Corporate India and the New Focus on ESG

Dr. Mukund Rajan

FORUM
OF FREE ENTERPRISE

“Free Enterprise was born with man and shall survive as long as man survives”.

- A. D. Shroff

Founder-President

Forum of Free Enterprise

SHAILESH KAPADIA

(24-12-1949 – 19-10-1988)

Late Mr. Shailesh Kapadia, FCA, was a Chartered Accountant by profession and was a partner of M/s G.M. Kapadia & Co. and M/s Kapadia Associates, Chartered Accountants, Mumbai.

Shailesh qualified as a Chartered Accountant in 1974 after completing his Articles with M/s Dalal & Shah and M/s G.M. Kapadia & Co., Chartered Accountants, Mumbai. Shailesh had done his schooling at Scindia School, Gwalior and he graduated in Commerce from the Sydenham College of Commerce & Economics, Mumbai, in 1970.

Shailesh enjoyed the confidence of clients, colleagues and friends. He had a charming personality and was able to achieve almost every task allotted to him. In his short but dynamic professional career, spanning over fourteen years, Shailesh held important positions in various professional and public institutions.

Shailesh's leadership qualities came to the fore when he was the President of the Bombay Chartered Accountants' Society in the year 1982-83. During his tenure he successfully organized the Third Regional Conference at Mumbai.

Shailesh was member, Institute of Fiscal Studies, U.K.; member of the Law Committee and Vice-Chairman of the Direct Taxation Committee, Indian Merchants' Chamber. He was also a Director of several public companies in India and Trustee of various public Charitable Trusts.

He regularly contributed papers on diverse subjects of professional interest at refresher courses, seminars and conferences organised by professional bodies.

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Corporate India and the New Focus on ESG

Dr. Mukund Rajan*

This article offers a perspective on the rising importance of ESG for Corporate India. This is drawn from my new book, 'Outlast – How ESG Can Benefit Your Business', co-authored with Colonel Rajeev Kumar.

ESG is a term which has entered the lexicon in a big way over the past two years, though it was first crafted over a decade and a half earlier. The "E" in "ESG", Environment, encapsulates the natural resources a business consumes, the pollution it creates, the carbon emissions it generates and many other environmental impacts. The "S", Social, refers to the links and ties a business develops with the local community, the way it treats its own

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people, and its focus on issues such as diversity and inclusion. “G”, Governance, deals with issues such as board effectiveness protocols, audit controls, appropriate reliance on independent directors, and approach to senior executive compensation.

ESG issues are seen to critically influence the sustainability of businesses. Their performance on material ESG criteria offer insights into their resilience in difficult times.

In India, such resilience was severely tested during the ongoing COVID-19 pandemic. It exposed the excessive short-termism of many Indian businesses, with limited financial reserves and an inability to sustain overheads beyond a few weeks. During the migrant labour crisis, the values many in the corporate sector professed to adhere to also came under scrutiny, for their treatment of stakeholder groups like workers and their decisions to terminate jobs.

The pandemic exposed the ESG vulnerabilities of many Indian businesses. If you dig deeper, it could even be argued that India is in the midst of what many would describe as an ESG crisis.

An ESG Crisis?

Let us start with governance, the G of ESG. The crisis is reflected in the volume of cases brought under the Insolvency and Bankruptcy Code to the National Company Law Tribunal – 13,000 and counting - and their linked impact on the high Non-Performing Assets in the Indian banking system, a big reason for India's economic under-performance. Beyond just failed strategies, the concern is that too many companies have suffered from ethical misconduct and exceptionally weak corporate governance.

Turning to the E of ESG, unfortunately the economic activity of Corporate India has yielded some of the worst environmental indicators in the world. 22 of the 30 most polluted cities in the world in terms of air pollution are in India, and data from the Indian Council of Medical Research (ICMR) suggests that air pollution kills over a million Indians each year. Of India's land mass of 328 million hectares, just under half, around 147 million hectares is undergoing some form of degradation due to deforestation, drought, and improper agricultural practices. And twenty-one of India's largest cities are projected by the Niti Aayog to run out of ground water, affecting 100 million people.

On the social dimension too, the S of ESG, India suffers from some of the worst indicators in the world. India, for instance, has one of the lowest levels of female participation in the workforce anywhere in the world at 22.2% – the global average is around 48.5%. Likewise, there has been poor absorption of representatives of the Scheduled Caste and Scheduled Tribe (SC/ST) communities in corporate workforces.

Stakeholder Reactions

Yet, the evidence on ESG is not all negative. The ESG crisis in India is stimulating important, mostly constructive reactions from stakeholders. For instance, growing public awareness and judicial activism are helping to force the pace of change towards better ESG practices. The issue of air quality in the National Capital Region is a good example. Between temporary fixes like the odd-even traffic rules to reduce vehicular traffic, or the bans on diesel gen-set operation and on construction and demolition activities; and more permanent actions like the migration of the Indian auto industry from the Bharat Stage 4 to Bharat Stage 6 fuel emission standards, bypassing Stage 5 altogether, or the measures being deployed to promote electric vehicles, or the scrappage policies designed to get old, polluting vehicles off the roads, a lot is being done to address the problem.

Judicial pronouncements are also becoming more aggressive, as can be seen from this quote from the Madras High Court's August 2020 judgment on a case relating to an industrial unit in Tuticorin – *"Economic considerations can have no role to play while deciding the sustainability of a highly polluting industry and the only consideration would be with regard to safeguarding the environment for posterity and remedying the damage caused."*

There are also strong regulatory tailwinds in favour of a powerful new focus on ESG in India. These include the 2018 'National Guidelines on Responsible Business Conduct' (NGRBC), designed by the Ministry of Corporate Affairs to mainstream the concept of Corporate Responsibility. These guidelines have been integrated into the Business Responsibility and Sustainability Reports that the Securities and Exchange Board of India (SEBI) has directed the top 1000 listed companies to publish, from this fiscal on a voluntary basis and from the next fiscal on a mandatory basis.

Parallelly, regulations with a significant focus on good governance are also influencing the conduct of Indian corporates. The key regulators, including SEBI, the Insurance Regulator IRDAI, and the Pension Fund Regulator PFRDA, have each defined Stewardship Codes, which emphasize ESG requirements, for institutional investors across the mutual fund, insurance and pension fund sectors in India. Going by an indicator like the rising 'against' votes by these investors on AGM and shareholder resolutions, they are beginning to flex their muscles.

In similar vein, the 2013 amendments to the Indian Companies Act strengthened the hands of minority shareholders, for instance mandating Approval of Related Party Transactions by Special Resolution. As a consequence, over the past several quarters, we have seen minority shareholders express their upset on matters such as unreasonably high management compensation packages, which they have proceeded to vote down, or voted out directors up for re-election who they felt did not discharge their responsibilities adequately. India has in fact been rated amongst the best countries in the world in terms of shareholder rights protection in the World Bank's Doing Business 2020 Report.

The 2013 Companies Act amendments also stipulated mandatory rotation of auditors to improve the quality of audits and reduce the risk of auditor-client collusion. And keeping Indian corporates on their toes are a clutch of stakeholder groups including proxy advisory firms and activist funds that are demanding better accountability. In this context, it is worth recollecting the efforts of Elliot Management, the activist fund that took a strong position on the strategy of Cognizant and essentially persuaded the company to use some of its free cash to buy-back shares in 2017; after that effort, the cash-rich Indian IT services industry as a whole has undertaken share buy-backs over the next four years in excess of Rs 100,000 Cr. We can expect more of such activism in the near future in the Indian market, and indeed, likely collaboration between activist investors seeking to influence change in the companies they target.

Changes in the Indian ESG landscape are also being catalysed by actions of stakeholders overseas. One of the critical drivers of this is the increasing concern about global environmental issues.

The Impact of Global Warming

Global environmental issues impact the whole world, and no single country can on its own successfully address them, so cooperation between nations is a must. The argument is the same as in the case of COVID 19 – nobody is safe until everybody is safe.

Examples include Ozone Depletion and the Loss of Biodiversity, but clearly Climate Change caused by global warming is the most pressing concern just now. Based on the work of the Intergovernmental Panel on Climate Change, there was a consensus at the recent 26th Conference of Parties on Climate Change or COP26 in Glasgow to go well beyond the 2015 Paris Climate Treaty target of a 2 degrees rise in global temperatures by the turn of the century, to instead target a lower 1.5 degrees rise.

We are seeing the impact of this in the European Commission's recent adoption of a proposal for a Carbon Border Adjustment Mechanism to address the climate change crisis. We are seeing it in the regulatory actions of countries like the UK which recently announced that UK-listed companies must release net-zero plans by 2023; it is only a matter of time before other markets follow suit. We are seeing it in the higher sustainability standards which multinational enterprises like Unilever and Nestle, which have declared 2039 and 2050 as their target years for achieving net zero status, are demanding from their supply chain participants from India. We are seeing it in the thrust of lenders on reporting of material climate-related risks by businesses in their financial filings. We are seeing it in the behaviour of investment funds which are demanding greater carbon disclosure and strong mitigation measures; some have already started decarbonizing their portfolios, like Norges Bank. We are seeing it in citizen movements that have evolved around the world, such as the one that persuaded the UK Parliament to declare a climate emergency, or the school strike made famous by Greta Thunberg.

India, as the third largest greenhouse gas producer in the world after China and the US, is key to how the world will resolve the problem of global warming. And so we saw at Glasgow, the Indian government announcing a significant enhancement in its earlier targets adopted after the Paris Climate Agreement. It has declared 2070 as the target date for achieving net zero status and promised to generate 500 GW of non-fossil fuel-based energy by 2030, with 50% of the energy mix from renewables by 2030, while improving the energy efficiency of the economy by 45% over 2005 levels by 2030. India is also anchoring the International Solar Alliance, where it is promoting its One Sun-One World-One Grid initiative.

The Influence of International Stakeholders

Beyond global environmental issues, thanks to the interconnectedness of markets, overseas stakeholders are influencing other aspects of the agenda of Corporate India. These include customers across the globe who are increasingly demonstrating a preference to embrace purpose-driven brands like “Patagonia” and “The Body Shop”. This is the reason a market leader like Unilever resolved last year that each of its 70,000 products would carry labels showing their carbon footprint.

The international business community's sense of global risks over the past decade has also evolved, to now include many ESG related risks. Where in 2009 and 2010 only one societal risk, 'Chronic disease', was reported by the members of the World Economic Forum (WEF) and no environmental risk featured in the top five in terms of impact, by 2021, four of the top five risks are related to societal or environmental issues.

To address corporate malfeasance and abuses, governments overseas are responding with new legislations and compliance requirements which often come with cross-jurisdictional and extra-territorial impact. For instance, under the UK Bribery Act, it is entirely possible that Indian companies could be prosecuted in the United Kingdom for corrupt practices in totally different geographies, such as in Africa, merely by virtue of having a small footprint in the United Kingdom.

Activists and non-profits who want to hold Indian companies to account for their ESG lapses are meanwhile conducting international campaigns against them. Examples include the campaigns against Indian companies involved in mining or plantation activity, that have allegedly failed to meet threshold standards of corporate responsibility. Likewise, the #MeToo campaign, championed across the world on social media, quickly went viral and felled some prominent Indian personalities.

Indian businesses are also being tasked to perform on the Sustainable Development Goals or SDGs defined by the United Nations, traversing issues ranging from poverty alleviation to addressing climate change. The SDGs have essentially fused the global with the local, and created an interest of the international community in the way in which local issues are now being addressed within countries.

Within this evolving international ESG landscape, foreign investors are making their preferences clear. Over $100 Trillion of invested funds around the world have now subscribed to the United Nations Principles for Responsible Investment or the UNPRI. These Principles require investors to incorporate ESG issues into their investment analysis and decision-making processes.

The European Commission has put out regulations that require all asset managers in the European Union to disclose the ESG performance of their investment portfolios, which include many Indian companies. We should expect that Indian businesses that are non-compliant on critical ESG issues will be progressively excluded from the investment portfolios of the largest fund managers in the world.

The Indian market is likely to see significant impact from foreign investors seeking promising ESG stocks that offer good risk-adjusted returns. This last is a trend that has picked up momentum, and there is now a great deal of academic literature to show that a greater focus on ESG typically yields greater resource use efficiency, lower cost of operations, reduced risk, lower cost of borrowing and greater prospects for valuation rerating. In the Indian market, this is borne out by the consistent outperformance of the MSCI India ESG Leaders Index when compared to the broader benchmark index for most periods of time since its inception in 2007, including the past three, five and ten-year periods. Similar consistent outperformance is witnessed with the NSE's Nifty 100 ESG Index when compared with the Nifty 100 Index.

In essence, capital, both as equity and as debt, will be allocated in the future primarily towards well-governed Indian companies that contribute to the goals of a more sustainable economy and society.

Embracing an ESG Agenda

Forward looking Indian companies recognise these pressures for change. More companies are emerging which are clearly doing the right thing – this is the reason the number of companies rated A or higher on their ESG ratings by MSCI, for instance, has increased from 19% of the pool to 26% in the past five years. This positive impact of the many diverse pressures for change is reconfirmed by another assessment of the NSE 100 companies and their S&P ESG scores, which shows that there has been an overall increase in the average score of the NSE 100 companies, which has increased in just this past year from an average of 33.6 to 39.2, an increase of 16.6%, with the number of companies scoring above 70, the highest bracket, doubling in one year from 7 to 14.

So, what do forward looking companies do differently? First, they accept the need for change. A good example is India's largest private sector company, Reliance Industries, which has acknowledged the climate change issue by setting a target to become net carbon-zero by 2035.

Next, they put in place the right governance structures to develop and execute ESG strategies that are relevant for them, spanning what are called "material" issues. Material ESG issues will vary across sectors, so climate change may be a material ESG issue for a large fossil fuel-based energy consumer like a steel company, but may not have the same relevance for, say, a company that offers web design services.

In seeking to create a governance focus, we find increasing numbers of companies like Infosys, Ashok Leyland and Airtel that have created dedicated ESG Committees of the Board. Key interventions to strengthen governance typically cover investment in training and strong evaluation protocols; diversity right at the top, including in board composition, with an adequate complement of well qualified Independent directors and a strong chairperson; and deployment of a well-designed Code of Conduct and an ethics framework that addresses pervasive issues in the Indian context including dignity and respect at the workplace, conflict of interest, bribery, corruption, and the need to have a strong whistleblower mechanism.

We see a greater focus in forward looking businesses on resource use efficiency and embracing the circular economy practices that minimize waste and extend life across product life cycles. Through this, they also de-risk as much as possible the volatility we see in raw material and commodity prices. They try and attach a relevant cost to natural resources, including carbon. They prioritize better design to assist product reuse and repair, and recycling of waste.

They also recognize that many ESG enhancement measures are no-regrets measures that require little by way of capital investment; investments in renewable energy or energy efficiency improvement, for instance - a great example is the shift to more energy efficient lighting solutions with LEDs - have high returns on investment and can pay for themselves quite swiftly.

Such businesses embrace their supply chains in their progressive actions. They recognize that the MSMEs that form a significant part of the supply chain account for close to half the actual resource consumption that takes place within the economy. In sectors like auto where huge disruption is on the cards for many component suppliers who are wedded currently to the internal combustion engine, EV OEMs are beginning to extend significant support so these component manufacturers can pivot their business models.

Indeed, forward-looking companies are constantly innovating and pivoting their business models to find competitive advantage. Thus, when Tata Power found itself at the receiving end of portfolio decarbonization initiatives by major investors, it chose to pivot towards renewable energy and away from coal-fired thermal power. The same company is also now trying to build non-traditional collaborations, stimulating the green energy market by offering green power to subscribers who are willing to pay a higher price per unit of electricity.

It is well known that R&D has traditionally been an area of weakness for Indian businesses. India's R&D spends at around 0.7% of the GDP are far lower than China, at over three times that percentage on a far higher GDP base, and the developed markets like the US, Japan and Germany. However, we may be seeing this begin to change. Certainly, there are a range of innovations and new business opportunities emerging across areas like Electric Vehicles, EV Batteries, Green Hydrogen, high efficiency materials, biomass to energy, more water and energy efficient agricultural techniques, meat alternatives, carbon credits trading and carbon capture and storage.

Forward-looking enterprises are also endeavouring to improve diversity within their workforces. This includes gender diversity, the employment of more representatives of the SC/ST communities, and the recruitment of those who are physically challenged. Visionary leaders recognise that such endeavours don't cost much, but deliver outsize gains, including in employee motivation, brand value and reputation.

Such organizations also often demonstrate heightened awareness about their responsibilities towards the welfare of local communities. They leverage their CSR spending obligations to become neighbours of choice. They also champion corporate volunteering by their employees, as the Tata Group does, and seek to link their CSR endeavours with volunteering opportunities. This enhances the pride their employees feel in the organization, improves employee engagement levels and helps deliver powerful social outcomes which draw from the skill sets their employees possess.

Just as global leaders like Microsoft and Indian ESG leaders like Marico are doing, the best companies are now linking ESG performance on critical issues like carbon emission reduction and workforce diversity improvement to appropriately benchmarked executive compensation. As they say, what gets measured gets improved, and linking senior executive compensation to ESG outcomes forces the pace of change.

Integral to the link with compensation is a strong focus on measurement of ESG parameters that are material to their operations, tracking performance over time, and making transparent disclosures. There are multiple reporting frameworks being used, including the Global Reporting Initiative or GRI and Integrated reporting or IR.

While a universal framework, to be crafted by the new International Sustainability Standards Board announced at Glasgow at COP26, is still some distance away, and we therefore lack a common vocabulary that assists transparency and comparability across sectors and markets, the Business Responsibility and Sustainability Report mandated by SEBI or the BRSR will offer one valuable tool for Indian businesses to communicate their ESG commitment. In the past, there have been allegations of non-transparency of data and “greenwashing”. With the guidelines issued for the preparation of the BRSR reports, such gaps will be scrutinised intently by a varied set of stakeholders, including regulators, analysts, proxy firms, activists, the media and others, and you can expect both naming and shaming as well as withdrawal of investments when the gaps are particularly egregious.

Meanwhile, a clutch of decision support service entities, like MSCI, Sustainalytics, Crisil, Acuite and others are processing the voluminous data becoming available on ESG performance and coming out with ESG ratings. Forward looking businesses engage with such ratings providers and ensure they are provided the appropriate data to secure fair ratings.

A Note of Caution

But despite all this activity, it would be a mistake to conclude that all is going well with Corporate India’s response to the new ESG challenges. There are still large gaps in the response, and I will call out two in particular. The first is the tendency of many Indian businesses, with a few honorable exceptions, to resist change until they are forced by regulation and the threat of penalties.

Take for example the strongly adverse reaction of the Indian two-wheeler industry, the world's largest, to the call of the Niti Aayog to embrace full electrification by 2025. Akin to the leapfrog that took place in Indian telecoms from fixed line services to mobility, resulting in a massive telecom and IT led transformation of the landscape of opportunities in India, the Indian two-wheeler manufacturers could similarly have considered the possibility of leapfrogging and leading India and the world down the path of electrification. But this determination to own the future seemed to be missing, and instead the Niti Aayog got strong push-back from the two-wheeler industry to drop its 2025 target.

You see this tendency to delay the onset of regulation and resist change in industry after industry - from delays sought in eliminating single-use plastics that go on to choke city drainage systems or litter the oceans, to the delays sought in implementing the directive to thermal power plants to deploy Flue Gas Desulphurisation plants designed to reduce air pollution across India. While it might be possible to deflect the attentions of regulators for some time, the question these companies need to ask is whether their customers will continue to be forgiving.

Many commentators, including the marketing guru Philip Kotler, have pointed out how consumers are beginning to re-examine what they consume and how much they consume. Consequently, as Harvard Business School Professor Rebecca Henderson argues, “We need to move from a world in which environmental and social capital are essentially free – or at least someone else’s business – to a world in which the need to operate within environmental limits within a thriving society is taken for granted.”

The second gap you see in Corporate India’s response is with the way in which Micro, Small and Medium Enterprises or MSMEs are included, or not included, in the plans of the larger corporates in India to tackle ESG challenges like climate change. Just as the developing countries expect help and support from the developed countries to tackle global environmental issues, the MSMEs need the help and support of the larger, technologically adept and well financed corporates in India. It is unclear, however, that this is going to happen on the scale required to secure the interests of a major part of the MSME community.

There are two major risks that follow as a consequence of these gaps in Corporate India's response to the new ESG challenges. First, if the transition to a more ESG friendly future is not undertaken in a calibrated manner and we see significant job losses in the MSME and informal sector, there will be a significant exacerbation of inequality in India and resultant social tension. Already, as we learnt from this year's Oxfam India report, inequality is at an all-time high in India. The top 10% of the population controls 45% of the nation's assets, and the wealth of fewer than a 100 families is more than that of 550 million Indians at the bottom of the pyramid. This leads me to the second major risk that follows.

This is the risk that community protests will lead to the heavy hand of government on business. For the business community that has repeatedly pleaded for regulatory shackles to be lifted, and that has broadly expressed its intent to embrace free enterprise, greater government intervention would represent a significant setback to its vision of growth. It is therefore in business's own enlightened self-interest to address the challenges that loom large, ahead of time.

In sum

In conclusion, ESG indicators are becoming a critically important measure of how businesses are performing. As the principle of shareholder primacy gets overtaken by a modern standard of corporate responsibility that advocates value creation for all stakeholders, Corporate India has no choice but to move swiftly to embrace this new focus on ESG.

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

“People must come to accept private enterprise not as a necessary evil, but as an affirmative good”.

- Eugene Black
Former President,
World Bank

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