



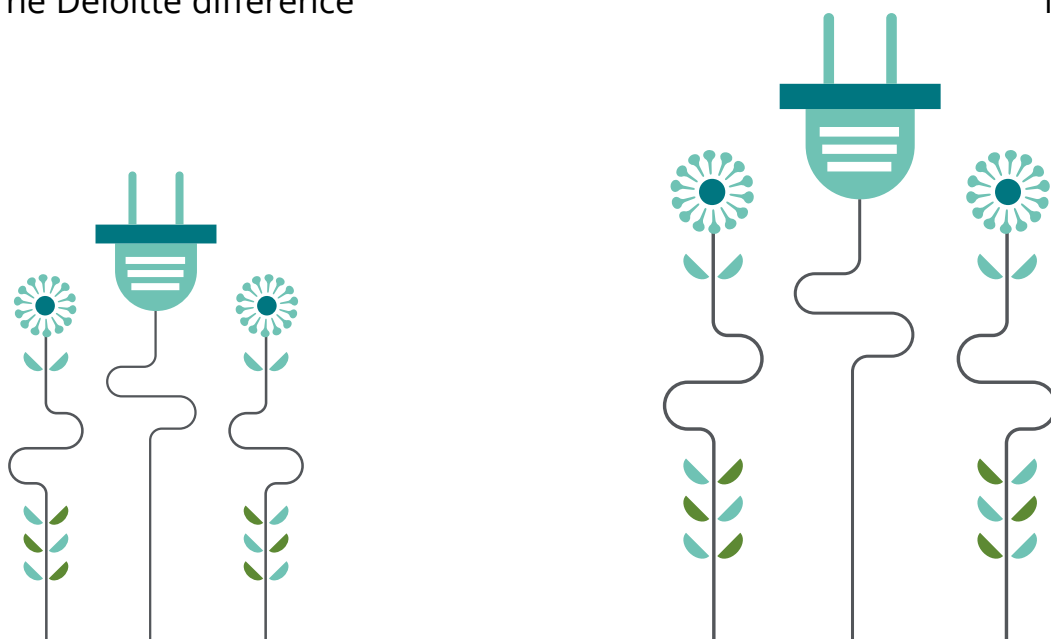
# ESG and Credit Risk

An overlay of ESG for credit appraisal

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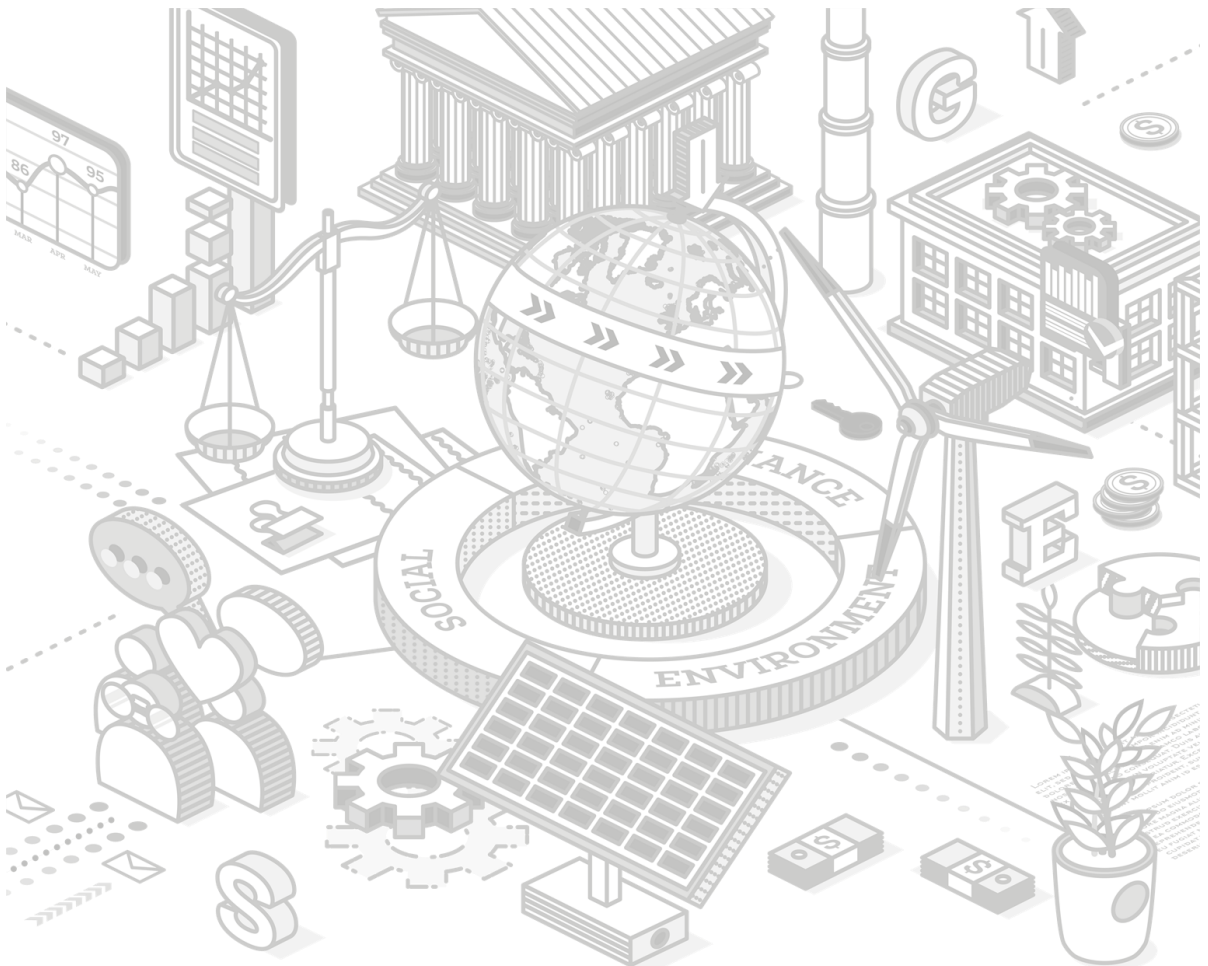


## Preface

With the increasing consensus in expanding the conversation around targeted outcomes of running businesses, there has been a growing need to consider the impact a business makes to all stakeholders, the community at large, and the environment. This change in thinking has been triggered by accelerating climate change over the last several years, with the global financial services community coming together to acknowledge how lending institutions can play a key role in not only mitigating adverse fallout, but also facilitate positive change.

Lending is at the core of the business at financial institutions and is driven by, and also influences, the strategic direction for these entities. Having the ESG lens applied to lending decisions is a clear actionable manner in which financial institutions can pro-actively drive towards the objectives mentioned earlier.

Given that achieving this would require a methodology revamp to existing credit rating / appraisal processes, we have developed an ESG overlay mechanism to help with this journey. We believe this overlay brings together a practical approach to introducing these additional dimensions to the credit lending decisioning process, acknowledging the challenges with data required as well as inefficiencies around unnecessarily cumbersome appraisal requirements.



## What is ESG assessment in the context of credit appraisal?

- Environmental, Social, and Corporate Governance (ESG) refer to three central factors required to measure the sustainability and societal impact of a company or business investment.
- Assessment of ESG factors help in identifying risks linked to causes such as, climate change, scarcity of resources, labour policies of the company, mismanagement by board members etc.
- The key objective of integrating ESG considerations in credit decisioning is to measure a company's resilience to long-term, industry material ESG risks and to assist the financial institution in better-informed decision-making while evaluating the borrower.

### The ESG overlay broadly encompasses to capture following factors:



#### **Environment parameters:**

To capture the impact of externalities like climate change, policies regarding the environment on the business operations.



**Social parameters** typically represent how the organisation focuses on social issues inside and outside the organisation like labour laws, animal welfare etc.



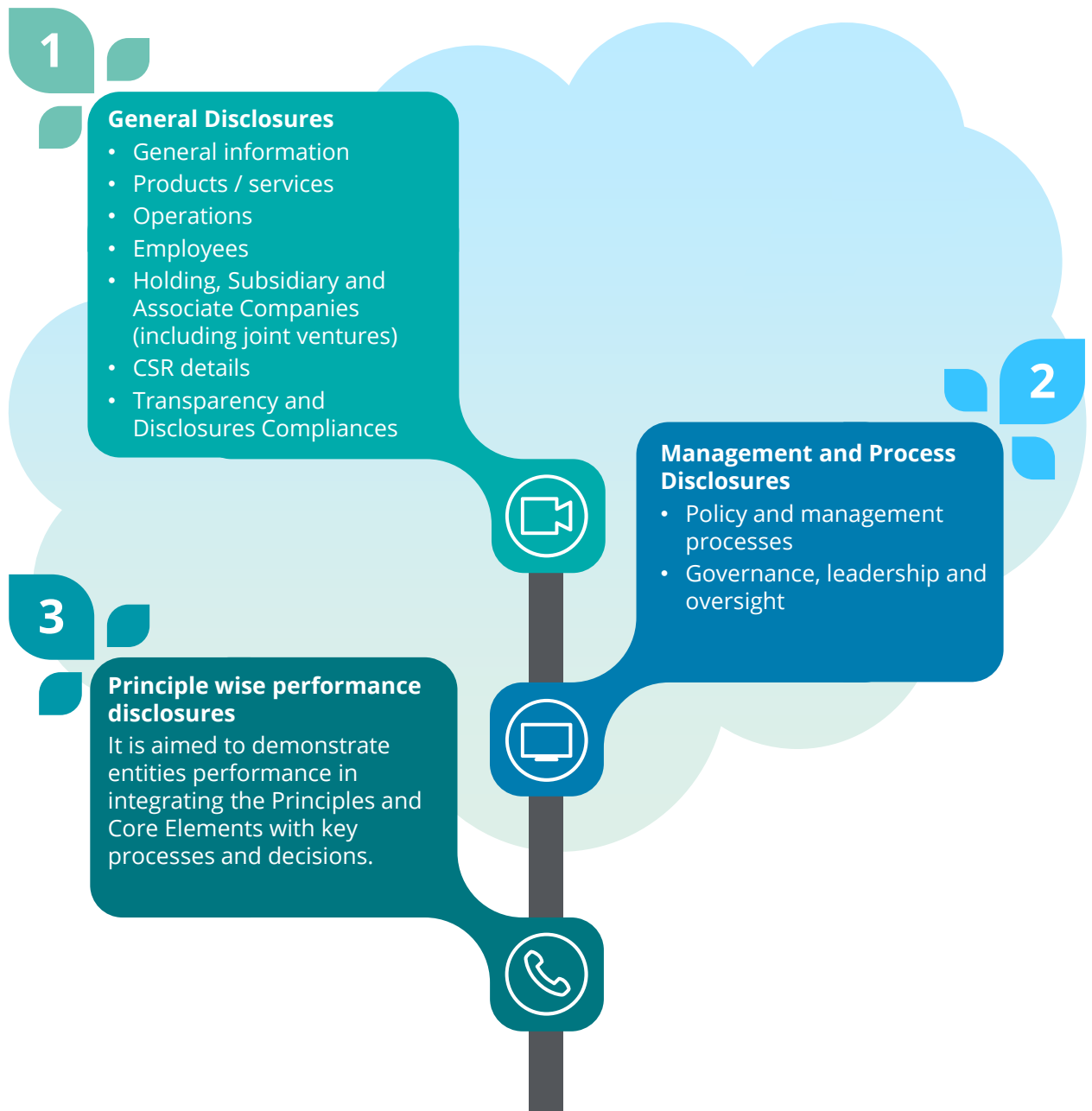
**Governance factors** deal with the structure and responsibility of the management towards employees, shareholders, society etc.



# Relevance of the ESG conversation in credit lending

## Global regulations and steps put in place to manage ESG risks

- Domestic regulators / guiding authorities such as SEBI have started to request corporates / entities to disclose ESG-related data.
- The SEBI's 'Business Responsibility And Sustainability Reporting format\*' broadly encompasses to capture the following three sections. A detailed list of indicators asked under each of the factors has also been suggested by SEBI in the reporting format.

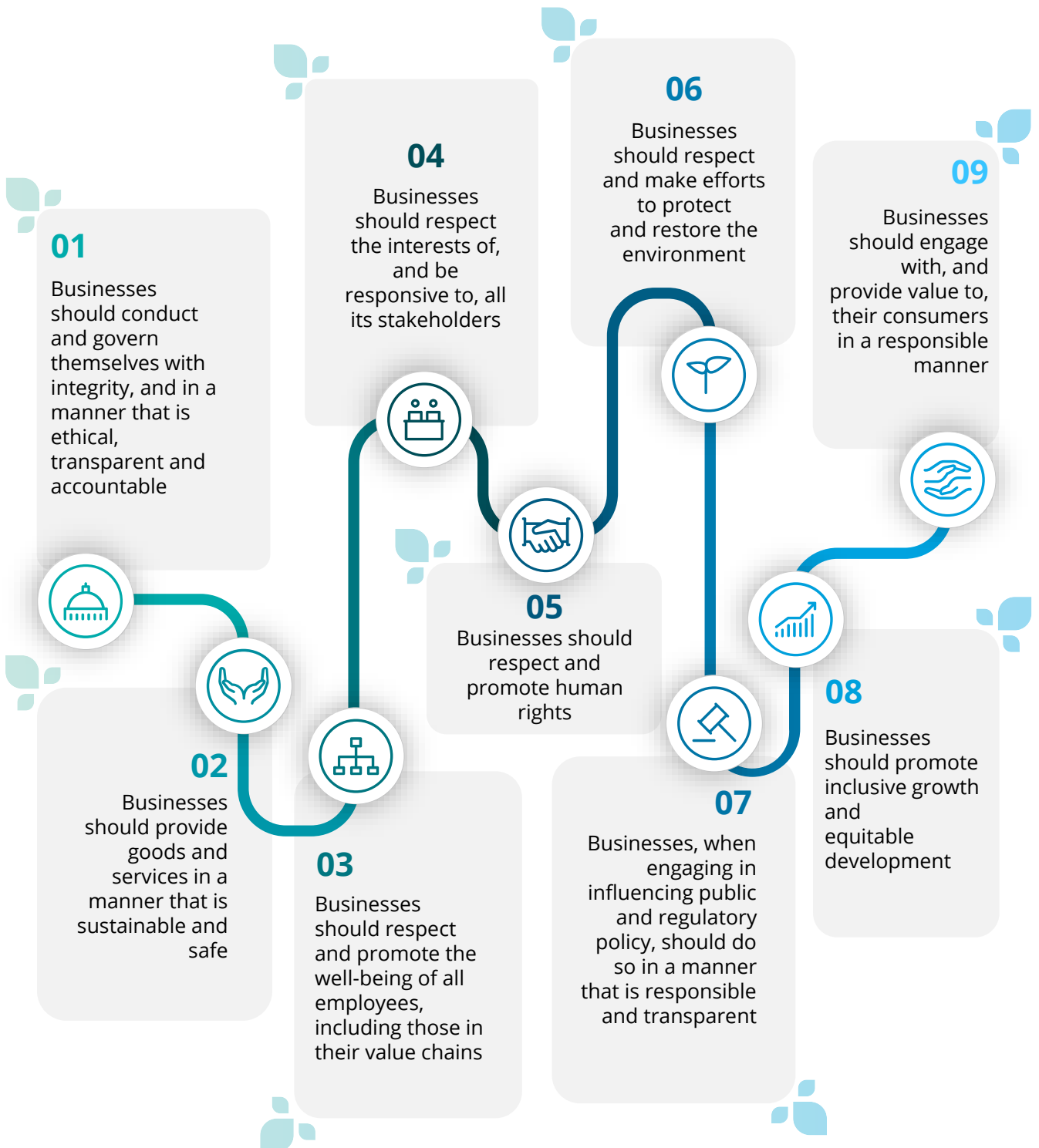


\*Source: 'Business Responsibility and Sustainability Reporting by listed entities' circular issued by SEBI



# SEBI Guidance on sustainability reporting

SEBI's Business Responsibility And Sustainability Reporting format broadly captures the following principles 'under Section 3 - Principle wise performance disclosure':



# ESG Factors considered for evaluation of borrowers

Factors that can be considered for evaluation of Environmental Social and Governance are indicated below:

### Social factors cover evaluation around:

- Workforce ethics
- Products and services
- Treatment and welfare of communities

### Environmental norms cover following aspects:

- Water and energy consumption
- Waste management
- Emissions
- Environmental compliance

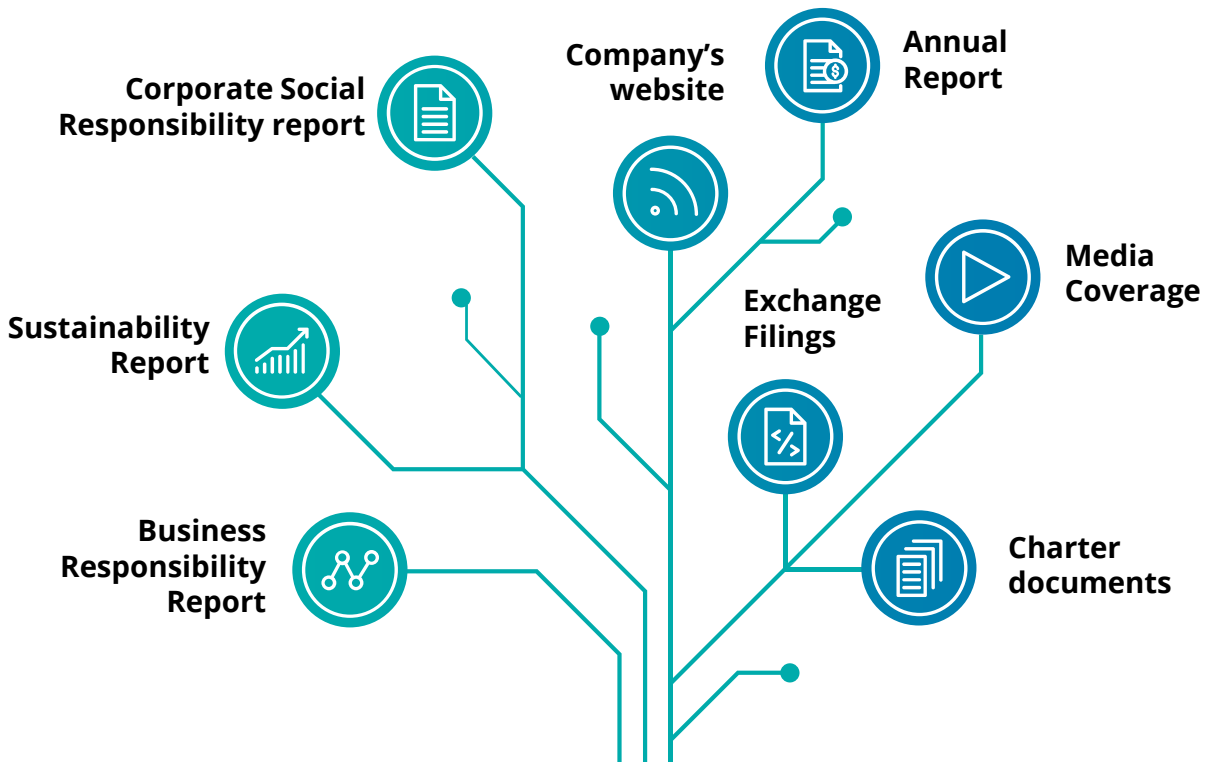


### Governance aspects covers evaluation around:

- Rights and equitable treatment of shareholders
- Disclosures and Transparency
- Responsibilities of the board

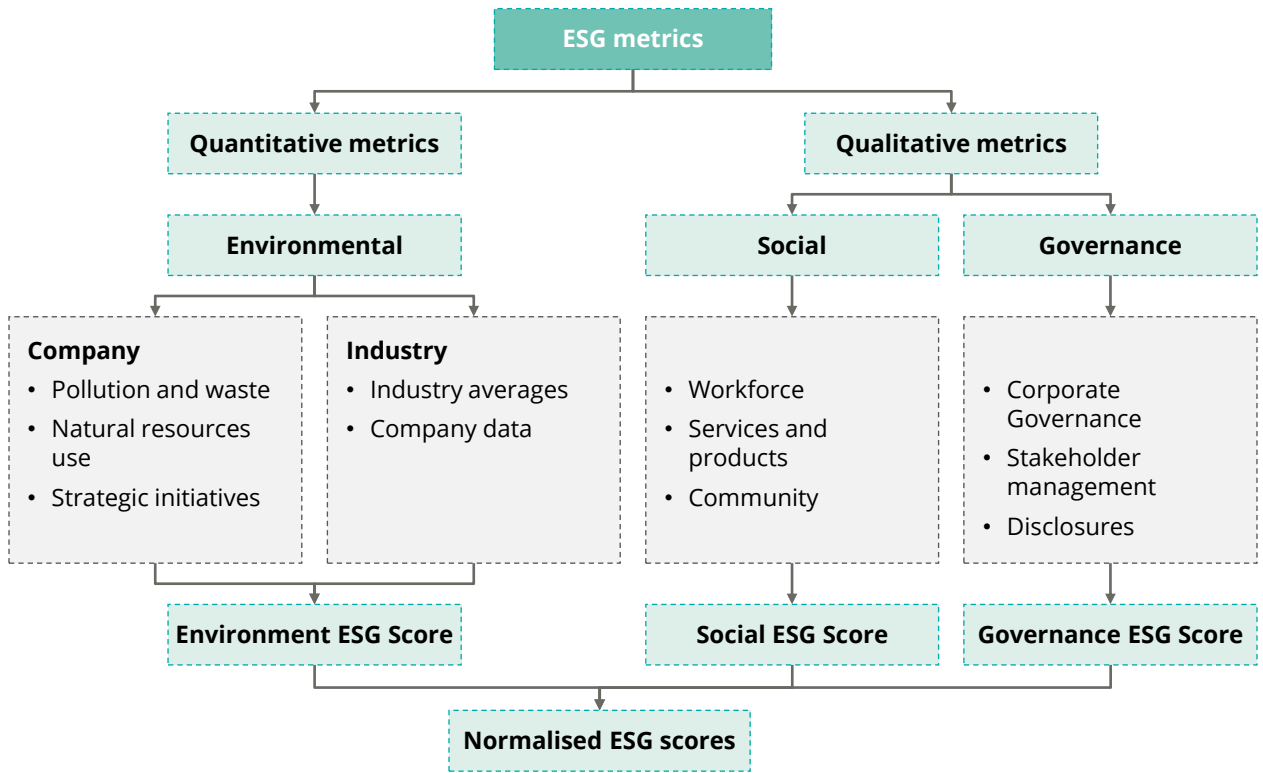
# Data sources for evaluation of ESG metrics

- Given that ESG assessment is a relatively new concept, disclosures and availability of information varies across different geographies, and is a known challenge.
- According to the SEBI BRSR expectations, it is mandatory for the top 500 companies to disclose ESG parameters to govern their operations with regards to issues related with environment, social and governance factors.
- Broadly the information for ESG parameters can be extracted from the following sources:



## ESG overlay metrics

ESG assessment metrics consider both quantitative and qualitative elements of the concerned borrower.



## Environmental factors considered for ESG evaluation

Assessment of environmental parameters help in understanding the company's contribution in climate change and steps taken to mitigate the carbon footprint. The following factors help in assessment of environmental factors:

### Greenhouse gases emission:

The GHG Emission parameter includes the direct (emissions from sources owned or controlled by the organisation) and indirect (emissions from purchased or acquired electricity, heating, cooling and steam) greenhouse gases emitted by an organisation.

### Water Consumption:

Water consumption measures the amount of water used by an organisation that is no longer available for use by the local community or the ecosystem.

### Water Treatment:

Water treatment evaluates the ability of the company to recycle the water and re-use the water thus reducing water consumption

### Energy consumption:

This includes non-renewable fuel consumed, renewable fuel consumed, net electricity, net heat, net steam and net cooling consumed

### Waste generation and treatment:

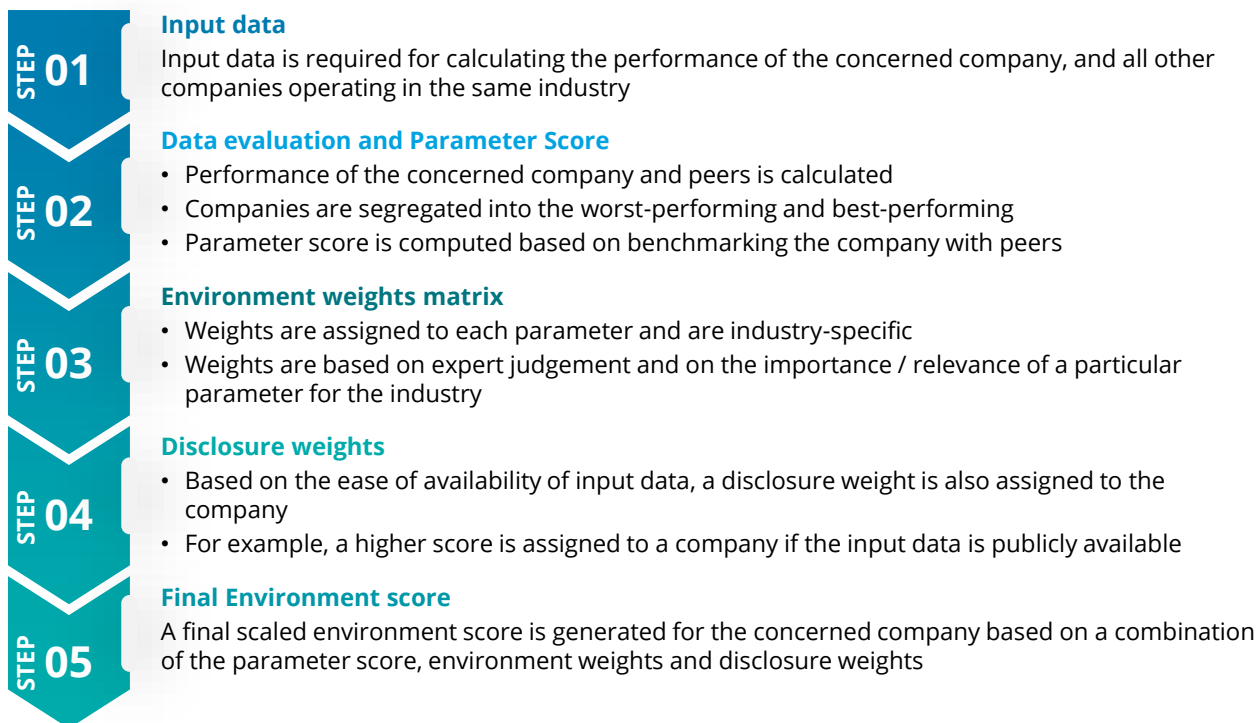
The waste parameter monitors the waste generated and is disposed off by the organisation's activities upstream or downstream in its value chain

The assessment of the above factors can be conducted based on disclosures in annual reports and in various environmental permissions and disclosures done by the company on a periodic basis



## Environment Overlay: Steps to evaluate risk

The environmental overlay incorporates both quantitative and qualitative assessments of the concerned borrower. The environment score calculation is done through a five-step process:



## Social factors considered for ESG evaluation

Assessment of social parameters helps in understanding the company's outlook on workforce welfare and responsibilities towards local communities and consumers. The following factors help in the assessment of these social factors:



The assessment of the above factors can be conducted based on disclosures in annual reports and also based on qualitative assessment based on publicly available information



## Governance factors considered for ESG evaluation

Assessment of governance parameters help in understanding the company's view towards minority shareholders and responsibilities of the board in effective governance. The following factors help in the assessment of governance aspects:

### Role of stakeholders in corporate governance

A corporate governance framework must ensure active co-operation among the parties involved. The assessment covers:

- Ability of the company to protect the rights of its lenders, creditors, and suppliers with necessary mechanisms.
- Effective mechanism for the company to address the employee welfare and health

### Rights and equitable treatment of shareholders

Assessment covers the following aspects:

- Fair and equal treatment of all common equity shareholders
- Framework established for minority shareholders

### Disclosures and transparency

The framework covers the company's disclosure and transparency policy which allows investors and other stakeholders to monitor their financial performance and corporate behavior.



### Responsibilities of the board

This assessment covers the effectiveness and control of the board in ensuring good governance and effectiveness of policies and framework.

## Integration of ESG factors

The final ESG score can be used for credit worthiness assessment, product design, pricing and sales decisions for a borrower. There are options to choose bespoke approaches to arrive at the final ESG score, which can later be integrated with credit underwriting process.

### ESG integration strategies

The individual parameter scores under each ESG dimension can be used to integrate in multiple ways to adjust for ESG related risks

### Weightages

The different factors under ESG may be assigned specific weights based on their relative importance and judgement of the bank to arrive at the final ESG score

### Deflator

Each of the factors under ESG may be used as deflators to reduce the overall credit rating of the borrower.

### Individual ESG factors

The individual ESG scores may be used to set the exposure limits for the borrower. For e.g., a borrower which scores low on either or all of the ESG factors may be subject to higher scrutiny during the credit underwriting process.



# The Deloitte difference

## Key differentiators



**Rich experience in financial services:** Our experience working with banks on emerging non-financial risks across the last several years has streamlined our approach to how such risks are to be integrated with existing risk management frameworks; be it across policy and governance, identification and assessment, or monitoring and reporting.



**Deep expertise in credit rating models:** We have worked with the largest banks in India on rating model re-development, aligning model structures to business requirements and leading practices, while ensuring optimal balance between risk assessment and ease of business use



**Accelerators and enablers:** All this experience, specifically focused on the credit and climate change intersection, has led to the development of this scoring methodology for ESG assessment for credit appraisal; this is supported by working prototypes that can be customised across the methodology to align with banks' credit and ESG strategies



**Quant-oriented skill-sets:** The team has significant experience in several statistical modelling techniques that can be leveraged to assess and quantify climate risks such as risk modelling, survival analysis, stochastic calculus, multivariate modelling, time series analysis, loss reserving, contingency modelling, and financial analysis



**Global expertise and network:** Our team that focuses on climate risk considerations is supported by a global network of experts in this area, who have led and delivered transformational engagements at large banks in response to regulatory experiences, as well as liaising with regulatory authorities in shaping expectations related to risk management and disclosures.

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