ESG Mutual Funds Schemes

Background

Importance of ESG investing

Businesses were established with the primary objective of creating wealth for their shareholders. However, the emerging challenges and the scenarios in the recent past have compelled businesses across the globe to transit from a stage of being a mere economic unit aimed at earning profits to a business, the objective of which is aligned with the sustainable development goals of the society, nation and the globe - the stakeholders of any business. That is the journey from creating wealth for shareholders to the wealth and well-being of its stakeholders.

Reporting frameworks outside India

In view of the global issues related to the environment, society imbalance, governance, and the contributions made by the companies to combat these challenges, several countries initiated a reporting framework for such companies.

For instance

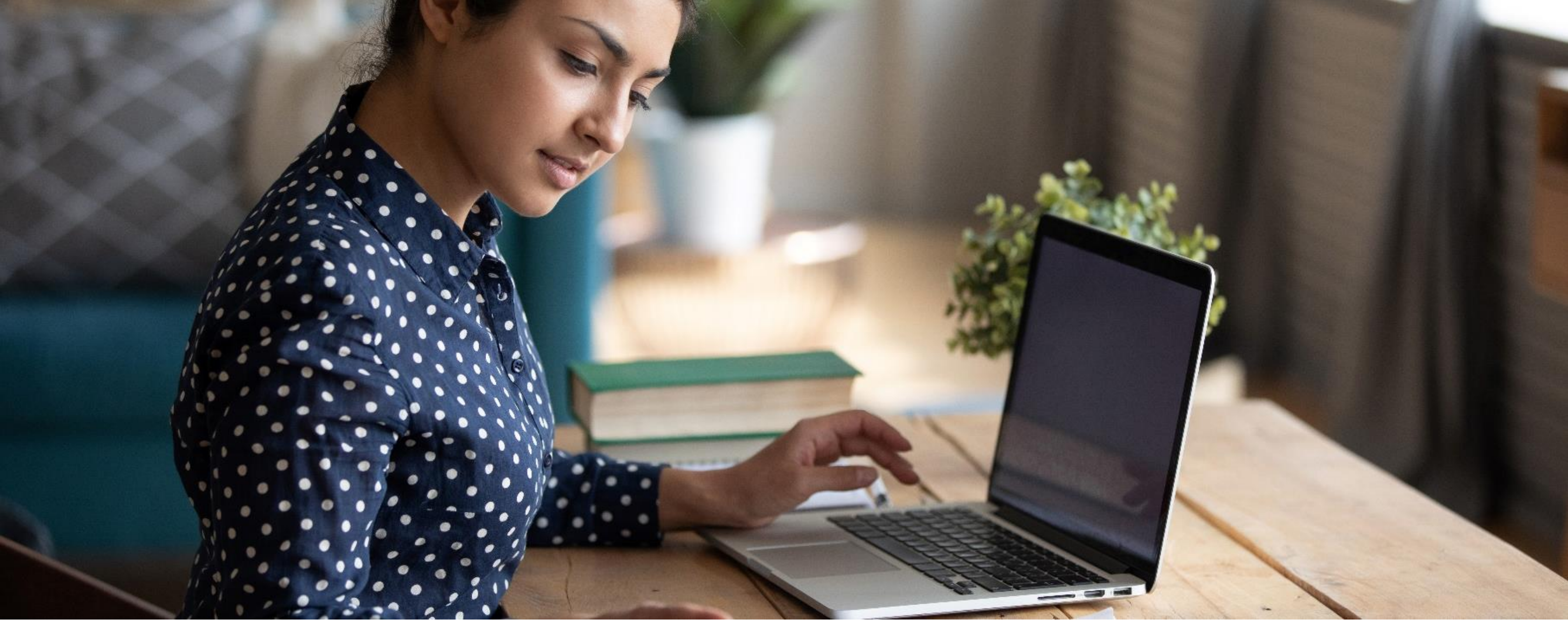
01 The United Kingdom has introduced climate-change reporting by listed premium companies based on the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD), on a 'comply-or-explain' basis from FY 2021-22.

02 The European Union (EU) is strengthening its 'Non-financial Reporting Directive', which requires ESG disclosure from companies with more than 500 employees doing business in the EU.

03 New Zealand has announced mandatory climate-related disclosures, based on the TCFD framework, for all listed equity and debt issuers by 2023.

04 The USA Securities and Exchange Commission has also recently announced its intention to enhance its focus on climate-related disclosures.

Source – A SEBI memorandum seeking the approval of the board for revising the format for business responsibility reporting on Environment, Social, and Governance (ESG) indicators issued in April 2021



Reporting framework in India

- Likewise, in 2012, the Securities and Exchange Board of India (SEBI) mandated the top 100 listed entities by market capitalisation to file and form the Business Responsibility Report (BRR) as a part of their annual reports. This regulatory requirement emanated primarily from the National Voluntary Guidelines on Social, Environmental, and Economic Responsibilities of Business (NVGs – 2011, released by the Ministry of Corporate Affairs), guiding businesses on responsible business conduct. Pursuant to the emerging global concerns, the NVGs were revised and released as National Guidelines on Responsible Business Conduct (NGRBC) in 2019, designed to assist businesses in embracing the principle of 'responsible conduct going beyond the requirements of the regulatory compliances.' In due course, a committee on business responsibility reporting of the MCA ('Committee') rolled out the BRR formats for listed and unlisted companies. It recommended that the BRR be called the Business Responsibility and Sustainability Report (BRSR) to reflect the scope of the reporting requirements better.
- The requirement of the BRSR intended for the businesses to reflect the actions undertaken by them in alignment with the principle of responsible business conduct, to serve as a single source for all non-financial disclosures, and to enable meaningful engagement of the companies with all their stakeholders, and in the long-term to be used to develop a Business Responsibility Sustainability Index (BRSI) for companies. This framework of reporting, disclosure, and measurement of non-financial information from companies enables a supply of more consistent and handy data for the investors to assess the sustainability impact of capital allocation and investment choices.
- The BRSI would facilitate informed and better investment decisions, enable comparative study and statistics, and breed a ground for the peer companies to scale up the conduct to ace the index, encouraging them to look beyond financials and towards social and environmental impacts and making a difference.
- SEBI has mandated the top 1,000 listed companies (by market capitalisation) to make ESG disclosures as per the Business Responsibility and Sustainability Reporting (BRSR) from FY 2021-22 voluntarily and mandatory from FY 2022-23. (Source - SEBI circular dated 10 May 2021, business responsibility and sustainability reporting by listed entities)
- Pursuant to the growing recognition of the significant economic and financial impact of climate change, and the environmental, social, and governance (ESG) risks, several ESG funds have been launched globally in the past three years, including in India. As ESG investing is forming a part of the mainstream, companies have been urged by both investors and regulators to make detailed ESG-related disclosures to their stakeholders. The use of ESG ratings and rating products is on the rise, as investors increasingly factor ESG parameters in their investment decisions.
- Against this backdrop, the securities market regulator has felt a need to streamline three areas, viz. i) ESG disclosures, ii) ESG ratings, and iii) ESG investing.
- SEBI issued a press release on 29 March 2023 with respect to a decision taken during its board meeting. The board has approved the regulatory framework for ESG (environmental, social and governance) Disclosures, Ratings and Investing to facilitate a balanced approach.
- With the evolution of the ESG framework and its adoption by the companies and investors, the current state of the ESG financial ecosystem is opined upon as under, subject to development and dynamics of the regulatory and other external changes:

ESG financial ecosystem

- The ESG financial ecosystem is evolving, as are issuers and investors who disclose and use information. Financial intermediaries, governments, and global companies influence emerging ESG investing practices. Constructive and inclusive progress has been made in developing ESG practices by several ESG players. It has generated the spread of a wide array of disclosure frameworks, which resulted in metric inconsistencies and a lack of comparability for investors.
- Consequently, while ESG methodologies are improving with a focus on transparency, scoring remains in a state of transition, with some rating providers still refining their methodology by including factors such as materiality.

The ESG financial ecosystem today is comprehensively depicted as:

Issuers

Issuers that received ESG rating

Financial intermediaries

- **ESG rating providers**: SEBI approved ESG rating providers
- **Indices**: Firms that construct ESG indices
- **Asset managers**: Firms that construct ESG funds, ETFs, schemes, etc.
- **Institutional investors**: Entities with fiduciary responsibilities to manage assets

End investors

Owners who bear the ultimate rewards and risks

Governance

- SEBI that determines disclosure requirement for issuers companies, ESG rating providers and asset managers
- National guidelines on responsible business conduct release by MCA
- Ethical standard setters including OECD and UN, that provides guidelines on responsible business conduct and societal values

Proposed requirements mentioned in the SEBI publication for public comments

SEBI's ESG Advisory Committee (EAC / Committee), constituted in May 2022 and chaired by Navneet Munot, MD and CEO, HDFC AMC, deliberated to address the concerns of green-washing and mis-selling and to facilitate the balance between transparency, simplification, and ease of doing business in an evolving domain. On 20 February 2023, SEBI issued its recommendations for public comments. The same is divided into three parts - Part A, Part B, and Part C on ESG disclosures, ESG ratings, and ESG investing, respectively.

Part A | Disclosure

- **An assurance on the BRSR reporting to enhance the credibility of disclosure and investor confidence**. Assurance here means a limited assurance of **reasonable assurance**. While globally limited assurance is accepted assurance, reasonable assurance draws more confidence.
- The BRSR core has been developed for reasonable assurance, which consists of select key performance indicators (KPIs) under each E, S, and G attributes/areas that need to be reasonably assured. **The KPIs should be: i) Quantifiable and outcome-oriented metrics, ii) Relevant, and iii) Comparable across jurisdictions**
- The KPIs in the BRSR core contain many intensity ratios, such as the intensity of greenhouse gas (GHG) emissions, water consumption, waste generation, etc., to enable comparability, irrespective of the company's size. These intensity ratios are based on revenue and volume, considering that global investors and ERPs also use these ratios.
- In its meeting dated 29 March 2023, SEBI has taken the following decisions:
  - In order to enhance the reliability of ESG disclosures, the BRSR (Business Responsibility and Sustainability Report) Core shall be introduced, which contains a limited set of key performance indicators (KPIs), for which listed entities shall need to obtain reasonable assurance.
  - The BRSR core will be applicable tor the top 150 listed entities (by market capitalisation) from FY 2023 - 24, which shall be gradually extended to the top 1,000 listed entities by FY 2026 – 27.

- For a number of companies, significant ESG footprints, such as the use of natural resources, employment practices, emissions, and wastages, may be found in their supply chain. Hence, it is proposed to gradually introduce a limited set of ESG disclosures, on a 'comply-or-explain' basis. The proposed implementation plan is illustrated on the right:

FY 2024-25	FY 2025-26
• ESG disclosure as per the BRSR core, for supply chain for top 250 companies (by market cap) on a 'Comply-or-explain' basis. • Assurance is not mandatory.	• ESG disclosure as per the BRSR core, for supply chain for the top 250 companies (by market cap), on a 'Comply-or-explain' basis. • Assurance on a 'Comply-or-explain' basis.

Part B | **ESG rating**

- General issues faced by ESG rating providers:
  - The ambiguity of the wide range of rating products offered, along with inconsistency in disclosures and transparency of the methodology and rating process.
  - The lack of transparency in ESG ratings and conflict of interests.
- To mitigate the above-mentioned challenges, SEBI, in its consultation paper issued on 24 January 2022, proposed that SEBI-registered credit rating agencies and SEBI-registered research analysts are proposed to be considered eligible to be accredited by SEBI as ERPs, subject to fulfilment of the accreditation criteria.
- SEBI has suggested that **ESG rating providers can form an industry association** and play an active role in developing a regulatory framework for ERP in the securities market and engage with the regulator at its ESG advisory committee.
- SEBI further said that **ERPs should not provide ESG ratings to any related parties** or securities issued by them or the ERP.
- The analysts involved in the ESG rating assessment shall **disclose any conflicts of interest** involving a company/issuer to the ERP and shall not be allowed to rate such companies.
- The committee noted that the **ESG ratings given by ERPs were missing the Indian context,** as ESG in emerging markets is different compared to developed jurisdictions. The ESG committee has recommended a list of **15 ESG parameters with an Indian context, broadly categorised into: i) Environmental parameters, ii) Social parameters, and iii) Parameters on governance.**
- **ERPs will provide ESG ratings based on the assured/audited data**. The point to deliberate here is who will be providing the data to ERPs, auditors, or a company?
- However, SEBI, in its press release dated 29 March 2023, mentioned that to facilitate the credibility of ESG ratings, ERPs shall offer a separate category of ESG rating called as the 'Core ESG Rating', which will be based on the assured parameters under the BRSR core.
- Further, SEBI approved the proposal on the introduction of a regulatory framework for ESG rating providers (ERPs) in the Indian securities market, and related proposals on:
  - Enhanced transparency in ESG rating rationales,
  - Measures to mitigate conflict of interest by ERPs,
  - Facilitating augmentation of transition finance in India, and
  - Facilitating ESG ratings based on assured data.

- It prescribed the following norms for the ESG schemes of mutual funds:
  - Disclosures in Scheme Information Document (SID).
  - Disclosures related to the engagement undertaken by AMCs for ESG schemes.
  - General obligations related to the declaration, resource augmentation, marketing material, and the development of common sustain.
- Enhanced stewardship reporting for ESG schemes: **Voting disclosures by ESG schemes:**
  - AMCs will **increase the engagement** for improved corporate governance in the investee companies.
  - It is proposed that AMCs need to provide better clarity on the 'in favour' or 'against' votes cast on resolutions in a year by disclosing if the resolution has or has not been supported due to any environmental, social, or governance reason.
  - Further, as the mutual funds may have holdings in the same investee company(ies) under non-ESG funds as well, in cases where the voting approach for ESG and non-ESG schemes is the same, the reporting may be made on a fund house level on 'in favour' or 'against' votes. However, in instances where the voting approach for ESG and non-ESG schemes is not similar, AMCs should provide details and rationale for 'in favour' or 'against' votes cast on resolutions for ESG schemes and non-ESG schemes separately.
  - **Voting disclosures are to be mandated from FY 23-24, i.e., for annual general meetings held from 1 April 2023 onwards.**
- **Mitigation of risks of mis-selling and greenwashing:** Since there is a possibility of the risk of greenwashing existing at both the investee company level and the scheme level, the following measures will be introduced as per SEBI's press release dated 29 March 2023:
  - Mandating ESG schemes to invest at least 65% of AUM in listed entities, where assurance on the BRSR core is undertaken.
  - Mandating third party assurance and certification by the board of AMCs on compliance with objective of the ESG scheme.
  - Mandating enhanced disclosures on voting decisions, with a specific focus on environmental, social and governance factors.
  - Mandating the disclosure of fund manager commentary and case studies, which inter-alia highlight how the ESG strategy is applied on the fund / investments.
  - Introducing a new scheme category, enabling the launch of multiple schemes on ESG-related factors.

Sub-categories	Indicative investment strategies
ESG exclusion scheme	Invests in securities after excluding specific parameters such as ESG-related activities, business practices, or business segments.
ESG integration scheme	Invests in companies after considering ESG-related factors to evaluate the risk, return on investment, and financial aspects.
ESG best-in-class and positive screening scheme	Invests in companies that perform better than their peers in terms of ESG parameters.
ESG impact investing scheme	Invests in companies that bring a positive, measurable social or environmental impact.
ESG sustainable objective scheme	Invests in companies that are likely to benefit from the long-term macro or structural ESG-related trends.

Our assessment of how the proposed SEBI requirement will impact the following stakeholders

Stakeholders and key impacts

Asset management companies

- ESG investment policy needs to be developed, increase in the disclosure requirement in SID, ESG scheme performance parameters, monitoring of the investment limits, continuous monitoring of ESG ratings, put systems in place to review and monitor disclosures requirement of SEBI to investee companies, enhanced stewardship code, etc.
- It increases the number of ESG schemes that AMCs can launch, increasing the base and potentially leading to higher AUM.
- Higher reliance due to reasonable assurance from an independent third party on BRSR reporting.

Credit rating agencies
(ESG rating providers)

- Credit rating agencies (ESG) - Challenges in developing the methodology and aspects to be considered for assigning a rating in line with global trends.
- ESG rating providers must be registered with SEBI and comply with the accreditation criteria.
- Audited data needs to be considered for rating.

Investors

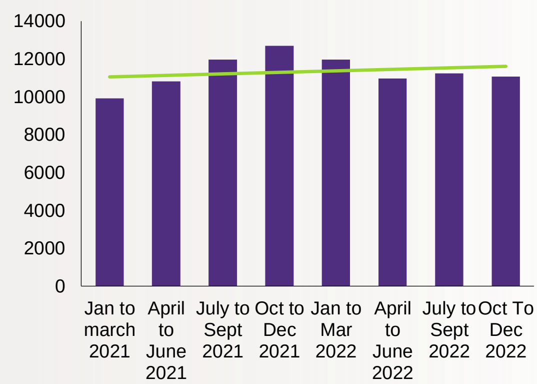
- Higher transparency in the disclosure leads to the avoidance of mis-selling of schemes.
- Standardised disclosure will help in comparability.
- Increased investment due to better quality of disclosures and assurance on the reporting.
- An increase in the number of schemes will give more options to investors.

Our review basis the key trends observed in investments in ESG mutual fund schemes

AUM

Key trends

- In India, the AUM of ESG schemes was INR 11,074.36 crore for the QE 31 December 2022, comprising eight equity schemes, one ETF, and one FOF scheme. (Source: AMFI Quarterly Average AUM)
- The AUM of schemes grew from INR 9,914.16 crore (March 2021 quarterly average) to INR 12,686.32 crore (December 2021 quarterly average) and was reduced to INR 10,970.17 crore (June 2022 quarterly average) (Source: AMFI Quarterly Average AUM)
- Mentioned at the right is the trend of average quarterly AUM from January 2021 to December 2022:



Returns

- Indian ESG funds' three-year return ranged from 14.47% to 17.73%. The benchmark index return for a similar period was 16.64% (Source: AMFI Fund performance).
- The one-year return on 31 January 2023 ranged from -4.44% to 18.79%, and the benchmark index return was -3.06% (Source: AMFI Fund performance).
- The expense ratios of the schemes were in the range of 0.09% to 1.34% as of 31 January 2023 (Source: AMFI Fund performance).

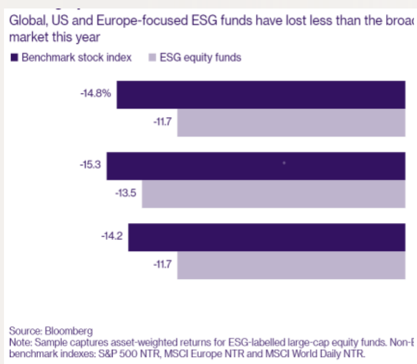
Concentration risk

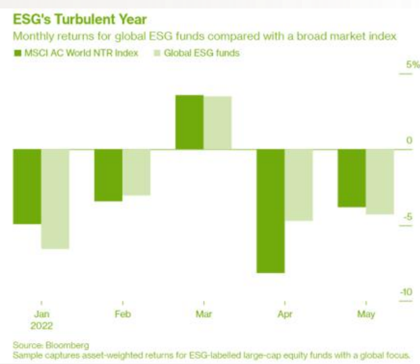
- Financial and technology stocks tend to dominate the holdings of ESG mutual funds.
- Seven of the eight companies that form a part of most ESG funds are from IT services or private sector lending.
- The concentration on the IT and banking sectors will lead to sectoral risk and impact on AUM on the occasion of an unwarranted situation in the IT and/or banking sectors.

(Source: https://www.bqprime.com/business/esg-mutual-funds-in-india-are-having-a-reality-check)

Resistance to the market downturn

- In three broad categories — Europe-focused, US-focused, and global — ESG equity funds have done better this year, on average, than their non-ESG counterparts. All are negative, in line with the broad market selloff, but ESG funds are down less than the others, in spite of typically tech-heavy, energy-light portfolios.





Key takeaways

Concentration risk has to be managed. Recently, we have seen that banking and technology stocks are not performing, impacting the one-year returns of the ESG mutual fund schemes.

There is an overlap of investments in other mutual fund schemes. As per the latest portfolios, there was a more than 50% median overlap between the ESG portfolios and NIFTY100 and around 30% overlap with NIFTY50 and the respective flagship funds. (Source: Motilal Oswal report on sustainability for December 20021).

The AUM growth is not much as compared to other schemes. With an increase in the number of schemes, disclosure quality, and ESG rating improvement, the AUM will also multiply.

Investing in ESG is a long-term game and not for the short-term return.

Identification of ESG investment strategies is going to be critical.

Currently, MF invests based ESG data available to them. Going forward, with the whole disclosure requirement and reasonable assurance from the third party, better investment decisions will be made, and investors' confidence will be enhanced, eventually increasing investments.

The standardised rating methodology of ESG rating providers will be the key to placing reliance on the ratings, which will impact investment decisions.

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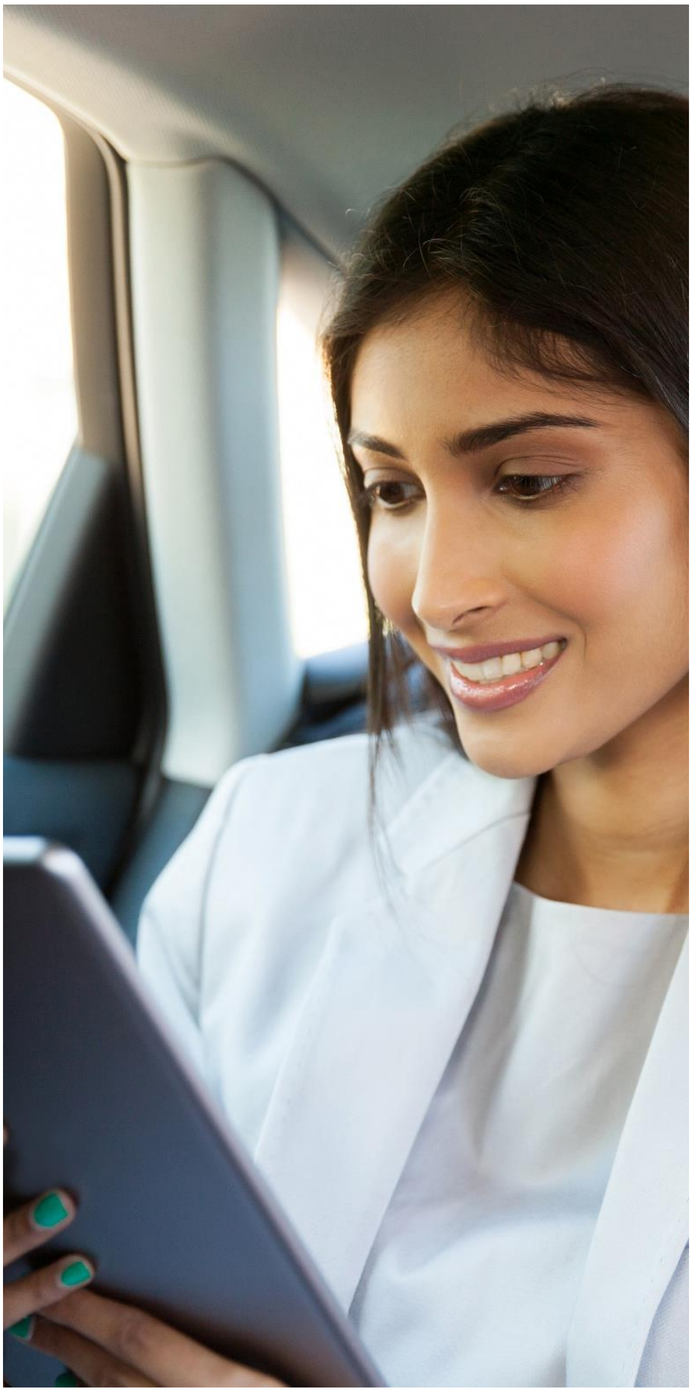

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