Environmental and Social Management System (ESMS) Policy

Muthoot Microfin Ltd

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1) Overview of Muthoot Microfin Ltd (MML)

Muthoot Microfin Limited (MML), the microfinance arm of Muthoot Pappachan Group is one of the leading and fast-growing microfinance institutions (NBFC-MFI) in India. The MML has focused on providing micro-loans to women entrepreneurs with a focus on rural regions of India.

There has been increasing awareness of business activities' environmental and social impacts. Environmental risks can include the depletion of natural resources, pollution, climate change, and biodiversity loss. Social risks can include human rights violations, labour rightsa violations, community displacement, and negative impacts on local cultures.

One of the most active tools used to judge the impact of business activities on environmental and social is the Environmental and Social Management System (ESMS) policy. The Environmental and Social Management System (ESMS) Policy draws from several international frameworks, environment management guidelines and other applicable national regulations considering the risk and sustainability of business activity.

An Environmental and Social Management System (ESMS) summarises a set of policies, and tools to identify and manage its exposure to the environmental and social risks of business activities.

- **Microfinance institutions identified environmental and social risks**

In recent years, the microfinance sector, like many other industries has started to look at its environmental and social impact. According to the existing literature, adapted green microfinance programs that help microentrepreneurs identify and manage environmental risks and opportunities could thus bring them benefits on a triple bottom line: environmental including reduction of environmental risks, social like improved working conditions, reduction of health and safety hazards and economic including sustainability of livelihood, improved efficiency, new business opportunities.

There are two main approaches to evaluating the environmental performance of microfinance institutions. First, measuring operational performance, or outcomes, and Second, assessing management performance, or processes.

According to the existing literature, microfinance institutions can obtain five strategies to cover environmental and social risks. They are (1) adopting environmental policies (2) reducing the internal ecological footprint; (3) managing portfolio environmental risks (4) providing green microcredit, and (5) providing environmental nonfinancial services.

Having an ESMS policy is perhaps the best possible integrated solution to cover environmental and social risks.

2) Objectives of the Policy

The primary objective of the Environment and Social Management System (ESMS) of MML is to mainstream environmental and social deliberations into business activities and safeguard institutions' investments from credit, and reputational risk. The ESMS will ensure compliance with applicable local and national laws on environment, health, and safety standards and International Finance Corporation (IFC) Performance Standards. MML ensures timely communication of various environmental and social objectives to its stakeholders, along with proper mechanisms for handling queries/ grievances. The Company shall also provide adequate capacity-building measures to identify and monitor environmental and social risks, including senior management, environmental and social (E&S) officers, and support team.

Benefits of integrating ESG risk assessment:

- Ability to attract stable investors: ESG investing involves long-term focus on value creation through Responsible Investment and ESG focused investors bring in capital for a longer horizon.
- Reducing cost of capital: Firms with ESG focus have been successful in reducing their cost of capital by having access to cheaper source of funding

- Identifying and managing material ESG risks: which are likely to convert in to credit/asset value risks in future for the organization.
- Identifying and mitigating reputational and liability risks: associated with ESG factors for the organization
- Enhancing the Brand value and reputation of the Bank: as a responsible financial institution and as an employer of choice

3) Scope of the policy

The ESMS framework will be integrated into MML's existing credit/ loan appraisal systems and standard operating procedures. At the time of loan applications, the exclusion list will be used to reject applications whose purpose falls within activities in the exclusion list. The appraisal format will include possible environmental and social risks associated with the said activity and the borrowers will be subject to appropriate risk categorisation based on the type of activity. Appropriate monitoring and reporting formats will be prepared to effectively identify and mitigate the environmental and social risks.

3.1- Applicability of ESMS Policy – The microfinance industry has a favourable impact on the well-being of the weaker section of society. In best practice, MML shall have an ESMS policy. MML E&S policy shall ensure compliance with national and state governments' objectives, requirements, regulations, guidelines and IFC performance standards.

3.2- Availability & Review – This ESMS policy is accessible on MML's web portal. This policy document would be reviewed periodically subject to the change in the regulation and business practice. The ESMS should be reviewed at least once every year.

3.3- Responsibility – The E&S Manager is responsible for preparing and updating the ESMS Manual periodically in consultation with the concerned members.

4) Structure of ESMS Policy

The microfinance industry has a favourable impact on the well-being of the weaker section of society. In best practice, MML shall have an ESMS policy. MML E&S policy shall ensure compliance with national and state governments' objectives, requirements, regulations, guidelines and IFC performance standards. The governance structure shall consist of 4 pillars including members of the board, the Chief Risk Officer, Credit Risk Department and the ESG-Sustainability Committee.

Key Member	Role
Board Members	ESMS policy is approved by the Board of Directors and is subject to annual review by the Board.
Chief Risk Officer (CRO)	The CRO will closely work with ESG-Sustainability Committee, and shall be responsible for developing and maintaining the ESG Risk Register of the company
Credit Risk Department	• Approve and monitor the E&S Risk in credit analysis. • Responsible for capturing the E&S grading in the sanction order and ensuring that the E&S Risk Assessment is conducted for the borrower as per the policy guidelines.
ESG-Sustainability Committee	• The committee should be headed by an Executive at the top management level. • The Committee ensures the integration of economic, social and environmental considerations for business strategies. • To ensure the conduct of periodic E&S monitoring and ESMS policy implementation and modification as per need base. • To review and modify the exclusion list.

5) E&S Risk Assessment Framework

To ensure the mainstreaming and implementation of the policy, the MML shall establish an ESG-Sustainability Committee; comprising senior representatives across key business segments. The MD & CEO and the ESG-Sustainability Committee have a key role in E&S risk assessment. The ESG-Sustainability Committee will be responsible for ESMS implementation.

The E&S risk assessment framework comprises the following procedures

- ❖ Screening of proposals based on the exclusion list
- ❖ E&S Risk Categorization (Part of the ESG Risk Register)

❖ Screening of proposals based on the exclusion list

MML Shall ensure that it shall not extend any loans that fall under the IFC exclusion (prohibited activities) list for microfinance institutions as mentioned below –

- Production or trade in weapons and munitions.
- Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements, or subject to international bans,
- Production or trade in alcoholic beverages (excluding beer and wine)
- Production or trade in tobacco
- Gambling, casinos, and equivalent enterprises
- Production or trade in radioactive materials. This does not apply to the purchase of medical equipment, quality control (measurement) equipment and any equipment where IFC considers the radioactive source to be trivial and/or adequately shielded.
- Production or activities involving harmful or exploitative forms of forced labour /harmful child labour
- Production, trade, storage, or transport of significant volumes of hazardous chemicals, or commercial-scale usage of hazardous chemicals
- Projects located within a zone for the protection of surface water or groundwater.
- Project construction involving more than minimal pollution or entails health and safety risks
- Projects located on contaminated land from historical land uses
- Projects that could result to the reduction of community resource
- Projects involving wet manufacturing activities which generate industrial wastewater
- Projects that could result in damage to known or unknown physical cultural resources

❖ E&S Risk Categorization

The risk categorization is based on the ESMS policy. The Loan applications broadly fall into 2 different categories allied to specific periods- Medium Risk and low Risk. The climate risk has become an integral part of environmental risk assessment applicable to all projects. The high-risk category does not apply to MML based on the portfolio mix which has low E&S risk.

1) **Medium Risk Proposals -** Proposals that fall under this category typically have moderate negative environmental and social impact and appropriate risk mitigation measures are available for the majority of the E&S risk parameters. Medium-risk proposals are escalated for a focused review and approval by the BU Head.
2) **Low-Risk Proposals** - Proposals falling under this category have minimal environmental and social impact. The checker reviewing these proposals is required to check whether the minimum E&S criteria applicable are

met, and BU Head is authorized to provide approval for such low risk projects. Most of the MML projects fall under this category

3) **Climate Risk**- Climate change is a reality and is affecting every walk of our life. Compounded by other facets of environmental changes, viz. land-use changes and natural resource degradation, climate change impacts on natural systems and processes compound to produce extreme events and disasters, causing serious damages and losses to lives, infrastructure and resources. Climate risk can be caused by the physical effects and changing weather patterns that result from climate change or by efforts to reduce and eliminate the greenhouse gas emissions that cause it.

Climate risk is usually divided into two broad categories:

• "Physical risks" refer to the financial risks from the increasing severity and frequency of climate related extremes and events (i.e. acute physical risks); longer-term gradual shifts of the climate (i.e. chronic physical risks); and indirect effects of climate change such as public health implications (e.g. morbidity and mortality impacts).

• "Transition risks" refer to the financial risks related to the process of adjustment towards a low greenhouse gas (GHG) economy. These risks can emerge from current or future government policies, legislation, and regulations to limit GHG emissions, as well as technological advancements, and changes in market and customer sentiment towards a low-GHG economy.

Category	**Parameters**	**Tool**
Low-Risk Proposals	Minimal or no adverse social or environmental impacts from the borrower activity.	Due to the small ticket size* and low E&S risk involved in this segment, an undertaking has been drafted for the customer. This will only be a declaration taken by the customer by MML to ratify the declaration made.
Medium Risk Proposals	Moderate social or environmental impacts from the borrower activity.	Low to moderate E&S risk involved in this segment, however declaration taken by the customer is sufficient.
*The average ticket size for the entire portfolio is around Rs INR 57,000/. Source -MML Q4 FY'24 Earnings Conference Call" May 07, 2024.		

Measures to mitigate climate risk for non-banking financial institutions (NBFCs)-

The first step is to Integrate climate risk assessment into the overall risk management framework. This includes:

- Integrate climate risk into capital adequacy assessment process
- Define key risk indicators for all stakeholders
- Setting targets for KRIs
- Developing process to measure and report progress towards targets

6) Monitoring & Review

MML will incorporate environmental and social compliance as a part of its existing operational audit/risk monitoring procedures. The MML will ensure that all the loans are properly evaluated against the Exclusion List. Periodic loan utilisation checks will be conducted to ensure adherence to the ESMS policy. Any incidences of non-compliance will be discussed with the customers, and they will be encouraged to comply with the required environmental laws, regulations, standards, and procedures. MML will ensure proper reporting of its environmental and social performance on a quarterly basis. The E&S officer will submit the ESMS compliance report to the CEO. CEO will subsequently report to the Board of Directors.

7) E&S Due Diligence

MML shall conduct E&S due diligence in respect of all borrowers, pertaining to environmental and social aspects, failing under the scope of ESMS policy. The due diligence shall be conducted by the field force consisting of loan officers, branch managers, and area managers. This will include annual customer declaration on ESG compliance and absence of prohibited activities. The internal audit and risk management process shall also integrate E&S risk assessment to understand how the E&S risks are managed by the borrowers. The E&S due diligence will also recommend a corrective action plan to help the borrower take the required measures within the stipulated time to mitigate the E&S risks.

Following are major steps for conducting ESG due diligence:

- Identifying ESG risks and opportunities -
- Evaluating ESG performance metrics-
- Conducting stakeholder engagement
- Integrating ESG into loan portfolio making decision

The scope of E&S due diligence shall be to cover the critical E&S risks, understand how the same are being managed by the borrower and the residual risks that are not capable of cure. It shall also include compliance with National E&S laws and E&S performance standards.

8) Roles and Responsibilities for Implementing the ESMS

MML shall ensure clearly defined roles and responsibilities for the effective implementation of the ESMS framework. This shall entail an integrated approach to sustainability, involving various functions and departments in the MML. Implementation of ESMS is an organisation-wide activity involving coordination of the ESG-Sustainability Committee, legal department and all other departments dealing with credit administration, risk management, compliance management, legal reporting, human resources and training and information technology, and any other relevant committees and sub-committees. The overall responsibility will be with the ESG-Sustainability Committee.

The specific roles are as indicated below:

- Board of Directors – Signatory of the E&S Policy
- CEO – Assumes overall accountability with respect to the ESMS implementation on behalf of MML
- ESG Officer – Coordinate with all stakeholders on the ESMS to ensure implementation of the ESMS and revise/update the ESMS as required. Monitor/Track the progress of the implementation and overall compliance of the ESMS within MML.
- Risk Team – Undertake of E&S Risk assessment and mitigation of key risk areas
- Credit team – Monitor the implementation of ESMS procedures
- Operations Team – Assist in the implementation of ESMS procedures and conduct E&S screening to ensure primary implementation of ESMS procedures
- Legal Team – Review of MML's legal agreements and advice on matters requiring legal expertise
- IT Team – Development of platforms to house the ESMS tools for better controls
- Internal Audit Team – Review the operation of ESMS and various compliances on the same at regular intervals.

- HR Team – Develop training modules on ESMS procedures

The responsibilities of the Board of Directors under ESMS are listed below:

- Approve the E&S Policy and review its continuing suitability and effectiveness periodically.
- Provide leadership in the management of E&S aspects of the loan transactions.
- Review the activities under the ESMS at least once every year.
- Approve the changes to the ESMS as applicable.

The responsibilities of the Managing Director under ESMS are listed below:

The overall accountability with respect to the ESMS responsibilities will be vested on the CEO. In specific he/she will be responsible to:

- Maintain oversight on the implementation of the ESMS.
- Ensure the availability of adequate resources (human, technological and financial) to enable effective functioning and continual improvement of the ESMS.
- Suitably address any grievance arising from the customers with regard to concerns on E&S issues when escalated.

The responsibilities of the ESG officer under ESMS are listed below:

The ESG Officer at MML will be responsible for the overall implementation of the ESMS. He/she will have working knowledge of the reference framework of the ESMS, and the procedures developed under the ESMS. The ESG Officer will also coordinate with different stakeholders, including the internal team, management, customers, and investors. The ESG Officer will be competent and qualified enough to execute the ESMS Policy and Plan. If need be, MML may also appoint an external consultant to assist the ESG officer.

The responsibilities of the ESG Officer are as follows:

a) Act as a focal point for all E&S-related activities with internal and external stakeholders.
b) Ensure that all process steps linked with E&S risk assessment such as action planning, and periodic reporting on E&S aspects are carried out for all transactions.
c) Conduct E&S Monitoring annually in coordination with the Risk team and ensure E&S risks (if any) are addressed.
d) Maintains a log of all ESG-related grievances received from stakeholders and tracks the process of addressing the grievances.
e) Coordinate with the Internal Audit Department to conduct Internal Audit annually.
f) Coordinate and prepare E&S Reports for submission to investors.
g) Support the HR team in organizing training activities on aspects related to the ESMS.
h) Update the ESMS Manual based on operational experience.
i) Conduct and coordinate the Management Review meetings.
j) Report findings of the Internal Audit in coordination with the Internal Auditor to the Management for review.

Common Responsibilities Across Teams

The common responsibilities under the ESMS for all teams in MML are presented below.

a) Attend training activities conducted by the ESG Officer on ESMS.

b) Cooperate with the Internal Audit Department in the Internal Audit of the ESMS.

k) Assist the ESG Officer in any manner as may be required for implementing the ESMS in MML.

9) Deviation Management

The following are the deviations that may arise from the ESMS policy guidelines:

a. Deferral of ESMS policy.

b. Loans in which ESMS policy is applicable but the guidelines are not followed.

c. Borrower not agreeable to E&S guidelines.

d. Noncompliance with ESMS guidelines.

a. Deferral of ESMS policy- The deferral of ESMS policy should be discouraged. However, on a case-to-case basis

deferral can be allowed during a genuine business exigency by the ESMS committee.

b. Loans in which ESMS policy is applicable but the guidelines are not followed- There are possibilities that the application of the ESMS policy guidelines are not assessed for the eligible borrowers. Whenever such instances are identified by any of the offices or branches, the same should be reported to the ESG-Sustainability Committee through the ESMS team and as per the direction of the committee it should be completed.

c. Borrower not agreeable to E&S guidelines-

If the borrower is not agreeable to the prescribed E&S, the request should be submitted to the ESG-Sustainability Committee for the waiver/ relaxations considering the impacts of E&S risks identified and the risks that may arise in future.

The following should be submitted to the committee:

1. Request from the borrower and it should include the proposed compensating mitigates by the borrower.

2. Recommendation from the respective Business Head

d. Noncompliance with ESMS guidelines-

The noncompliance of E&S CAPs and guidelines included in the legal documentation and accepted by the borrower is a major issue and may cause potential risks. Such instances should be reported to ESG-Sustainability Committee.

ESG-Sustainability Committee has power for the following in case of the above-mentioned four deviations if required:

- Recall of the account
- Reduction of limit
- Hike in ROI

10) Training and Capacity Building

MML will ensure that all personnel participating in implementation of the ESMS are competent on the basis of appropriate education, training, or experience, and will retain associated records.

MML will also identify training needs associated with E&S aspects of their customers' operations and its ESMS, will provide necessary training during an orientation programme which will be conducted quarterly focusing on reporting requirements and will retain associated records. An ESG Training and Awareness programme shall be created for the MML Training team, who will then impart the knowledge to all other MML personnel.

The team at MML at each relevant function and level will be made aware of:

- MML E&S Policy
- The importance of conformity with the E&S Policy and Procedures of the ESMS
- The risks to MML from negative impacts of customers on environment, labour & working conditions, and occupational health & safety and benefits of improved performance
- Scope and overall reference framework for ESMS
- Their roles and responsibilities in achieving conformity with the requirements of the ESMS

A training will be provided to all personnel that will be participating in implementation of the ESMS once the E&S Policy and ESMS are approved by the Company's management. Induction training for new joinee and ongoing refresher training on the ESMS will also be conducted for all relevant personnel. The E&S aspects of customer business will also be covered during these trainings. To Provide training and awareness program on the importance of ESMS activity and encouraging certifications on Sustainable finance from external institutions for employees.

11) Reference Framework

Indian Legal Requirements

The environmental regulations in India address protection of environment and natural resources that form the input to any process or activity as well as for management and handling of pollutants released from a process or activity and the social regulations in the country address concerns related to land acquired or purchased for development of a project; and employee/ worker welfare, health, and safety for those engaged in a project. Many of these environmental, and occupational health and safety (EHS) and labour welfare regulations will be applicable to MML and its customers.

12) Stakeholder Engagement

MML recognizes the business and reputational risks that exist due to poor stakeholder relations and as a result, has developed a broader, inclusive, and continuous process of engagement which is described in detail in the sub-sections below.

Stakeholder Engagement Plan

MML's key stakeholders and their criticality from the perspective of MML's ESMS and E&S performance of their transactions are identified and assessed based on the following: The planned approach for engaging with each of the stakeholders has been presented in Table 2 below.

Table 1: Stakeholder Engagement Plan				
Stakeholder	**Purpose of Engagement**	**Engagement Method**	**Minimum Information to be Disclosed by MML**	**Inputs Expected**
Customers (direct)	•Building and maintaining Company reputation •Growing company business	•Loan Agreement with E&S loan covenants •Personal discussions during credit appraisal and reporting •Response to queries/ grievances	•MML E&S Policy •E&S loan covenants •Responses to concerns raised	•Reporting of serious incidents •Suggestions on improving E&S performance •Reporting of grievances
Employees (direct)	Ensure implementation of ESMS in operations	• Induction training on ESMS • Training and awareness raising on ESMS implementation	• MML E&S Policy • Roles and responsibilities of each team under ESMS	Suggestions on improving E&S performance
Investors (direct)	Reporting and discussion on implementation of ESMS	• Investment Agreement with Investor • Annual E&S Performance Report • Response to queries	• MML E&S Policy • Disclosure on E&S performance of MML and its customers • Response to concerns raised if any	• Suggestions on improving E&S performance of customers and MML's ESMS • Human and financial resource allocation for improving E&S performance
Regulatory Authority (indirect)	No direct engagement	None	None	None

13) Conclusion

ESMS policy will enable MML to minimise the negative environmental and social impact posed by the lending activities. The policy proposes to ensure funding to the borrowers whose business activities are sustainable and environment friendly. This will be achieved through meticulous risk categorisation of the borrowers and by ensuring that the funds lent by MML will be used for purposes/activities that have minimal impact on the environment and society.

Annexure 1: IFC Performance Standards

The IFC Performance Standards 2012 are an internationally accepted benchmark for identifying and managing Environment & Social risks and have been adopted by many organizations as a key component of their environmental and social risk management. IFC provides technical guidelines with general and industry-specific examples of good international industry practices to meet IFC's Performance Standards.

USF has adopted the IFC Performance Standards ('IFC PS') as published by the IFC on 1 January 2012 and shall apply for the duration of the Fund life, unless there are material changes which shall be addressed at the time and with the advisement of the Fund's advisory board.

USG's Portfolio Companies will also align themselves with these requirements laid down in IFC PS. However, USF understands that such consideration has to pass the test of materiality, context, and feasibility given that some of the Portfolio Company may be in very early stage of their operations.

The scope and intent of the IFC Performance Standards is completely or significantly addressed by Indian E&S regulatory framework. When requirements of IFC PS and national regulations/standards differ; portfolio investments are expected to achieve whichever is more stringent. If less stringent levels or measures are appropriate given specific circumstances, a full and detailed justification for any proposed alternatives is needed as part of the site-specific environmental assessment. This justification should demonstrate that the choice for any alternate performance levels is protective of human health and the environment.

The IFC Performance Standards encompass the following eight topics[1]:

PS1: Environmental and Social Assessment and Management System: Portfolio Investments are required to manage the environmental and social performance of their business activity, which should also involve communication between its workers, and the local communities directly affected by the business activity. This requires the development of a good management system, appropriate to the size and nature of the business activity, to promote sound and sustainable environmental and social performance as well as lead to improved financial outcomes.

PS2: Labour and Working Conditions: For any business, its workforce is a valuable asset and a sound worker-management relationship is a key component of the overall success of the enterprise. By protecting the basic rights of workers, treating workers fairly, and providing them with safe and healthy working conditions, commercial clients/investees can enhance the efficiency and productivity of their operations and strengthen worker commitment and retention.

PS3: Pollution Prevention and Abatement: Increased industrial activity and urbanization often generate increased levels of pollution to air, water, and land that may threaten people and the environment at the local, regional and global levels. portfolio companies are required to integrate pollution prevention and control technologies and practices (as technically and financially feasible as well as cost-effective) into their business activities. However, this PS could also be extended to issues like circular economy, resource (e.g., water and energy) conservation and GHG emission reduction in portfolio investments.

PS4: Community Health, Safety, and Security: Business activities can increase the potential for community exposure to risks and impacts arising from equipment accidents, structural failures, and releases of hazardous materials as well as impacts on a community's natural resources, exposure to diseases and the use of security personnel. Commercial clients/investees are responsible for avoiding or minimizing the risks and impacts to community health, safety and security that may arise from their business activities.

PS5: Land Acquisition and Involuntary Resettlement: Land acquisition due to the business activities of a portfolio investment result in physical displacement (relocation or loss of shelter) and economic displacement (loss of access to resources necessary for income generation or as means of livelihood) of individuals or communities. Involuntary resettlement occurs when affected individuals or communities do not have the right to refuse land acquisition and are displaced, which may result in long-term hardship and impoverishment as well as environmental damage and social stress. Portfolio investments are required to avoid physical or economic displacement or minimize impacts on displaced individuals or communities through appropriate measures such as fair compensation and improving livelihoods and living conditions.

PS6: Biodiversity Conservation and Sustainable Natural Resource Management: Protecting and conserving biodiversity (including genetic, species and ecosystem diversity) and its ability to change and evolve, is fundamental to sustainable development. Commercial clients/investees are required to avoid or mitigate threats to biodiversity arising from their business activities and to promote the use of renewable natural resources in their operations.

PS7: Indigenous Peoples: Indigenous Peoples are recognized as social groups with identities that are distinct from other groups in national societies and are often among the marginalized and vulnerable. Their economic, social, and legal status may limit their capacity to defend their interests and rights to lands and natural and cultural resources. Commercial clients/investees are required to ensure that their business activities respect the identity, culture and natural resource-based livelihoods of Indigenous Peoples and reduce exposure to impoverishment and disease.

PS8: Cultural Heritage: Cultural heritage encompasses properties and sites of archaeological, historical, cultural, artistic and religious significance as well as unique environmental features and cultural knowledge, innovations and practices of communities embodying traditional lifestyles, which are protected for current and future generations. Commercial clients/investees are required to avoid significant damage to cultural heritage due to their business activities.

if's Performance Standards offer a framework for understanding and managing environmental and social risks for portfolio investment, esp. during the E&S due diligence process.

This could be used as a widely accepted benchmark to improve E&S performance over time.

If non-compliances with the IFC Performance Standards are identified and depending on the severity of the issue, the financial institution can require the commercial client/investee to develop a corrective action plan for addressing the issue within a reasonable timeframe and stipulate this as a condition of the financial transaction with the commercial client/investee