

# **Leveraging ESG Principles for sustainable growth & Risk Assessment**

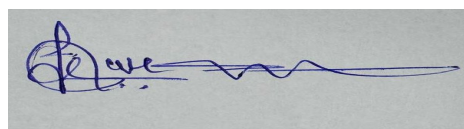
## Cover Page of Abstract and Case Study

The participants/team should mention the following details on the front page:

|                         |                                                                               |
|-------------------------|-------------------------------------------------------------------------------|
| Title of the Case Study | <b>Leveraging ESG Principles for sustainable growth &amp; Risk Assessment</b> |
| Theme of the Case Study | ESG, the Future of Banking                                                    |
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### CERTIFICATE OF ORIGINALITY

This is to certify, that the Case Study and the Facilitation Note submitted by me/~~us~~ are an outcome of our independent and original work. We have duly acknowledged all the sources from which the ideas and extracts have been taken. The project is free from any plagiarism and has not been submitted elsewhere for publication / presentation.



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Date: 26/Sep/2024

Place: Mumbai

**Abstract:**

This case study focuses on evaluating and integrating Environmental, Social, and Governance (ESG) principles into the credit risk assessment process for financing large infrastructure projects. It aims to assess both the risks and opportunities that arise from ESG factors and their long-term implications for the borrower and the bank. Specifically, the study will evaluate the ESG risks associated with financing XYZ Infrastructure Ltd., examining how these risks impact the financial viability of the project and the bank's portfolio.

Additionally, the case study explores how the adoption of ESG principles can promote sustainable business practices within XYZ Infrastructure Ltd. By emphasizing sustainability, the project can contribute to broader societal and environmental goals while maintaining profitability. Suitable risk management approaches, viz. Rejections, or Structuring sustainability-linked loans (SLL), will be analysed to balance financial returns with ESG compliance and corporate responsibility.

A structured decision-making framework will be provided, offering a roadmap for integrating ESG criteria into the bank's credit risk assessment processes. This will help the bank make informed lending decisions that align with its long-term sustainability objectives and risk management strategies. Lastly, the study will address the importance of aligning the bank's lending practices with evolving regulatory expectations, investor demands, and market trends, ensuring that the bank strengthens its reputation as a responsible and sustainable financial institution.

## **Title: Leveraging ESG Principles for sustainable growth & Risk Assessment**

### **Objective:**

The objective of this case study is to explore how ABC Bank can integrate Environmental, Social, and Governance (ESG) principles into its credit evaluation process to promote sustainable growth while effectively assessing and mitigating associated risks. Specifically, the case study aims to:

1. **Assess the ESG Risks and Opportunities:** Evaluate the potential environmental, social, and governance risks associated with financing a large infrastructure project and how these risks impact the long-term financial viability of both the borrower and the bank.
2. **Promote Sustainable Business Practices:** Examine how ESG principles can incentivize sustainable development within XYZ Infrastructure Ltd., ensuring that the project contributes to long-term societal and environmental goals while maintaining profitability.
3. **Balance Risk and Reward:** Analyse the bank's options in managing ESG-related risks through various approaches, including conditional loan approvals, rejection, or structuring a sustainability-linked loan (SLL). The case study aims to provide insights into how the bank can balance financial returns with ESG compliance and corporate responsibility.
4. **Enhance Decision-Making Framework:** Provide a structured approach for integrating ESG criteria into credit risk assessment frameworks, helping the bank make informed lending decisions that align with its long-term sustainability objectives and risk management strategies.
5. **Align with Regulatory and Market Expectations:** Align the bank's lending practices with evolving regulatory expectations, investor demands, and market trends toward sustainability, enhancing the bank's reputation as a responsible financial institution.

This case study seeks to demonstrate how adopting ESG principles can create value for both the bank and its stakeholders, while contributing to a sustainable future.

### **Background:**

This case study explores the challenges faced by ABC Bank as it integrates Environmental, Social, and Governance (ESG) principles into its corporate credit risk assessment framework. The bank is evaluating a ₹2,000 crore term loan application from XYZ Infrastructure Ltd., a

large infrastructure company planning to expand into renewable energy with a solar project in Rajasthan. While the company demonstrates reasonable financial stability, with a Debt Service Coverage Ratio (DSCR) of 1.25 and a leverage ratio of 2.75x, it faces significant ESG-related risks.

XYZ Infrastructure has a history of environmental non-compliance, including ₹50 crore in penalties for violations in 2023, and ongoing social challenges such as labour strikes and community opposition to its projects. Additionally, concerns have arisen over the company's corporate governance, particularly around transparency and related-party transactions. These ESG factors present potential risks that could affect the company's long-term sustainability and, consequently, its ability to service the loan.

The case prompts credit analysts to assess how the ESG risks impact the company's creditworthiness beyond traditional financial metrics. It challenges participants to decide whether the loan should be approved and, if so, under what conditions. Analysts must consider ESG-related mitigants, such as stricter environmental compliance, improved labor practices, and enhanced governance oversight.

Furthermore, the case encourages exploration of alternative financing options, including structuring the loan as a sustainability-linked loan (SLL), where interest rates could be tied to the company's achievement of specific ESG milestones. Ultimately, this case study highlights the increasing importance of integrating ESG considerations into banking practices to mitigate risk, promote sustainability, and align with the growing regulatory and market focus on sustainable finance in India.

## **Problem Statement**

ABC Bank is considering a ₹2,000 crore term loan application from XYZ Infrastructure Ltd., a large infrastructure company transitioning into renewable energy by developing a solar power project in Rajasthan. While XYZ Infrastructure has demonstrated financial capability, with a Debt Service Coverage Ratio (DSCR) of 1.25 and a leverage ratio of 2.75x, the company's ESG (Environmental, Social, and Governance) performance raises significant concerns.

Historically, XYZ Infrastructure has faced multiple environmental penalties totalling ₹50 crore for non-compliance with regulations, posing potential future risks of operational delays or further penalties. Additionally, ongoing social issues, such as labour strikes and local community protests, could disrupt the project, leading to higher costs and delays. Governance-

related concerns, particularly around the transparency of related-party transactions and weak board oversight, further complicate the risk profile.

The bank's credit committee is tasked with deciding whether to approve the loan, considering both traditional financial metrics and emerging ESG factors. While the company's financial health indicates repayment capacity, the ESG risks introduce potential uncertainties that could affect the long-term viability of the project and the borrower's creditworthiness. The problem centres on how to integrate ESG principles into the bank's credit risk framework and whether the loan can be approved with risk mitigants such as additional ESG conditions or structured as a sustainability-linked loan (SLL).

This case study challenges analysts to assess the potential impact of ESG risks and recommend a course of action that balances financial returns with sustainability.

### **Options Available to ABC Bank for the ₹2,000 Crore Loan to XYZ Infrastructure Ltd.**

In response to the loan request from XYZ Infrastructure Ltd., ABC Bank's credit committee faces a multifaceted decision involving traditional financial metrics and the integration of Environmental, Social, and Governance (ESG) principles.

The company's expansion into renewable energy through a solar power project in Rajasthan presents both opportunities and challenges, particularly regarding the company's historical ESG performance.

The credit committee has two possible courses of action:

1. **Loan Rejection**
2. **Sustainability-Linked Loan (SLL)**

Each of these options offers a different approach to balancing financial returns, ESG risks, and sustainability goals. Below is a detailed analysis and justification for each option.

#### **Option 1: Loan Rejection**

Given the significant ESG risks, the bank may choose to reject the loan application outright. This option is based on the premise that the risks associated with XYZ Infrastructure's weak ESG performance outweigh the financial benefits of the loan, potentially jeopardizing the bank's own sustainability objectives and risk profile.

## **Reasons for Loan Rejection:**

### **High ESG Risk:**

The company's history of environmental violations and ongoing social issues present significant risks. While XYZ Infrastructure is moving toward renewable energy, its past record shows a pattern of non-compliance that may continue in the future. The financial penalties incurred in 2023, totalling ₹50 crore, underscore the severity of these risks.

**Justification:** The bank has a responsibility to uphold its own ESG commitments, and lending to a company with a poor environmental and social record could harm the bank's reputation. Furthermore, the ongoing labor and community protests increase the likelihood of project delays, which could negatively affect the company's cash flow and repayment capacity.

### **Governance Weaknesses:**

XYZ Infrastructure's governance structure lacks transparency, particularly concerning related-party transactions. This weak governance poses a risk of financial mismanagement or even fraud, which could ultimately affect the company's ability to repay the loan.

**Justification:** Inadequate governance controls increase the risk of operational inefficiencies and ethical lapses, which can directly impact financial performance. Rejecting the loan avoids the potential fallout from such risks.

### **Bank's ESG Commitments:**

As part of its ESG framework, ABC Bank has committed to financing/ supporting those projects that meet its sustainability criteria. Lending to a company with poor ESG performance contradicts the bank's commitment to sustainable finance and could lead to reputational damage among investors, regulators, and customers.

**Justification:** To maintain its reputation as a responsible lender, ABC Bank must uphold its ESG principles. Rejecting the loan demonstrates the bank's commitment to aligning its lending portfolio with sustainability goals.

## **Pros of Loan Rejection:**

**Avoidance of Risk:** By rejecting the loan, the bank eliminates its exposure to the significant ESG risks associated with XYZ Infrastructure's business practices.

**Reputational Protection:** Rejection of the loan safeguards the bank's reputation as a responsible financial institution committed to sustainable lending practices.

**Focus on Stronger ESG Projects:** Loan rejection frees up capital that can be redirected to companies with stronger ESG records, better aligning the bank's portfolio with its sustainability objectives.

#### **Cons of Loan Rejection:**

**Loss of Financial Opportunity:** ABC Bank would lose the opportunity to finance a large-scale renewable energy project that could provide significant returns. Additionally, the bank may miss out on future business from XYZ Infrastructure as the company grows in the renewable energy space.

**Competitive Disadvantage:** Rejecting the loan could result in XYZ Infrastructure seeking financing from competitors, potentially damaging the bank's relationships in the infrastructure sector.

**Missed Chance for ESG Improvement:** By rejecting the loan, ABC Bank forfeits the opportunity to influence XYZ Infrastructure's ESG practices through its financing conditions.

#### **Option 2: Sustainability-Linked Loan (SLL)**

The second option involves structuring the loan as a **Sustainability-Linked Loan (SLL)**. This approach ties the loan's terms to the company's achievement of specific ESG targets. Under this structure, XYZ Infrastructure would benefit from reduced interest rates or other favorable terms if it meets pre-agreed ESG milestones. Conversely, failure to meet these milestones could result in penalties or higher interest rates.

#### **Structure of the SLL:**

##### **ESG Targets:**

XYZ Infrastructure must achieve specific, measurable ESG improvements, such as reducing its carbon emissions, obtaining environmental certifications, or resolving labor disputes. These targets must be clearly defined and agreed upon at the outset.

**Justification:** By setting measurable ESG targets, the SLL incentivizes the company to improve its ESG performance. This structure aligns the bank's financial interests with its sustainability goals, creating a win-win scenario.

#### **Interest Rate Adjustments:**

If XYZ Infrastructure meets its ESG targets, it would benefit from a lower interest rate, rewarding its progress in sustainability. If it fails to meet the targets, the interest rate would increase, compensating the bank for the increased risk.

**Justification:** The adjustable interest rate motivates the borrower to prioritize ESG improvements while protecting the bank's financial interests in case of non-compliance.

#### **Ongoing ESG Monitoring:**

XYZ Infrastructure would be required to provide regular reports on its ESG performance, with independent audits to verify progress.

**Justification:** Continuous monitoring ensures transparency and accountability, allowing the bank to track ESG improvements and adjust loan terms accordingly.

#### **Pros of an SLL:**

**Incentivizing ESG Improvements:** The SLL structure encourages XYZ Infrastructure to improve its ESG practices, aligning with the bank's commitment to sustainable finance.

**Financial Return with Risk Management:** By linking the loan terms to ESG performance, the bank manages its risk exposure while still benefiting from the financial returns of the loan.

**Positive Impact on the Client:** This approach positions the bank as a partner in XYZ Infrastructure's sustainability journey, potentially strengthening the long-term relationship between the two entities.

#### **Cons of an SLL:**

**Complexity in Structuring:** SLL requires detailed negotiations and clear definitions of ESG targets, which can be time-consuming and complex to implement.

**Uncertain ESG Outcomes:** While the SLL incentivizes ESG improvements, there is no guarantee that the company will meet its targets, potentially leaving the bank exposed to ongoing ESG risks.

**Monitoring Costs:** The bank will need to invest in ongoing monitoring and audits to ensure that the company is meeting its ESG targets, increasing administrative costs.

Both options available to ABC Bank—Outright rejection, or structuring the loan as a sustainability-linked loan—each offer different ways to balance the financial and ESG risks posed by XYZ Infrastructure’s loan application.

Loan rejection avoids the risks entirely but sacrifices potential financial gains. The sustainability-linked loan (SLL) incentivizes ESG improvements while protecting the bank’s financial interests.

**Considering the fact that benefits of Option-2 outpaced the risk involved, the Bank shall go for Option-2 in view of the risk appetite, ESG commitments, and long-term strategy for sustainable finance.**

Further, in order to attain a Win-Win situation, Bank may offer various innovative Products, which shall suit the XYZ Infrastructure’s requirement/s and Bank’s commitment for a sustainable finance by keeping in mind the Bottom line.

In order to Leverage on Bank’s commitment for financing through ESG Principles Complied Products, the ABC Bank may develop & offer following products, which shall serve the purpose.

## **1. ESG-Linked Loans:**

**Description:** Loans that link interest rates to the borrower’s overall ESG performance. These loans incentivize companies to meet environmental, social, and governance targets, such as reducing emissions, improving labour conditions, and strengthening governance.

**Business Leverage:** By offering ESG-linked loans, a bank can foster sustainable growth across industries while reducing its risk exposure. Companies that meet their ESG targets are often more resilient and attractive to investors, lowering the bank's credit risk.

## 2. Green Supply Chain Financing:

**Description:** Financing solutions that help businesses make their supply chains more sustainable. This could include funding for suppliers that reduce their environmental impact or improve labour conditions.

**Business Leverage:** By supporting green supply chain financing, banks enable companies to enhance the sustainability of their operations while opening new business opportunities in sectors focused on ethical sourcing and responsible production.

## Conclusion

By developing and offering innovative financial products that align with ESG principles, banks can capitalize on the growing demand for sustainable finance solutions. This enables them to tap into new markets, reduce risk exposure, and build stronger relationships with clients who prioritize sustainability.

Each ESG pillar—environmental, social, and governance—offers unique opportunities for product development, allowing banks to drive business growth while promoting a more sustainable and equitable economy.