The Problem Of Greenwashing In ESG Investments In Finance

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Why ESG investors, financial firms in India must form a shared intellectual framework to measure efficacy of financial inclusion.

At the start, ESG investments supported financial inclusion investments in India well. Today, this community is much more skeptical about the problem of greenwashing, where what is claimed to be ESG, in truth is not. While it is easy to make claims about facilitating financial inclusion, it is more difficult to establish that it improves the quality of lives of the less well-off. While renewable energy visibly fits ESG, financial firm investments are viewed with skepticism. Solving this problem requires financial inclusion measures that are used by investors and financial firms. This can be built through an input-output-outcome approach for financial inclusion of a household. Here, input is participation, output is usage, and outcome is the ability of a household to manage their expenses well, both in the present and in their perception of how well they can manage it in the future. Such measures about the customers of a financial firm can both identify the financial excluded, as well as capture impact in response to changes in financial participation.

What Is The Problem Of Greenwashing?

It is useful to illustrate with an example of two standard pathways of financial inclusion: an *affordable housing* loan and an *agricultural* loan. The first may be used to finance house purchases in Mumbai worth Rs 8-10 lakh, while the second may be used to finance the purchase of cows. The second may be considered financial inclusion for the otherwise excluded. These are just two possible financial services and products. There can be further nuances: the affordable housing loans may be solely for working women. The agricultural loan may be several hundred cattle. The problem is whether the end product is a match with the defined investment mandate.

These pose two layers of difficulty in matching investment to mandates. The first is when the fund manager promises to invest in financial inclusion. How does the investor verify that this is taking place? The second is when the fund manager invests in a business doing financial inclusion. How does the fund manager verify this? When the measurement is weak, there will partly be bad decisions about where to allocate capital, but there will definitely be less effort towards financial inclusion. In the early stages of the ESG revolution, there was more tolerance and complacency about these problems. Later, there was a proliferation of ESG ratings. This met with the well-known problem of Goodhart's law: any measure that becomes a target ceases to be a good measure. There was an upsurge of criticism of the mechanical application of ESG evaluation, which then led to more tough questions about impact.

What Measurement Strategy Should Be Adopted For Financial Inclusion?

There are many measures offered, all of which have their own failings. The typical administrative measure counts the fraction of bank loans to retail customers, or the total number of bank accounts, or the insurance products sold. The biggest failing here is that these do not cover all products or services that the formal financial system offers. Other than bank accounts, there is little information that is reliably available about insurance, pensions, post office savings accounts and others. More recently, the number of UPI transactions are cited as how much the payment systems have become digitised. But these do not capture the impact of financial inclusion because these do not show how much household earnings is withheld for ready use in future expenses or how often they use cash in a day.

One measurement strategy learnt from public policy is to use a *input-output-outcome* approach. A useful illustration is from education: investments are made to build schools and hire teachers. But these generate more educated people only if the children attend schools, and if they learn to read, write and count fluently. The investments into schools are an *input*. Attendance and passing exams are *outputs*, and literate, numerate children are the *outcomes*.

When this strategy is applied to financial inclusion, the current standard measures capture only how the average household *participates* in the formal financial system. This is the *input* to financial inclusion. *Output* measurement is about how the average household *uses* finance. An example can be how frequently an account is used by an account holder during the year, on average, or what fraction of their transactions are done using digital means.

The most elusive measure in this strategy is the *outcome* of financial inclusion. What is the benefit to the household, once household members participate financially? This requires more thought about what finance is and what it seeks to achieve. The first principle's understanding is that finance can or should help a household do the following: be able to manage regular expenses *irrespective of unexpected changes to income*, and be able to reach higher standards of living. Those households, which face challenges in managing their consumption, need finance more. Several countries now conduct household *well-being* surveys to capture their perception about their resilience to future shocks, and their ability to achieve their aspirations. Such outcome measures are used to demonstrate the impact of financial inclusion to investors.

In a recent study, a financial inclusion input-output-outcome survey was conducted on 300 microfinance customers in India. The study found that customers' financial participation was correlated with financial well-being. This relationship was small but significant, even after adjusting for the income level of the household and the physical assets that the households held, and supports the idea that financial inclusion matters for household well-being.

Conclusion

ESG investors and financial firms in India need to form a shared intellectual framework about how financial firms will measure the extent to which they are, indeed, doing financial inclusion. Once this is done, there can be a manifold increase in ESG investment into finance.

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