Why ESG Matters in Financial Services

By Invite

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The whole of 2019 saw a fierce and intense debate globally around the adoption of environmental, social and governance (ESG) principles as a way of doing business. The year gave the world in general and India, in particular, some compelling reasons to improve their ESG standards. For example, July 2019 was declared to be the hottest month on record for the planet, and a report in April indicated that air pollution alone kills 1.2 million people in India. Add to it a spate of corporate governance issues that cropped up in India throughout the year.

Underscoring the importance of ESG principles, 181 top global CEOs signed in August a mission statement, declaring that companies exist for all stakeholders, not just shareholders. The message is clear: a responsible corporate house needs to understand the importance of sustainability and ethical impact of its business model. A failure by companies to adapt to the growing mood of environmental sustainability concerns could also see stakeholders abandon them if they are not happy with their long-term ESG commitments.

In recent times, a business strategy that considers the ESG consequences of various corporate decisions is gaining traction in India, because it is believed to show better operational performance and is less risky Here is an evidence of that: the MSCI India ESG Leaders Index, which invests in companies with high ESG performance, has outperformed the MSCI India Index over three-, five- and 10-year periods.

It's a welcome progress, indeed, and as a financial services company, we are glad to be a part of the positive transition. Still, as a creditor, I often get asked: "How are ESG factors a concern for a financial services company?"

A simple answer to this is: we want the money we lend to be a positive force in the world, which works towards making a better tomorrow. One way to accomplish that is by giving preference to companies that keep ESG factors at the heart of their plans.

Let's break it up.

ENVIRONMENTAL CRITERIA

There has never been as much focus on the environmental implications of a business decision as we have seen in the past few years, primarily because of the rising climatic threats to our planet. The detrimental impact of climate changes is rapidly becoming more apparent across the world. Recently, the supreme court in the Netherlands has upheld a decision that the Dutch government must take urgent climate action to protect the fundamental rights of its people.

In such a situation, an effective way for a lender to extenuate the threat is to promote renewable energy. Not only because it is the cheapest source of energy generation, but also because the prospect of its growth is immense. That is why the segment requires priority treatment from lenders, which will encourage eco-friendly business ventures and dissuade polluters.

VARANI SAHU

BUSINESS MODEL

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Lending to environment-friendly projects has plenty of business benefits as well. For example, the renewable energy lending book of L&T Financial Services has zero non-performing assets, which is the mainstay of any healthy lending business. In other words, if you are not going green you are more than likely on your way to becoming obsolete.

SOCIAL IMPACT

As far as social impact of the business is concerned, non-banking financial companies (NBFCs) have a crucial role to play in financial inclusion in India. Lending methodically backed by analytics to customers who do not have access to the last-mile credit presents a massive growth opportunity for the sector, considering the large potential customer base, and helps significantly in poverty alleviation and raising living standards.

NBFCs and NBFC-MFIs, according to a report by Microfinance Institutions Network, are significant providers of micro-credit with a loan amount outstanding of ₹21,381 crore and ₹62,960 crore, respectively, accounting for 11% and 31% of total industry portfolio. Equally important is the multiplier effect these micro enterprises have on employment generation and the social fabric of our country by way of giving rural women more control of their lives.

GOVERNANCE

A high corporate-governance standard facilitates effective, entrepreneurial and prudent management that can deliver the long-term success of the company. Therefore, stakeholders in various companies across the globe are taking the help of various ESG indices to separate governance issues from business fundamentals. For example, leading indices such as S&P Global Ratings ESG Evaluation and MSCI ESG Ratings help investors gain a better understanding of a company's strategy, purpose and management quality.

NBFCs in India play a critical role in powering consumption and ensuring credit flow to unbanked segments, and their long-term sustainability depends on their standards of corporate governance. Recent defaults and questionable governance practices had caused a crisis of confidence for the sector, but hard lessons have been learnt and corporate-governance standards will be held sacrosanct. As they should be.

The bottom line is: ESG criteria are becoming increasingly critical for large financiers to assess their borrowers because it can help them filter out companies that may not be sustainable and may pose a financial risk due to their practices. Therefore, I believe all serious lenders need to devote considerable resources to improve the data and analytics to measure ESG factors and integrate them across their credit platforms.

We have always strived to do our bit by making product choices that help in building a sustainable business for perpetuity. A company that aligns itself to the needs of the nation while being conscious of the impact of its operations is more likely to generate long-term sustainable returns for all stakeholders. Such companies are also generously rewarded with the licence to operate by the society they function in.

We need to remember that the future of our planet depends on us. The only question is: are financial institutions playing their part by taking into account the ESG consequences of the borrower's business plans?

The good thing is, we are in a position to say yes. And we are proud of it.

(The author is CEO of L&T Finance Holdings)