Regulatory Mandates On ESG Investing Fall Short Of Ensuring Impact

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While ESG investing has emerged as an important phenomenon worldwide, in India this has grown slower than anticipated. There is now a great deal of concern about the soundness of ESG investing, with two main problems.

First, there is a growing anxiety over green-washing in ESG investing globally, with stakeholders questioning the increasingly mechanistic nature of ESG investing. Complying with the disclosures framework enables firms to make claims of social impact without accountability towards the same. The second is the problematic method of fusing E, S and G into a single score or a standardised framework for investment decision-making. This limits the ability of an ESG fund to serve the cause its investors support. The ESG ecosystem is essentially a delicate dance of firms desiring investment and engaging with a diverse array of ESG funds on such questions.

The Securities Exchange Board of India has been actively developing the space of ESG investment, steering a disclosures-driven agenda for Listed Entities to make enhanced disclosures that are intended to be more compatible for ESG fund investments and their mandates.

The difference between voluntary and mandatory disclosures lies in the cost-benefit analysis. Forced disclosures induce higher compliance costs for the affected firms, some of which may not want to attract ESG investment. From this perspective, the recent set of amendments raise questions about the costs of the disclosures, and implications these place on the incentives and actions of various stakeholders in the ESG landscape.

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How this cost-benefit trade-off affects stakeholder incentives is especially important to consider in emerging market conditions, where domestic stakeholders typically have constrained access to liquidity and leverage, and market development tends to be slow. Thus, while the effect of these costs do not apply to the vast global ESG investment pools, it will have a significant effect on how the nascent domestic ESG funds grow.

India's ESG disclosure compliances have been evolving. The first was the Business Responsibility Report, which was mandated for the top 100 LEs (2012), and was gradually expanded to cover the top-1,000 by 2019.

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In 2021, the Core Business Responsibility and Sustainability Reporting was introduced, with disclosure mandates on the LEs. Most recently, SEBI approved amendments to the SEBI (Listing obligations and Disclosure Requirements) Regulations (2015) and the SEBI (Mutual Fund) Regulations (1996) to standardise disclosures and enhance the quality and reliability of disclosures made by ESG fund managers. These have new implications for three sets of domestic ESG participants.

For Listed Entities

BRSR Core introduces ESG disclosures and assurance for the value chain of listed entities, with certain thresholds of assurance that must be specified. The BRSR is a significant added cost, relative to the mandated disclosures in BRSR Comprehensive (2021). There is a transition path in the design of the policy—the top 150 LEs must comply by FY24 and the top 1,000 by FY27. But this is an additional cost to doing business for all eligible LEs.

For ESG Asset Management Companies (Ffunds)

ESG funds/schemes must now invest at least 65% of assets under management in LEs which provide BRSR Core disclosures. They are mandated to take third-party assurance and Board certification on compliance with the objective of the ESG scheme. ESG funds must disclose voting decisions by the Board on matters pertaining to all three elements of ESG separately and fund managers are liable to release commentary and case studies demonstrating the ESG strategy in place. All these impose explicit and tangible costs on the fund manager, and in exchange, the benefits that accrue to these actions remain unclear.

For ESG Rating Providers

The requirement of third-party assurances means that rating providers are henceforth required to factor in 'emerging market' parameters into their ratings. In addition, ERPs must also undertake the issuance of a separate category of ratings called 'Core ESG rating'.

For the nascent ESG industry in India, it is evident that the new SEBI rules bind in terms of higher costs of disclosure and escalates the cost of doing business for all the stakeholders. This is likely to have some predictable influences on the incentives and future actions of these stakeholders.

ESG fund management companies are of value to investors, who are otherwise unable to assess the ESG credibility of investment choices. When these funds incur the costs of complying with their customer disclosure requirement, they benefit from repeat investments by their customers. A similar cost-and-benefit is unclear when it comes to mandatory requirements.

Instead, there is the danger of complacency in investments. Mandatory investments into BRSR Core compliant LEs will reduce incentives for an ESG fund manager to go the extra mile on developing tools and techniques for the measurement of tangible outcomes from their investments. Both ESG fund managers and ESG rating providers are likely to fall into the trap of complacency in monitoring.

Lastly, the benefits of this policy rests on the usefulness of information mandated by the BRSR Core requirements. It remains to be seen whether these are effective in aligning LE incentives whilst designing management KPIs. What is required is to monitor the link between disclosures and firm choices towards ESG outcomes, for which we need better measurement.

ESG funds focus on long-term social impact to achieve environmental, social and governance transformations within companies. For an Indian LE seeking substantial ESG investment, the target investor is from offshore, who is likely to bring with it access to global ESG finance and a significantly higher volume of finance. This base will not be perturbed by these new disclosure requirements.

The new SEBI rules are curtailing the potential of a growing ESG market in India. Introducing standardised reporting mandates drives focus away from measuring impact to monitoring compliance. For example, it is perfectly possible to have a coal mining company that does disclosures well, and a small wind energy company that does not.

These recent amendments may enhance the eligibility of the top 1,000 firms that are mandated to comply with BRSR Core. But it reduces the flexibility of these funds to support and grow the vast base of ESG-potential entrepreneurship fermenting across India.

Susan Thomas is a Senior Research Fellow at XKDR Forum and a Research Professor of Business at Jindal Global University. She has worked across numerous engagements such as the design of the NSE-50 ("Nifty") index, as a member of the Standing Council on the competitiveness of the Indian Financial Sector (2013), and the Bankruptcy Legislative Reforms Committee (2014). She also led the research team that designed and drafted the Insolvency and Bankruptcy Code (2016).

Charmi Mehta is a researcher with XKDR Forum, Mumbai. Her research interests lie in the fields of public finance, government contracting and energy policy.

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