ESG & Board of Directors

Arun Duggal
Chairman
ICRA Ltd.

For Board of Directors, things were simpler in the past: their mission was clearer. They mostly followed, Friedman Doctrine, particularly in the US. Milton Friedman of Chicago University in his famous essay in 1970 said "The social responsibility of Business is to Increase its profits". Interestingly he published this essay in New York Times, a liberal publication and not in Wall Street Journal, a conservative paper.

Over time the thinking on Social responsibility for business have changed and how! Over the last decade there has been a lot of soul searching and there have been several initiatives to broaden the approach to the Purpose of business. The most significant development was in 2019 when the Business Round Table (in the US) adopted that Purpose of a Corporation is to serve all its Stakeholders: Customers, Employees, Suppliers, Communities, and Shareholders.

The mechanism for expressing Corporate Purpose evolved to include ESG (Environment, Social and Governance) considerations besides shareholder value creation. The investment community also concluded that companies with better ESG performance produce superior Financial results .Therefore, a very large portion, over 25 Trillion dollars of capital, has been invested in superior ESG performing companies mostly in the US, Europe, Japan and Australia.

In India also, both international and domestic investors are allocating more capital to companies with superiors ESG performance. Green Bonds have emerged as a separate Fixed Income asset class for loans for environmental up-gradation including Clean Energy. In India, in the last two years, eleven SEBI registered ESG Mutual Funds have been launched with current AUM of 12,000 Cr.

In this article, we will try to provide some suggestions and guidance to Board of Directors of Indian Companies in relation to understanding and improving ESG performance of their companies.

1. The first step should be to develop a common understanding among Board Members on ESG phenomenon by a presentation to the Board by experts on the ESG and how it may impact their company and its valuation. In this presentation, the components of ESG, i.e. Environment, Social and Governance INF the factors in each of these components should be discussed. For example in E i.e. Environment, factors like Climate change or carbon Foot print of the Company, Air pollutant emissions, Energy, particularly, Thermal Power consumption, Water Consumption, effluents, etc. need to be understood . Similarly in Social: gender balance, equal opportunity, training, Health and safety, R&D, innovation, etc. are important factors. In Governance: Composition and Skill set of Board of Directors, effectiveness of the Board, Compliance with regulations, reputation of the company, ethical standards, customer focus, need to considered . The Board also needs to understand Investor expectations and evolving regulatory requirements in relation to ESG.
2. The next important step is outside-in view; i.e. how others are viewing ESG Rating of your company. MSCI is the most well-known Rating Agency, but there are Refinitiv (part of LSE Group), Sustainalytics (Part of Morning Star) and a few other Rating organizations. MSCI has the largest market share (around 70%) and has seven rating categories AAA, AA, A, BBB, BB, B, and CCC. Refinitiv has 10 rating categories from A+ to D-. Sustainalytics measures ESG Risk as: Negligible (0-10), Low (11 to 20), Medium (21 to 30) High (31 to 40) and Severe (40+). Board should ask the Management to make a presentation on all the Ratings received by the company. They should also present the comparative Ratings of other companies in the same industry.
3. Management should also review and explain to the Board as to what are the weaknesses identified by Rating Agencies in the Company, the reasons why its ESG rating is not higher. Generally, issues relating to ESG rating will fall in the following categories (i) Incorrect Information (ii) Incomplete information (iii) Easily Fixable factors and (iv) Factors, which will take time and effort to fix. A discussion with Rating Agencies to provide correct/ additional information and to understand their perspective will be most useful.
4. Management should also compare and analyses in depth the factors which have a negative impact on its rating and study competitors who have better rating and why. For example if a company has MSCI rating of BBB and two of its competitors have A and AA ratings, it would be very useful to analyze as to reasons for competitor's better rating and get insights for improving your company's rating.
5. The company should have discussions with its top 10 investors on ESG subject and ascertain specific issues the investors are concerned about. The Board should, based on these inputs, review if any modifications are appropriate in the long term

strategic plans for the company. This may include new business opportunities relating to clean energy, batteries, etc.

6. The Board should set up a Board Sub Committee on ESG. Even though it is not required under regulation at present, it is likely to become mandatory in the next few years. The ESG Committee and the CSR Committee should function separately though there may be a small overlap. The CSR Committee oversees the CSR process as mandated by Companies Act and with various actions and reporting requirements as per the government. On the other hand, ESG Committee's goal is to improve ESG performance of the company, to better serve company's various stakeholders, attract more capital from ESG investors and thus improve its financial Valuation of the company. Therefore the two committees, which have different objectives, should be kept separate, but should coordinate their activities.
7. The Company, under the guidance of ESG Committee should develop an ESG Improvement Plan which should identify Short term and Long Term Action steps and prioritize them. It should also identify executives responsible for various action steps, resources required and time lines for implementation.
8. This ESG Improvement Plan should have 10 to 20 clearly articulated Action Steps covering Environment, Social and Governance which will result in maximum positive impact on its rating. For example, it could include on Environment: Carbon Foot Print improvement, Lower emissions, more water harvesting and recycling, lower power consumption per unit of output and higher renewable power, On Social: it could have improved supply chain standards, percentage of women in employees, senior executives and Board Members, Training coverage and budget, Employee Opinion Survey, Customer Satisfaction and net Promoter Score, R&D expenditure as a % of Revenue. In Governance : In Board Composition & Skills , Board and CEO, Succession Plan, Board Effectiveness (independent assessment), CXO Compensation structure & linkage to ESG targets, adherence to Code of Conduct, Related Party transactions, Company's reputation and Controversies, etc. For Financial Institutions this may include Portfolio Quality, women customers - depositors and borrowers, MSME lending, Automated processes and technology leadership, green bonds and lending, etc.
9. The ESG Committee should periodically (at least twice a year) review progress on ESG Improvement Plan, and make any changes, if required. It should make sure that the progress on Implementation Plan is Shared with ESG Rating organizations and with major investors. It should make a presentation to the Board on ESG matters at least once a year.

10 It should review the ESG impact of all major Capex proposals and its assessment should include in Board presentation for Capex approval.

11 The ESG Committee along with NRC should include ESG related Performance goals for CEO and CXOs.

12. ESG Committee along with Audit Committee should oversee statutory disclosures in relation to the "Business Responsibility and Sustainability Report" (BRSR Report) mandated by SEBI.