streamlined within the firm and linked to the company's business strategy, while contributing to a higher internal rate of return for the PE firm.

10. ESG Investment Returns Starting to Outperform Other Mutual Funds, ETFs, S&P Global, July 2018
11. Which are the ESG funds in India?, Samalad, Ravi, December 2020
12. BlackRock recommends a common language for sustainable investing, Finextra, January 2020

4. ESG-linked loans

ESG has been linked to debt, either in the form of 'sustainability-linked' or 'green' loans. Sustainability-linked loans are financial instruments and/or contingent facilities like guarantees or credit that encourage borrowers to fulfil proposed sustainability goals and targets. Green loans use the proceeds to finance or refinance green projects. Approximately 50 percent of green loans are directed towards energy projects, as is the case with green bond allocation. A third of the loans are allocated to buildings, followed by transport, water, waste and land-use projects.

Schneider Electric has launched its first sustainability-linked bond,[13] along with a Sustainability-Linked Financing Framework. Meanwhile, Novartis has linked its sustainability-linked bond to its 2025 Patient Access Target, in a first in the healthcare industry.[14]

Figure 6: The growth of Asia-Pacific's green loan market[15]

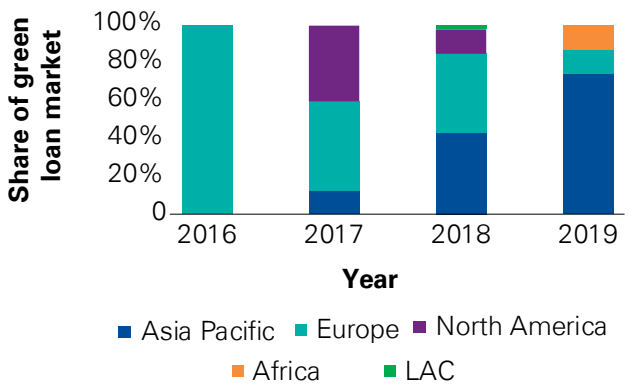
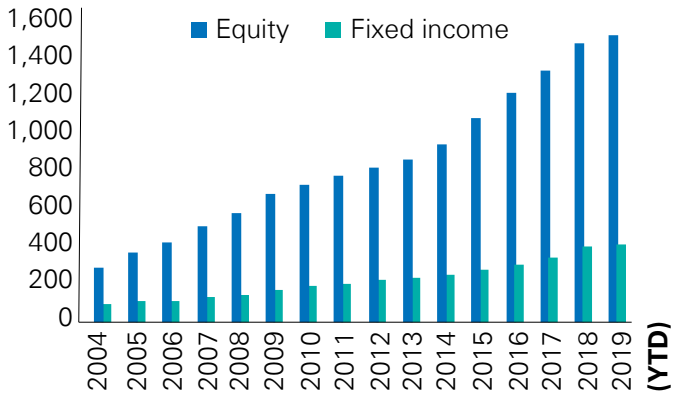


Figure 7: Number of ESG funds by asset class



2.2 Addressing global challenges through ESG

Innovation is key to moving ESG integration into the mainstream. It can act as a catalyst for organisations to bring new topics of discussion to the table. The transition from short-term gains to long-term benefits will require financial institutions and other companies to focus on innovation. This will drive the development of a customised ESG integration process that will be beneficial for the organisation, while simultaneously winning investor trust.

Innovation is also the key to unlocking solutions to global challenges. Of the 17 Sustainable Development SDGs, SDG 9 - Industry, Innovation and Infrastructure is an important goal for countries and organisations across the world. In the SDG Report 2020, this is one of the key focus areas directed towards small-scale industries, the backbone of any economy. One of the biggest challenges these industries face is the access to capital that helps run day-to-day business activities. The proportion of global Gross Domestic Product (GDP) invested in research and development (R&D) increased from 1.62 per cent in 2010 to 1.72 per cent in 2017. In absolute terms, global R&D investment reached USD 2.2 trillion (purchasing power parity) in 2017, up from USD 1.4 trillion in 2010.[16] However, this rate of growth will not be sufficient to meet the 2030 targets. Adequate financing is imperative for these industries to innovate, grow, improve efficiency and take their products to newer geographies and markets. The focus on innovation will allow these industries to not only return the borrowed capital and prevent default on the credit, but also increase the rate of return on the investment made in a sustainable manner.

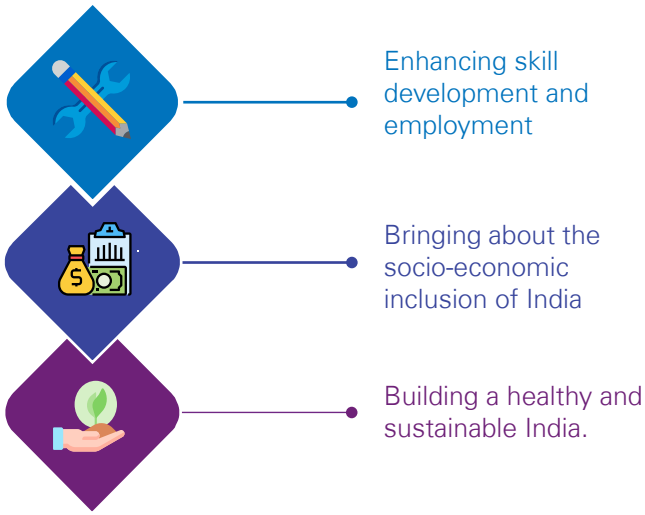
The importance given to ESG integration by bilateral, multilateral and large-scale global funds has become extremely evident. Credit lines are offered conditionally to local financial institutions based on the provisions in place to identify, manage and mitigate regional ESG issues material to the company.

As a global economic player, India is, and will continue to be, an important investment hub and must, therefore, gear up to conform to ESG related requirements.

13. IMF Global Financial Stability Report, IMF, October 2019
14. Novartis reinforces commitment to patient access, pricing a EUR 1.85 billion sustainability-linked bond, Novartis Media Release, September 2020
15. CBI Green Bond Market Summary Q3 2019, CBI, October, 2019
16. The Sustainable Development Goals Report 2020, United Nations, 2020

2.2.1. Challenges from an Indian perspective

As per a recent report by World Economic Forum (WEF), India needs to overcome three key challenges by 2030.[17]



During the India Economic Summit held in October 2019, discussions revolved around the fact that the country has emerged as a 'powerhouse in the world economy'. This is due to its impressive base of human capital, focus on continuous growth and dedicated investments made in digitisation and innovation.

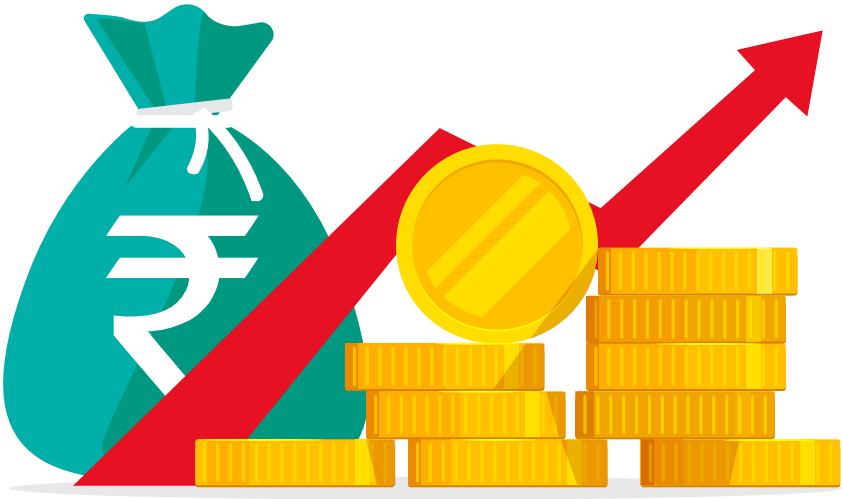
India has the ambitious goal of becoming a 10 trillion-dollar economy by 2030.[18] However, the question arises that, amidst its reduced economic growth rate, is it still on track to achieve this target? The currently elusive solution lies in leveraging its positive attributes in order to improve the negative ones and use diversity to bring about socioeconomic equality instead of increasing disparity at all levels. The SDGs adopted by the country, supported by the NDCs, are working towards addressing these concerns.

2.3. Linking ESG integration to long-term economic growth

The key aspect associated with fulfilling India's national goals and targets is the availability of dynamic, continuous and dedicated funds. The public and private sectors must come together to form partnerships to organise the vast volume of funds required. Different types of financial instruments have flooded the Indian market in an attempt to enhance the efficient movement of capital within the economy.

The Sustainable Development Goals Finance Facility SFF was launched on March 14, 2019 by the UNDP in collaboration with the Swiss Agency for Development and Cooperation (SDS), KPMG in India and Social Finance India, a not-for-profit organisation backed by Tata Trust. The SFF will act as an incubating platform towards developing innovative financial instruments aligned with the SDGs, assisting in the realisation of required social and development outcomes in India.[19]

In another landmark development, India's market regulator, SEBI, has set up a technical committee on the social stock exchange. This committee is intended to develop a framework for onboarding for-profit and non-profit organisations on such bourses and prescribe disclosure requirements relating to financials and governance. Additionally, requirements related to performance, social impact and social audits will also be deliberated by this committee. The Social Stock Exchange (SSE) will boost social impact investing in India by creating a new platform to fund social-sector organisations. This will enable direct listing through a new class of securities, and establish a standardised framework for measuring and reporting social impact for both donors and investors.



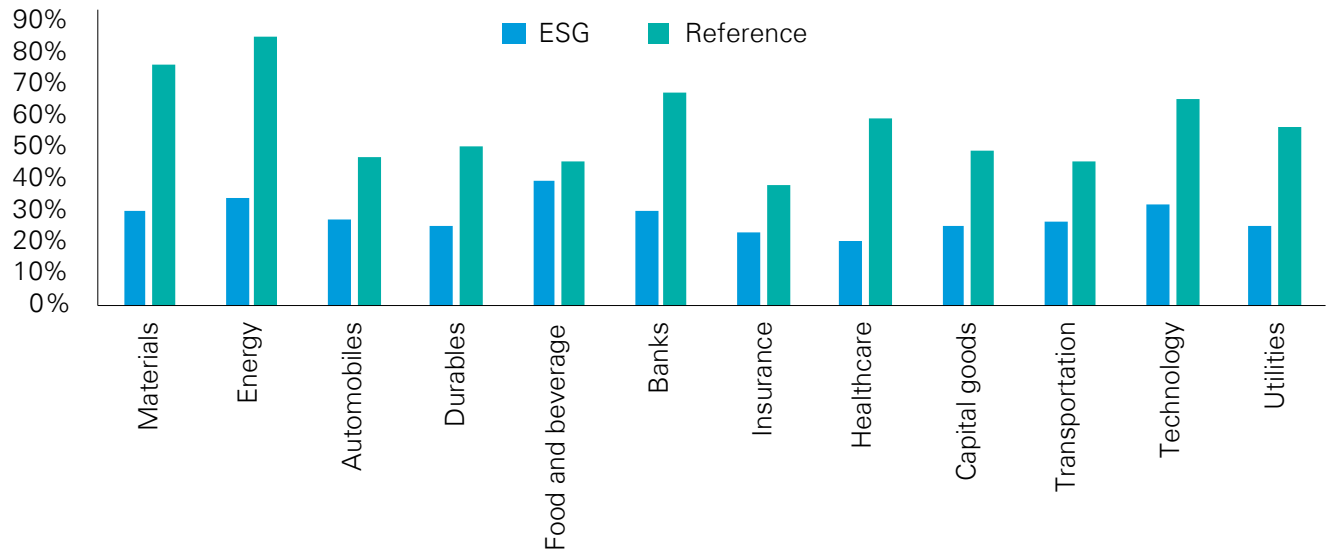
17. Future of Consumption in Fast-Growth Consumer Markets: INDIA, WEF, January 2019
18. Aim is to take economy to $10 trillion by 2030: Rajnath Singh, Economic Times, September 2019
19. Press Release: UNDP partners with SDC, KPMG and Social Finance India to launch the SDG Finance Facility, UNDP India, March 2019 Press Release: UNDP partners with SDC, KPMG and Social Finance India to launch the SDG Finance Facility, UNDP India, March 2019

2.3.1. Leveraging ESG for enhancing risk-adjusted returns

Studies showcase that when it comes to integrating ESG risks within the investment analysis, the rate of return is higher. This is due to the fact that ESG integration fosters lower market risk, resulting in lower volatility in overall stock performance.

One such study assessed 157 companies listed on the Dow Jones Sustainability Index (DJSI) and 809 that were not listed under DJSI, over a span of 2 years. The results showed that in all 12 industries studied, the group of ESG-listed companies showed an average of 28.67 per cent lesser stock return volatility in comparison to the reference companies. (Figure 10)

Figure 10: Annualised volatility comparison between ESG and reference companies[20]



These findings have been corroborated by many other financial institutions and rating agencies around the world. They provide evidence to illustrate that there are known 'alpha' factors that contribute positively to a portfolio's performance, including value, momentum, earnings quality, earnings growth and financial strength.

Early data indicates that RI funds are indeed losing less than their counterparts, which further strengthens the case for incorporating ESG issues into investment decisions. In the Canadian market, data provided by FunData shows that a staggering 83 per cent of RI funds outperformed their average asset class return in Q1, and 80 per cent of RI funds outperformed over the one-year period ending March 31, 2020.[21]

Similarly, in the U.S. market, a Morningstar analysis of 206 RI funds found that 70 per cent of RI equity funds outperformed their peers in Q1 of 2021.[22]

The evidence suggests that ESG factors are delivering alpha in both active and passive strategies. In the pandemic context, this data supports the argument that incorporating ESG issues into investment decisions can strengthen risk management and lead to financial outperformance.

Although the progress has been encouraging, more work is required on the interlinkage between ESG and risk. The 'delta' i.e. deviation between the conventional rate of return and the risk-adjusted return is dependent on several variables such as the industry, the material ESG topics considered, and the size of the company, which will impact the ability to internalise risks and other external factors impacting market volatility.

20. ESG factors and risk-adjusted performance: a new quantitative model, Kumar et al, Journal of Sustainable Finance and Investment, September 2016
21. RI Funds Quarterly Performance Report – Q1 2020, RIA Canada, April 2020
22. Sustainable Funds Weather the First Quarter Better Than Conventional Funds, Hale, John, April 2020

2.3.2. How to quantify risk-adjusted-returns

Studies continue to validate that ESG risk-adjusted returns outperform the rate of return on regular investments. The important question for companies and investors going forward is on the 'how' of calculating the delta.

One perspective revolves around the cost of internalising ESG risks and other externalities that can be incorporated into the calculation of P&L figures. The internalisation of the cost will impact the final value of free cash flow and net profit factors that will be relevant to potential investors using the Discounted Cash Flow (DCF) model to evaluate the profitability of the investment. Companies will have to find a way to evaluate the positive or negative ESG tilt from the industry average hurdle rate and what it signifies, especially from a future forecasting perspective. The DCF approach is a form of intrinsic valuation and is the most detailed and thorough approach to valuation modeling. Apart from being the most relied-upon methodology to arrive at accurate valuations, the DCF method can also be flexible enough to include sensitivity analysis and forecasting modeling to assess results based on different ESG thresholds and cut-off scores, allowing investors to evaluate results better.

UNPRI's ' A Practical Guide to ESG Integration for Equity Investing' talks about the DCF method and ESG integration in the following parameters:

Financial forecasting

1. Income statement adjustment - revenue
2. Income statement adjustment - operating costs and operating margin
3. Balance sheet adjustment - book value and impairment charge
4. Cash flow adjustment - capital expenditure

Company valuation models

1. Terminal value
2. Beta and discount rate adjustment
3. Scenario analysis

With the integration of ESG in multiple financial instruments, it is making a mark as a 'must-have' practice. Studies continue to demonstrate the direct correlation between ESG integration and returns. Further developments in valuation models will lead to a better understanding of the value linked to ESG and its long-term economic impacts.

03

Widening horizons – Understanding value better

The understanding of impact has evolved over time and is still evolving. People tend to focus on direct and tangible impacts a lot more than those that are indirect and intangible. However, the latter can be more significant than the former. Outcome-based reporting and impact-oriented performance measurement are gaining momentum, calling for a new approach to impact measurement.

The ability of financial institutions to enable and catalyse impacts is very far-reaching. By channeling funds towards the right sectors and activities, they can push growth in sectors that will have the right impact. To come to that decision, they first need to understand the full range of impacts that their investments create.

3.1. Linking risks, opportunities and impact

The correlation between risk and impact can sometimes be elusive, especially when it comes to risks that are indirect, induced or intangible, and/or having a long-term impact. A successful and responsible business understands the importance and advantages of managing not only the obvious risks to a company, but also the 'hidden' or innocuous risks that have the potential to severely impact business continuity, if overlooked.

Integrating ESG considerations into a business' strategy can help it mitigate the risk of incurring additional costs in the form of taxes or fines. It also comes with the added advantage of unlocking new opportunities, ranging from a wider product range to enhanced productivity. These, in turn, can help the business make a lasting, tangible impact on all its stakeholders, right from its clients to communities.

3.1.1. Evaluating the impact of ESG integration

"As the impacts of climate change, population growth, water scarcity and other mega-forces become more evident, businesses are under severe pressure to create value for all stakeholders. It is no longer a mere expectation from customers, employees, local communities and campaigners, but a mandate introduced by governments and regulators. Towards this, there are several new initiatives like carbon pricing, green product standards, clean energy tax breaks, non-financial reporting rules and mandatory investment in social programmes, to name a few. At the same time, the nature of markets is transforming. There is a vast potential for value creation in new industries and spheres – ranging from clean energy to smart city technology – that create value for society by addressing social and environmental problems."

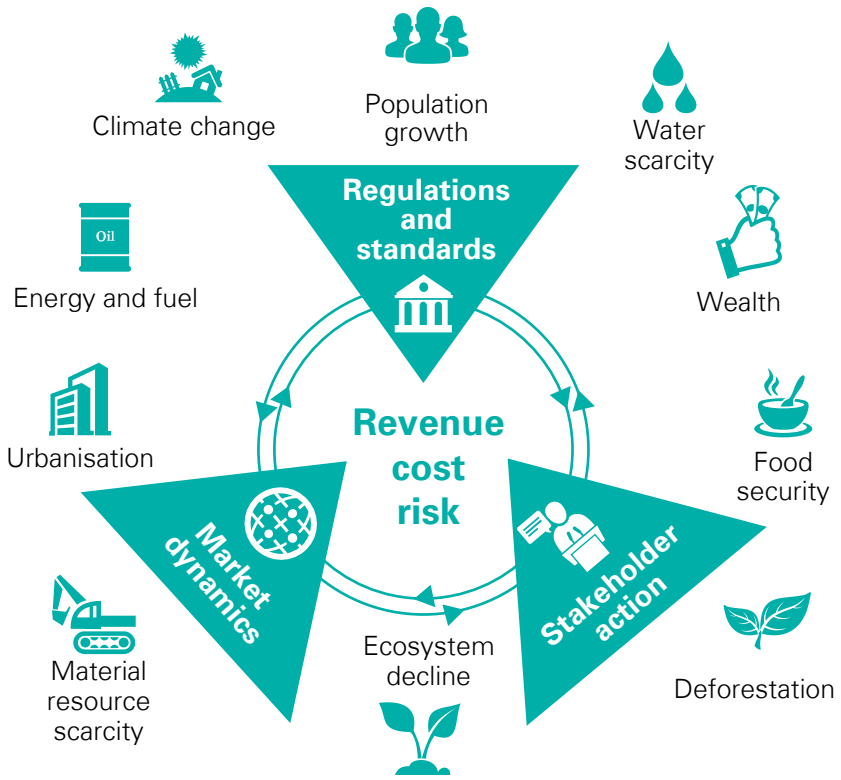
Prathmesh Raichura

Executive Director, Climate Change and Sustainability Services, KPMG in India

The value a company creates and reduces for society directly affect its earnings and risk profile. In short, societal value is now inextricably linked with shareholder value. The interlinkage and interdependencies need to be understood in tangible terms by organisations, and KPMG's True Value Methodology can help with just that.

The tool was developed to understand how the value a business creates and/or reduces for society is likely to affect the value it generates for shareholders. This knowledge provides a new lens for decision-making, helping improve performance, inform strategy and increase influence. KPMG True Value is a three-step process that can be applied across sectors and geographies. It is scalable and can be applied to an entire company, division or specific project. Similarly, it can be modified to evaluate specific ESG-related initiatives and best practices implemented.

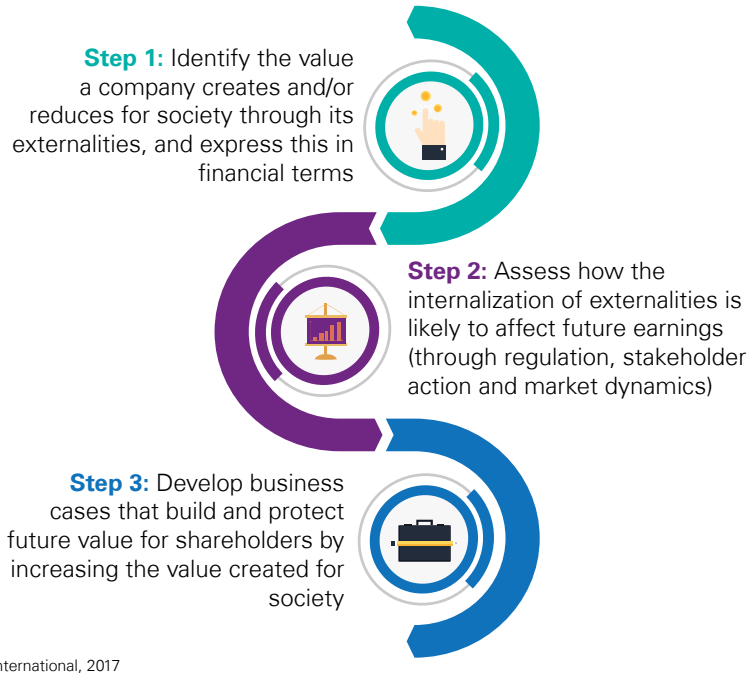
Figure 11: The three drivers of internalisation[1]



KPMG True Value uses a framework that classifies externalities as economic, social or environmental, and as either positive (bringing benefits to society) or negative (imposing costs on society). To express externalities in financial terms, we use a range of financial modeling tools, techniques and data sources.

A positive externality is an economic, social or environmental benefit that a company creates for society, for which it is not directly or fully rewarded in the price of its goods and services. Meanwhile, a negative externality is the economic, social or environmental cost that a company inflicts on society for which it does not directly pay a price.

Figure 12: KPMG in India's 3 steps for creating value

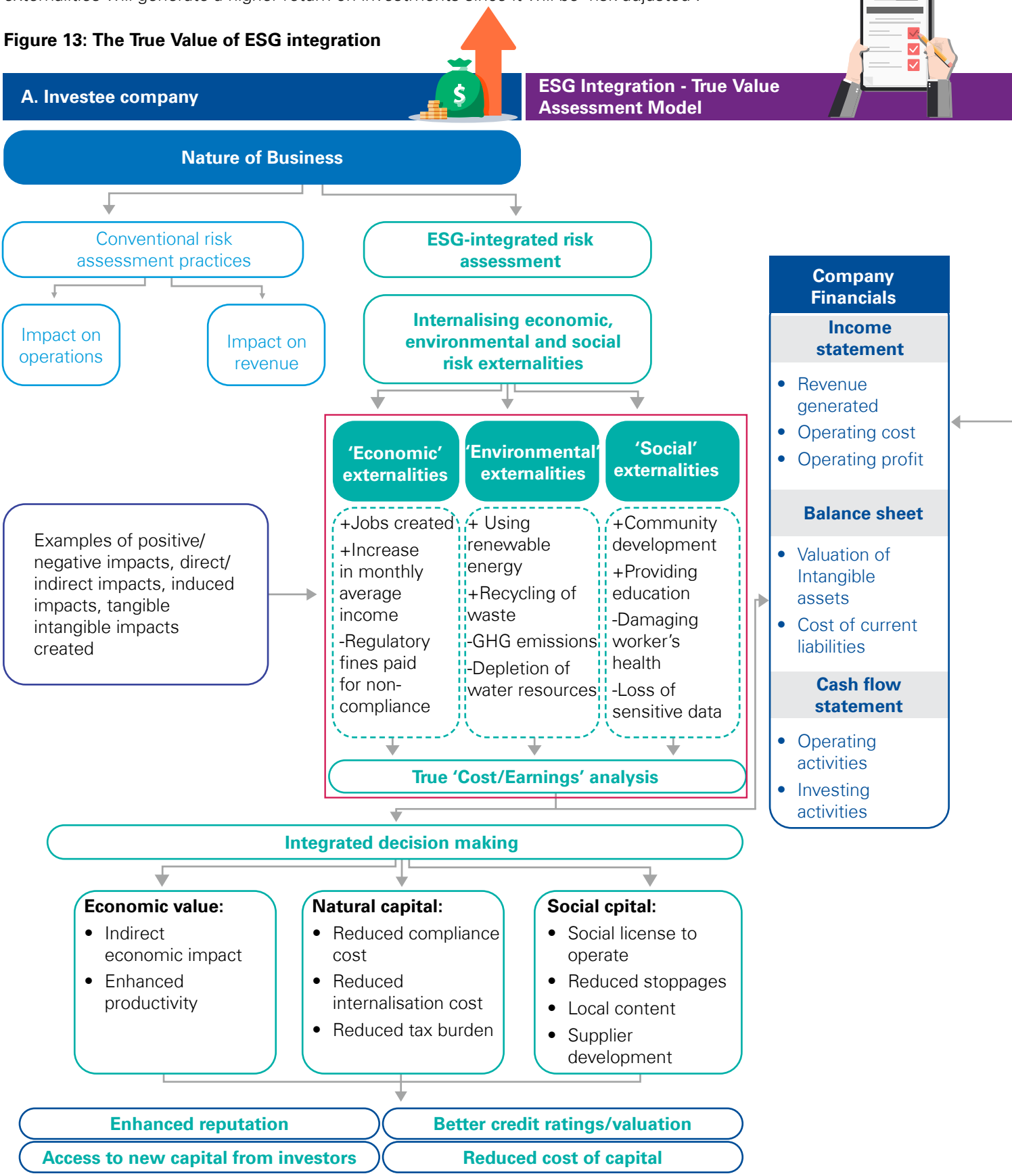


1. A New Vision of Value, Connecting corporate and societal value creation, KPMG International, 2017

3.1.2. True Value and ESG integration

In this section, KPMG assumes that a company or investor that implements ESG best practices creates positive externalities that can be measured, and that the lack of ESG practices can create measurable negative externalities. From the investor's perspective, a company that focuses on creating positive externalities and mitigating negative externalities will generate a higher return on investments since it will be 'risk-adjusted'.

Figure 13: The True Value of ESG integration



B. Investor

Conventional investment

Evaluating the financial impact of potential/current investment using standard assessment parameters i.e. without looking into ESG risks and opportunities

Investment evaluation

- Analysis of Return on Equity (ROE)
- Analysis of Return on Invested Capital (ROIC)

ESG Integrated investment

Integrating ESG parameters while assessing investment risk profile and volatility

Integrating ESG parameters while assessing investment differentiators

Integrating ESG parameters while assessing investment future performance i.e forecasting

Identification of hidden economic related cost

Identification of hidden environment related costs

Identification of hidden social related costs

Total cost of ESG-related risks and opportunities

Integration of total ESG cost to overall investment performance

- Analysis of 'risk-adjusted' ROE
- Analysis of 'risk-adjusted ROIC'

New investments

Investment decision to factor ESG risks

Continued engagement with investee for enhanced risk-adjusted return

Current portfolio

Continued engagement with investee for enhanced risk-adjusted returns

Deciding exit strategy or change exposure to investee

The model illustrated above is central to this publication. It showcases two different aspects of ESG integration, one from the perspective of an investee company and the other from the perspective of an investor, as well as how both aspects can be strategically linked.

From an investee perspective:

This approach can help measure and manage the impact of an organisation that has emerged as an outcome of its ESG strategy. Material economic, environmental and social risks and opportunities (externalities) can be identified and internalised using common financial metrics which, in turn, can be consolidated to evaluate the 'True Cost/Earnings' of an organisation. The benefits of identifying and understanding the 'True Cost/ Earning' can be four-fold:

1. The cost of internalization can give an understanding of the financial risks associated with externalities.
2. Better communication of value creation by an organisation or project.
3. Monitor continual improvement around value creation
4. It can be used to direct boardroom conversations and management decisions.

Implementing a strategy to enhance value creation will inspire a company to innovate. Innovation and increased value creation can, in turn, help the organisation access new forms of capital. In many sectors and markets today, an organisation's positive impact on society can make the difference between winning or losing a contract. Therefore, measuring and managing those impacts is simply good business sense.

From an investor perspective:

Different types of investors can customise the approach taken towards ESG integration. The common idea running through these financial institutions is to move away from conventional methods of evaluating the performance and impact of an investment. Instead of calculating the Return on Equity (ROE) and Return on Invested Capital (ROIC), investors have begun incorporating more sophisticated methodologies to derive a risk-adjusted ROE and risk-adjusted ROIC

Investors that integrate ESG parameters into their investment decision-making process can do so in several ways. However, using ESG to measure important aspects such as risk volatility, investment differentiation and future performance is key. This methodology can be used to discover hidden costs associated with various types of ESG risks and opportunities relevant to the investment in question. This ESG risk profiling and integration can be implemented in the pre-investment decision-making process to assess viability. It can also be implemented after an investment has already been made, and the investor wants to understand the extended positive or negative impacts created during the investment cycle.

Recent assessments and testimonials suggest that investors now prefer investing in and providing capital to companies that have a sound internal ESG strategyand implementation program in place. Quantified positive impacts bring a level of comfort to investors by assuring them that their investment will provide a strong rate of return on either equity or capital.

Investment companies that raise capital from other institutional investors can highlight the quantified positive impacts and leverage them:

- To extend their credit line
- To increase the volume of funds mobilised
- To bring down their cost of capital

04

The missing link- Framework for value realisation

The next step involves identifying the impacts created and leveraging them to bring value back to institutions. The tested value of an ESG-integrated investment is more lucrative to an investor compared to an investment that does not take ESG risks and opportunities into account.

However, since most of this value is intangible in nature, valuation techniques need to expand their horizons to consider economic, environmental and social externalities and their risk for internalisation.

Does the company focus on implementing ESG best practice: Yes

4.1. Monetizing external impacts

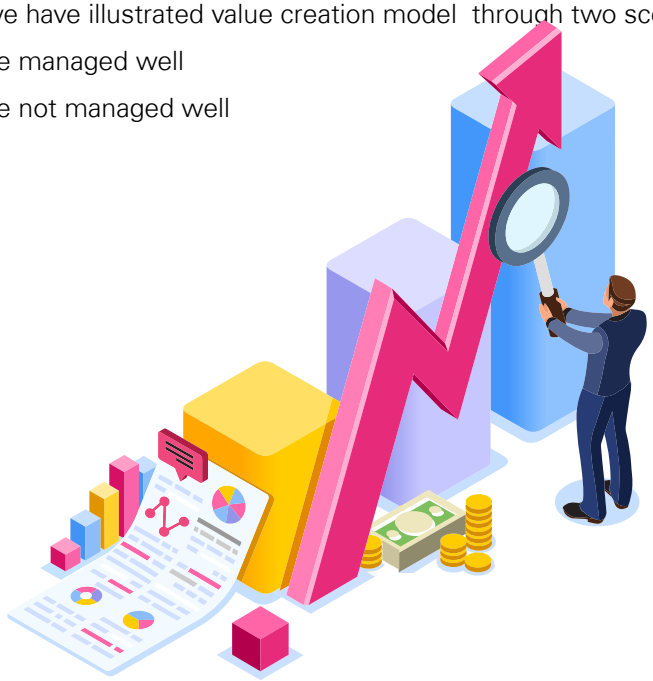
For value realisation, it is important to choose the appropriate impact indicators. This will provide stakeholders a clear understanding of the nature and extent of the positive or negative impacts created.

KPMG's True Value methodology assigns monetary values to the impacts created. Monetisation provides a common metric through which a company can understand and compare the magnitude of various externalities.

However, there are challenges in seeking to quantify externalities in financial terms, as it is not an exact science. Additionally, monetisation cannot fully express ethical aspects of externalities, such as human rights or health and safety. However, while we acknowledge the limitations of this approach, we believe that it is the method that currently offers the most potential to bring considerations of societal value into corporate decision-making.

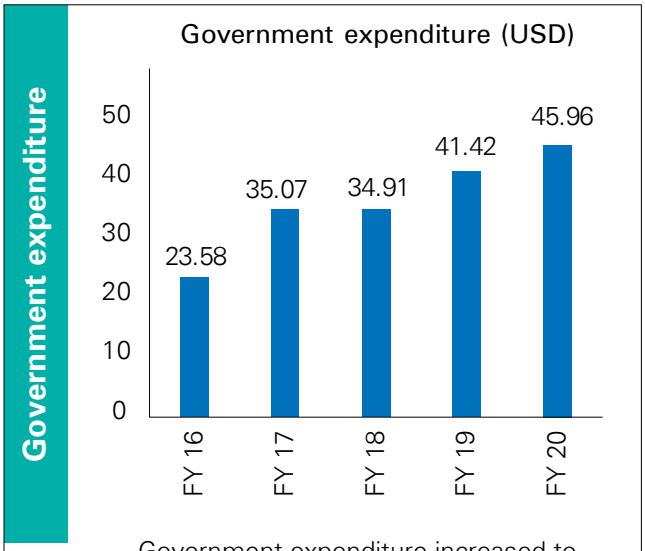
In the subsequent case studies, we have illustrated value creation model through two scenarios:

1. **Scenario 1:** When ESG risks are managed well
2. **Scenario 2:** When ESG risks are not managed well

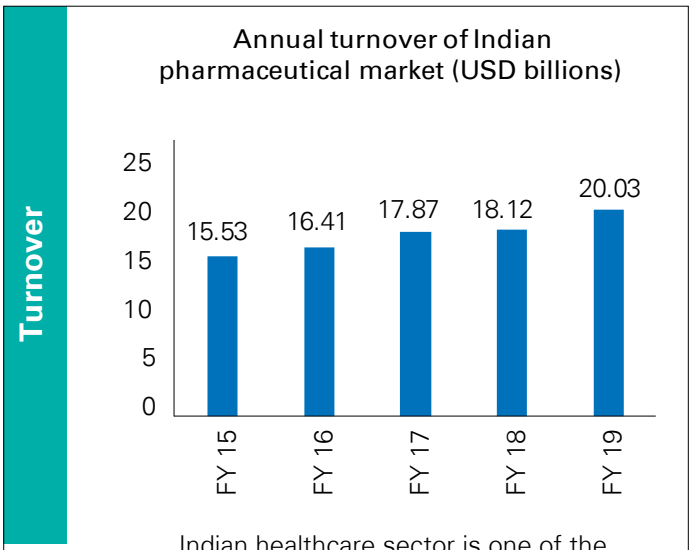


Case Study 1 **Sector- Pharmaceuticals** **Relevance to the Indian Economy**

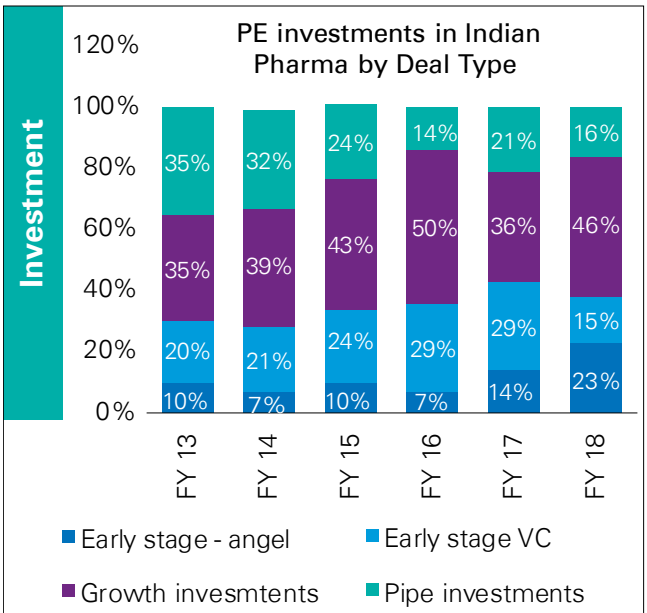
India plays an important role in the global pharmaceuticals sector. It has a large pool of scientists and engineers with a potential to steer the industry ahead to greater heights. Majority of the antiretroviral drugs used globally are supplied by Indian pharmaceutical firms.[4]



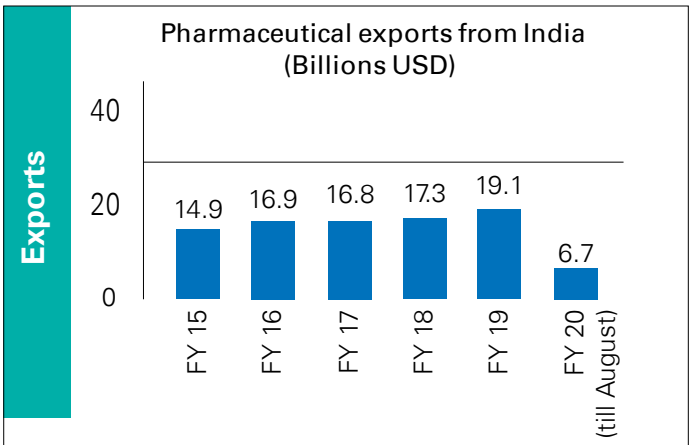
Government expenditure increased to USD 45.96 billion in FY20, CAGR of 18 per cent from FY16



Indian healthcare sector is one of the fastest-growing sectors and is expected to crossUS 372 billion by 2022.



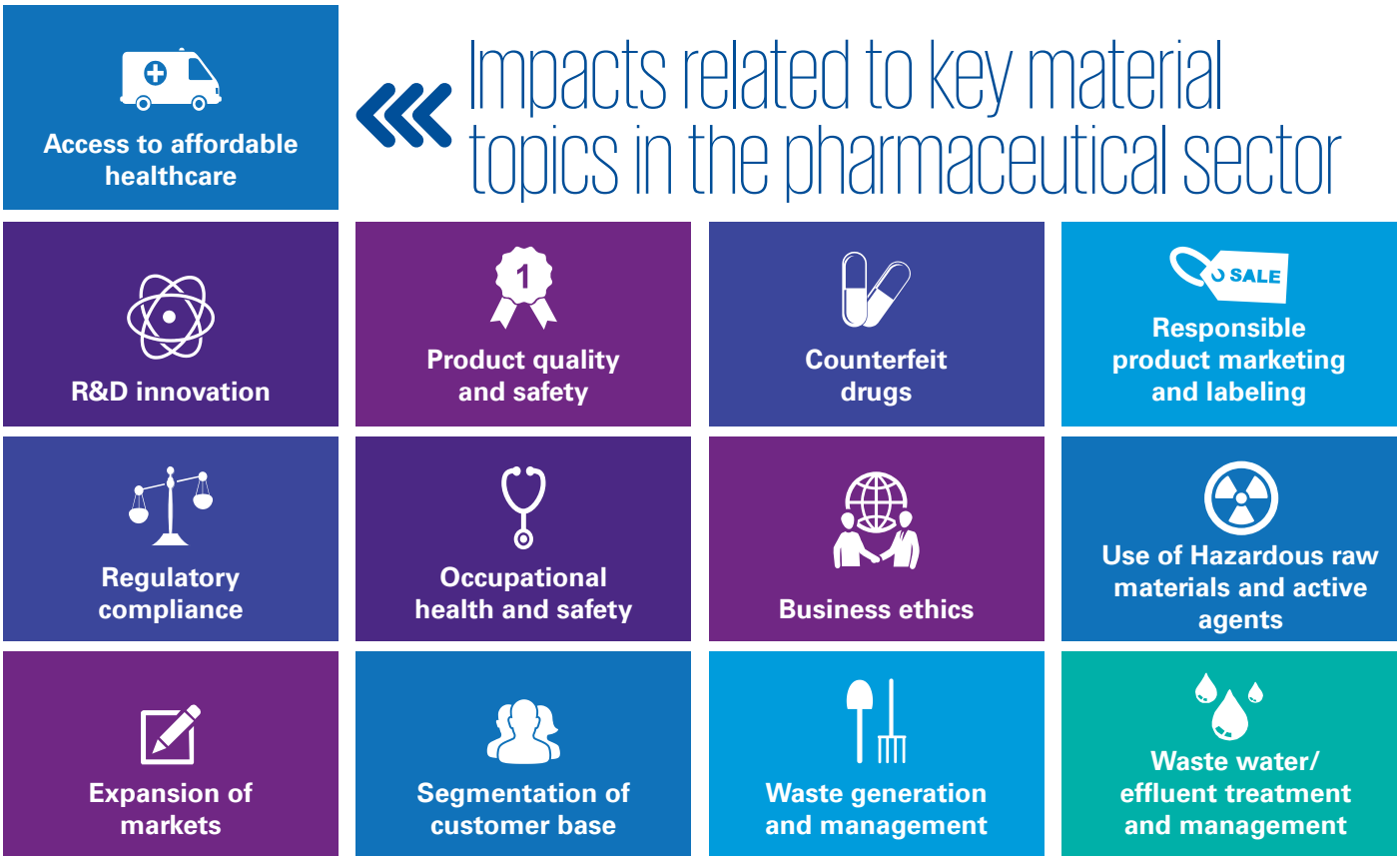
Indian pharmaceuticals sector has received cumulative FDI worth US 16.54 billion between April 2000 and June 2020.



- India accounts for 20 per cent of global exports in generics
- Indian pharmaceutical industry supplies over 50 per cent of global demand for various vaccines, 40per cent of generic demand in the US and 25per cent of all medicines in the UK.
- India's pharmaceutical export stood at US 16.28 billion in FY20.

1. Indian Pharmaceutical Industry, IBEF, November 2020

Figure 14: Key ESG material topics identified for company X:



Does the company focus on implementing ESG best practice: Yes

Figure 15: Key area of intervention required by company X: Investment towards effluent treatment reducing effluent discharge

Activity		Assumptions
Key negative impact identified by Company X: Increased susceptibility to anti-microbial resistant diseases (AMR) of community members		1. The pharmaceutical plant manufactures antibiotics 2. Un-treated effluent is discharged into natural water bodies surrounding the plant 3. Community members consume water from surrounding natural water bodies near the pharmaceutical manufacturing plant 4. The water source for each community member is the same.
Estimated number of rural community members impacted across 3 states - Maharashtra, Gujarat and Andhra Pradesh (in numbers)	~ 4,000	The largest number of India's bulk drug and formulation facilities is in Maharashtra, Gujarat and Andhra Pradesh.[2]
Estimated minimum cost of AMR treatment per community member across Maharashtra, Gujarat and Andhra Pradesh (in INR)	~2,50,000	It has been estimated that the average cost of AMR treatment for a rural community member in India is approximately 442 days' worth of minimum wages earned.[3]
Estimation of total, additional cost of treatment to be incurred by company X across Maharashtra, Gujarat and Andhra Pradesh (in INR)	~ 115 million	

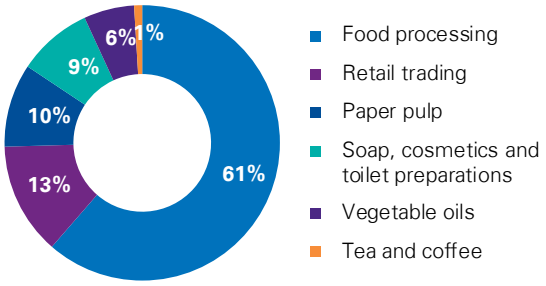
2. Map of India's bulk drug and formulation facilities, Taylor, Nick. August 2019
3. High cost burden and health consequences of antibiotic resistance: The price to pay, Chandy S et al, The Journal of Infection in Developing Countries, September 2014

Case Study 2: Illustration of an FMCG company[4]

Case Study 2	Sector- FMCG	Relevance to the Indian Economy

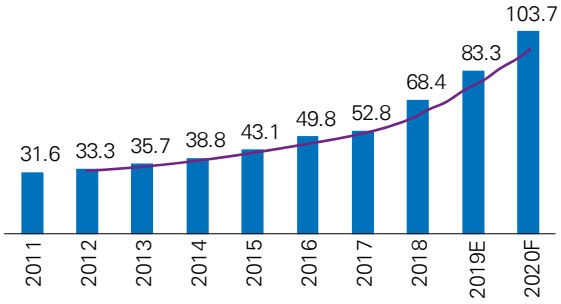
- Fast-Moving Consumer Goods (FMCG) is the fourth largest sector in the Indian economy. This sector comprises of three segments, viz. household and personal (50 per cent), healthcare (31 per cent) and food and beverage (19 per cent).

Cumulative FDI inflows from April 2000 to June 2020 (USD millions)



- The sector witnessed healthy FDI inflows of USD 16.5 billion between April 2000 and June 2020. Within FMCG, food processing was the largest recipient, with a share of 61.40 per cent.

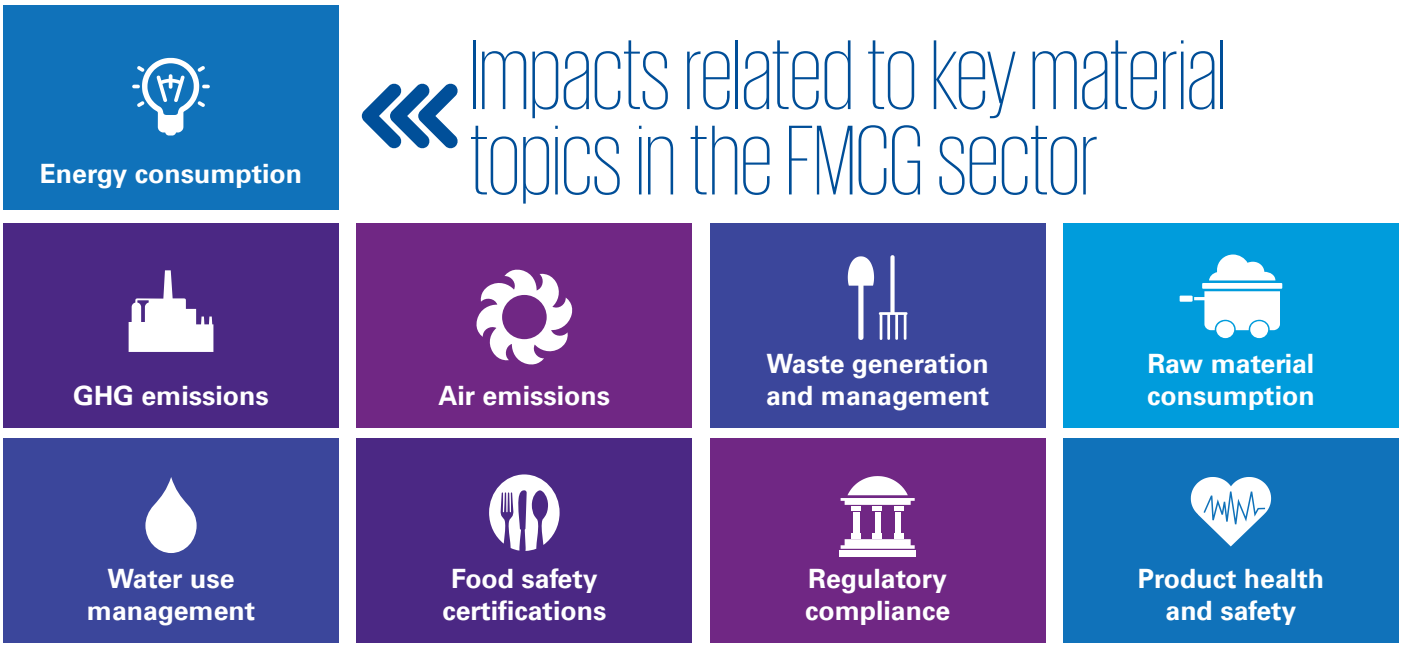
Trends in FMCG revenues over the years (USD billions)



E - Estimate, F - Forecast

- Since 2011, the FMCG sector has grown significantly reaching 3.4 lakh crore (US 52.8 billion) in FY 2018. It is expected to grow even further.

Figure 16: Key ESG material topics identified for company Y:



Does the company focus on implementing ESG best practice: Yes

4. Fast Mover Consumer Goods (FMGC), IBEF, November 2020

Figure 17: Key area of Intervention by Company Y: investment towards reducing dependency on coal generated power

Activity		Assumptions
Key positive impact identified by company Y: Reduction in scope 2 GHG emissions		54 per cent of thermal power derived from burning coal, which led to scope 2 emissions. Emissions are a material topic for most companies reporting on sustainability in India.
Total scope 2 energy consumption: Annual electricity purchased (in kWh)	~ 15 million	This value has been calculated as a three-year industry average of four leading FMCG companies in India. It represents purchased power generated only from coal. Calculated based on assumptions made by CEA.[5]
Average annual reduction in purchased power generated from coal (in per cent)	11	An average calculated over a period of three years across the four FMCG companies in India.
Reduction in electricity consumption (in kWh)	~ 16.6 million	
GHG emissions avoided (in tons CO_2e)[6]	~ 13,600	
Estimated volume of coal saved from reduced purchased power (in tons)	~ 5400	
A. Indirect impact - Estimated cost savings from tons of coal saved (in INR)	~ 14.8 million	Average cost of coal considered[6]
B. Induced impact-Reduction in 'social cost' from GHG emissions avoided (in INR)	~ 46 million	
Total cost saved by Company Y after reducing purchased electricity generated from coal power (A)+ (B) (INR)	~ 61 million	

4.2. Linking monetised impact to 'True Earnings'

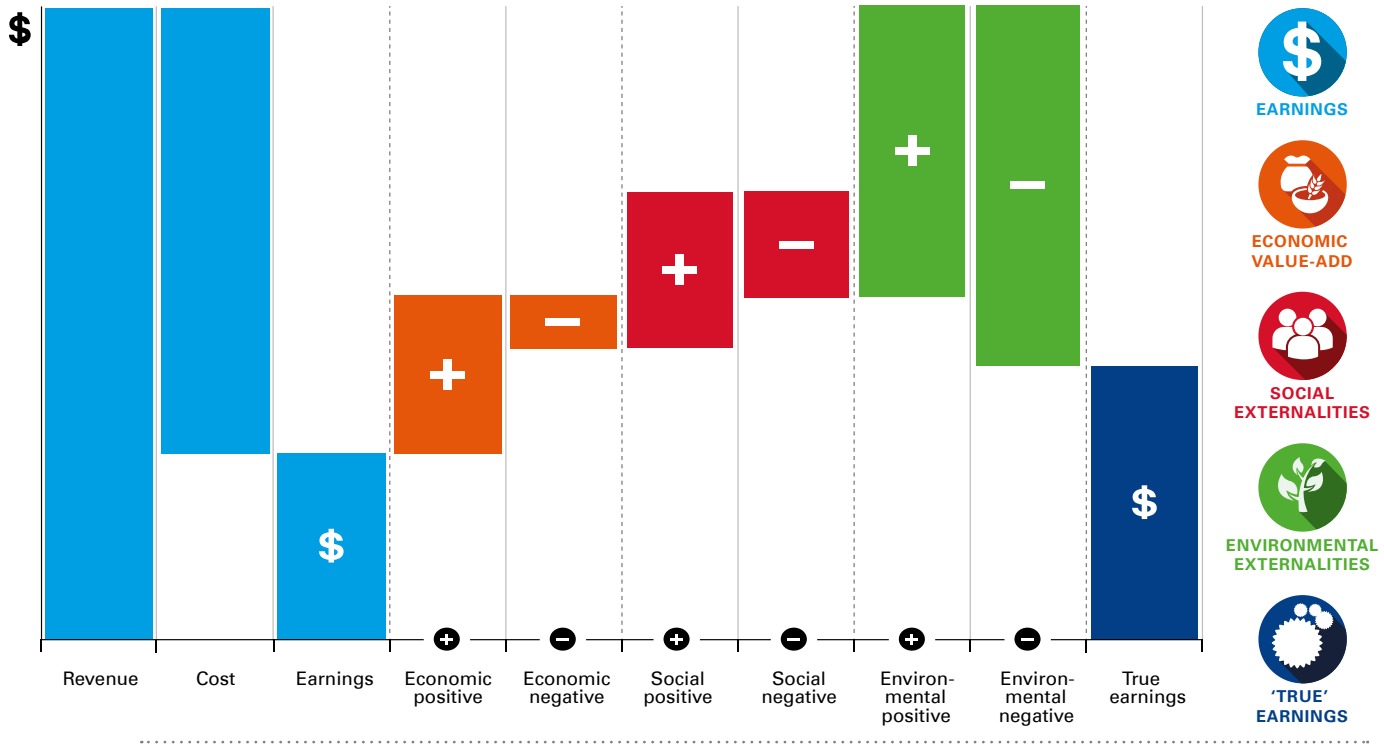
The key advantage of the True Value methodology is the flexibility in its application. The impact assessment, quantification and monetisation can be conducted for one particular product or service, a set of products and services, any selected project or to the entire operations of a company. Similarly, it can be applied only to the company's direct operations or be expanded to cover the value chain.

The financial earnings reflected in conventional reporting are key drivers of corporate value creation. However, this reporting does not provide a view of the impacts the company generates in the course of doing business. The combination of financial and non-financial impacts provides a more holistic view of the business' value creation, which includes the value generated by implementing ESG best practices.

The true earnings bridge helps stakeholders visualise the company's most significant positive and negative impacts and understand where the its actions may be creating or reducing societal value.

5. CO_2 Baseline Database for the Indian Power Sector, Central Electricity Authority, December 2018
6. Coal India e-auction fetches 44% higher prices, The Economic Times, June 2019

Figure 18- A generalized 'true earnings' bridge



The true earnings illustrate what a company's balance sheet would look like if all of its significant positive and negative externalities were fully internalised. However, the actual likelihood and extent of internalisation for each externality will be influenced by how the drivers of internalisation play out for the business.

4.3. Understanding the future earnings at risk

After the true earnings bridge is created, a risk analysis can be conducted on the impacts identified in terms of likelihood of the positive or negative impacts being enhanced in the future. This risk analysis should be performed with a medium to long-term view because, in general, the risk drivers may intensify over time.

4.4. Identifying potential investment

From the True Value perspective, there are two broad approaches that can be taken to identify potential investment:

01 Invest in reducing negative externalities

Similar to the negative screening approach, this step also includes reducing the risk of costs resulting from regulatory changes, stakeholder action and climate change, among others. This can include adapting the supply chain to reduce ESG risks, changing operations or shifting the focus of key markets and changing customer behaviors. A pharmaceutical company seeking to reduce its negative externalities can invest in areas like operational changes for reduction of GHG emissions, R&D for enhanced pharmacovigilance, mechanisms for enhanced safety, and so on.

02 Invest in enhancing positive externalities

Similar to the positive screening approach, this includes investing in impacts that yield returns in the form of regulatory tools, such as tax incentives, stakeholder action such as labour stability, and market dynamics such as competitive advantage and brand enhancement. Investments for a pharmaceutical industry would entail proceeds used for greater access to medicines, development of new products, employee wellbeing and so on.

These two investment approaches are not mutually exclusive and can be implemented simultaneously if required.[7]

7. A New Vision of Value, KPMG International, 2017

05

What the future holds – Maximising positive impact

The ability to maximise positive impact is an outcome. To generate such an outcome, several aspects of ESG integration must be streamlined across geographies, industries and most importantly, stakeholder groups. The process of ESG integration is a complex one, but also vital not just for fighting but also winning against global ESG risks. The importance of sustainable finance took centre stage at the 2020 World Economic Forum (WEF) held in Davos. Key areas of interventions that hold global relevance and importance have been prioritised amongst diverse stakeholder groups. How ESG integration is leveraged and used as a value creation tool over the next decade will determine the positive outcomes acrossthe most critical area of impact, i.e. achieving the global Sustainability Development Goals by 2030.

5.1. Finding a 'common language'

Larry Fink, the founder and CEO of BlackRock, addressed corporate leaders in the FY 2020-21 annual report, stressing the importance of taking definitive steps to navigating the imminent 'fundamental reshaping of finance'. Amidst the overwhelming list of ESG risks impacting global markets, climate change leads the way in modifying market behavior. He also suggests that the process of adaptation will unfold in a more organic manner if financial institutions and corporates were to speak a 'common language' on matters related to sustainable finance.

This was also a crucial point of discussion among stakeholders at the WEF Summit 2020. Developing a common language entails defining ESG taxonomy across different asset classes, which will allow asset owners and managers the flexibility to adopt the taxonomy most relevant to them. Greater clarity on specific requirements and expected ESG disclosures from investors will help promote this process of standardisation.

For instance, organisations should be able to clearly integrate and interlink the following: material ESG risks managed, observed impacts, outputs and outcomes of different products and services, and KPIs for ESG disclosure. Doing so will help provide quality data to investors that is relevant and comparable. Developing global ESG data management infrastructure, systems and technology has also been identified as a key focus area for the future.

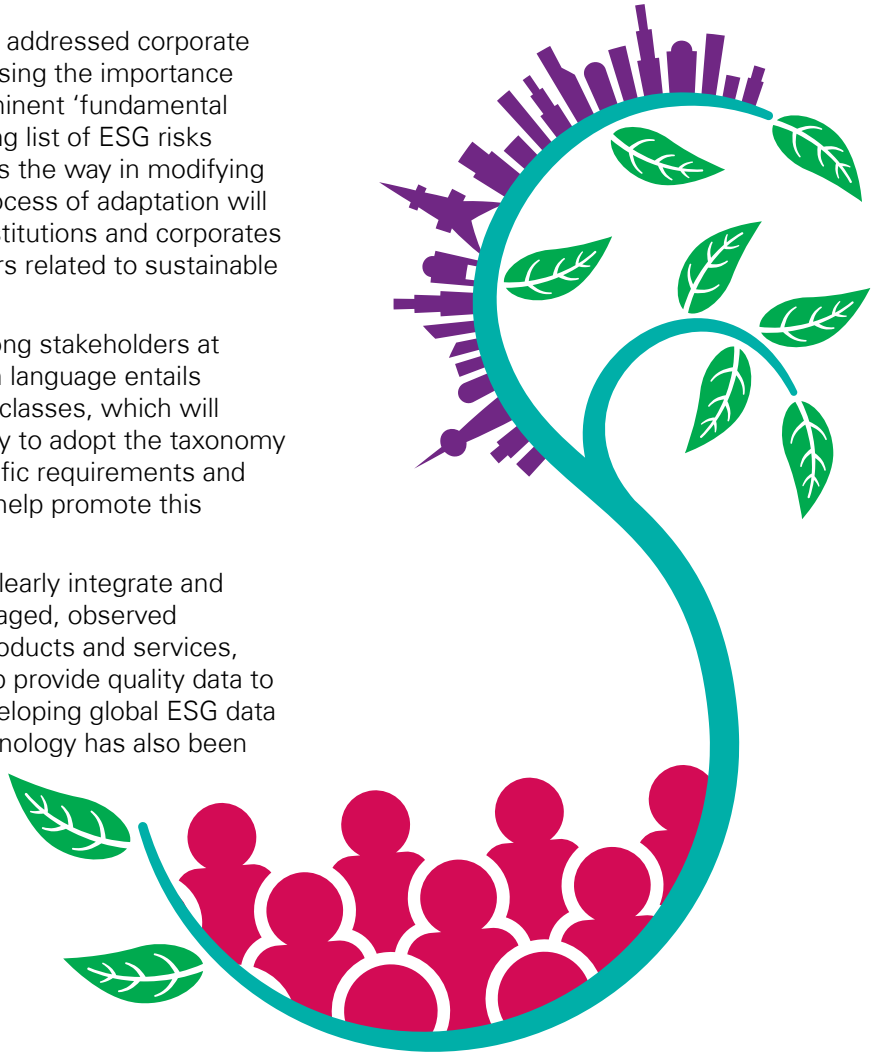


Figure 19: Stakeholders submit a proposal for standardising ESG disclosure at the WEF Summit 2020[1]

WEF 2020 highlights.

01 **The WEF and IBC have collaborated with the Big 4 accounting firms on developing a proposal towards a set of standardised universal ESG metrics.**

02 **This action has been taken as a response to the requirement of clear and standardised ESG data for comparative analysis and benchmarking.**

03 **The proposed metrics and recommended disclosers will be bucketed into four pillars that are aligned with the SDGs and principal ESG domains: Principles of Governance, Planet, People, and Prosperity.**

04 **Metrics are also aligned with existing standards and disclosure frameworks such as GRI, SASB, TCFD and CDSB, among others.**

Adding to these events, Corporate Reporting Dialogue launched a report in September 2020 called the 'Better Alignment Project', which brought together major global standard-setters and framework providers to assess their alignment with the recommendations of the Task Force on Climate- related Financial Disclosures (TCFD).

The technical mapping of various global frameworks (such as Global Reporting Initiative, Sustainability Accounting Standards Board and International Integrated Reporting Council) indicated strong alignment with the TCFD recommendations. Leaders feel that this report and metrics released by WEF will reduce the market confusion and bring harmonisation in disclosing culture.

1. Measuring Stakeholder Capitalism: World's Largest Companies Support Developing Core Set of Universal ESG Disclosures, WEF, January 2020

5.2. Driving positive and inclusive stakeholder engagement

The active and collaborative participation of a diverse set of stakeholder groups is important for demystifying important aspects of sustainable finance. Stakeholder groups include financial institutions, investors, corporates, borrowers, regulatory bodies, industry bodies, academics, knowledge partners and consumers, among others. Outcome-oriented engagement is the core pillar of ESG integration and sustainable finance, and can act as a catalyst for change. An investor with a clear strategy and implementation plan of creating awareness around ESG risks within the investee companies will drive mission-oriented stakeholder engagement. The outcome of such an engagement will be far superior to an engagement that is largely passive.

a. Addressing 'short-termism'

Active stakeholder engagement is also a solution to the challenge of 'short-termism' in business decisions. Focus on short-termism is also one of the primary reasons why sustainable finance has failed to garner popular support from the mainstream world of finance in the past.

In response to this challenge, a new model of shareholder engagement called Active Ownership 2.0 has emerged. This model is guided by the principle that ESG best practices will bear fruit if a business' board members are truly held accountable for their decisions. It can also be used as a tool to drive shared value between investors and their investee companies in two distinct ways:

a. Support business transformation through robust governance practices

b. Ensure that investors' requirements on ESG-related matters are heard at board-level meetings

b. Public policy advocacy

The government plays a crucial role in driving robust ESG practices across industries and in changing consumer behavior at the most fundamental level. Financial institutions and corporates participating in public policy advocacy help build the foundation for public-private partnerships.

In the Indian context, it is imperative that the public and private sector work together to identify a long-term strategy for sustainable finance. For example, it will become necessary for the Indian automotive sector to adopt hybrid and electric vehicles on a mass scale for the country to meet its emission reduction targets. This transition can only be supported through policy changes made at the national level. Therefore, addressing ESG risks at the industry level and aligning them with nationally determined contributions must be considered in a phased manner. The government and private sector can also consider adopting science-based targets to address long-term ESG challenges, especially targets related to GHG emissions.

Regulatory mandates may also provide impetus for robust ESG disclosure. Between 2016 and 2019, the European Union (EU) had released two directives on enhancing transparency on ESG disclosures, adopted a resolution on sustainable finance, and published new guidelines on corporate climate-related disclosures as part of its action plan on sustainable finance.[2] Consequently, Europe currently leads the way in global sustainable investing.

The possibility of developing regulatory compliance requirements around sustainable finance and related disclosures is still a topic of discussion amongst regulatory bodies in India. Several high-impact projects for socially responsible investments (SRI) can be covered under the CSR regulation in India. In the coming years, this may form the basis for new legislation. The current CSR regulation may undergo modification and allow SRI to be considered as CSR spending.

c. Changing consumer and investor behavior

Millennials have been demonstrating heightened awareness of the impacts of their consumption and production patterns. Enhanced consciousness is expected to impact market demand across sectors, which makes it important for organisations to engage with their consumers and take their requirements into account when designing products and services for the future.

A recent study found that 95 per cent of the millennial investors in the U.S. are gradually showing interest in sustainable investing. Further, the percentage of millennial investors who have adopted sustainable investing has steadily been increasing since 2015.[3]

2. European Union Commissions, Business and Development, Sustainable finance and EU corporate disclosure
3. Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice, Morgan Stanley Institute for Sustainable Investing, September 2019

5.3. Validating the 'Alpha' in ESG integration

ESG must be used as a differentiator to segregate positive investments from negative ones. Positive investments generate value in addition to profit. However, investors must actively validate the 'alpha' of ESG-driven funds to help provide evidence of the fact that ESG funds do not create value at the cost of profit. The allocation of capital towards addressing ESG challenges will become easier if the 'alpha' is proven across different asset classes.

5.4. Driving transparency

There is unequivocal agreement among stakeholders that transparency is key to driving the sustainable finance agenda. Corporate and investment leaders must be able to demonstrate how impact is being considered and integrated into every aspect of an investment cycle and overall business objectives. Clarity provided on an organisation's ESG management approach only adds to the credibility of the data provided.

Going one step further, it is also important to demand transparency from third-party data providers on methodologies adopted to assess organisations on ESG aspects.

Conclusion

The ascent towards establishing the importance of sustainable finance might have been gradual, however there is no denying the accelerated gain in momentum over the last few years. Global environmental, social and governance challenges that can no longer be ignored have forced stakeholders to take a united stand to do better and take responsibility for their actions.

The pandemic has brought to light the ESG-related challenges facing the world, while also highlighting the need for collective action to solve them. These are crucial to facilitating collaboration, integration and innovation that will usher in a new era of sustainable value creation.

Difficult times may lie ahead but embracing opportunities to collaborate, integrate and innovate will ensure the turning of the tide in favour of sustainable development.

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