# Channelling savings into ESG investments in India

Record levels of household savings provide a great opportunity for green deposit schemes in India. **Arjun Goswami, Ganesh Gopalakrishnan** and **Anmol Jain** of Cyril Amarchand Mangaldas explore how they can be promoted and regulated

India's climate change commitments at COP26, including its target to achieve net-zero carbon emissions by 2070, the carbon-reduction goals and the renewable energy-related promises to be met by 2030, require substantial funding. Meeting these targets necessitates the mobilisation of household savings in India, which are increasingly being channelled into financial assets.

In a recent report, the State Bank of India noted that, despite the pandemic, India's gross financial savings recorded a massive growth of INR7.1 trillion (approximately $93 billion) in FY 2020-21. This means that India has nearly doubled its savings in financial assets in just five years since FY 2016-17. This underscores the need to encourage retail investors to be key players in the transition of India's economy towards green and sustainable activities.

According to Reserve Bank of India data, the year-on-year growth rate in aggregate deposits for the third quarter of FY 22 is 9.6%, a substantial part of which comes from household savings. A strong characteristic of household savings is that they get parked as bank deposits.

As of June 2020, bank deposits constituted 56% of household financial assets. Consequently, incumbents and global banks operating both in India and in the Gujarat International Finance Tec City International Financial Services Centre (GIFT City IFSC) have a unique opportunity to leverage this flow of savings to build financial assets.

An increase in retail participation in green and sustainable projects would give impetus to India's green ambitions. In turn, green deposits could present alternative savings options for new retail investors and also be a source of capital for outward-facing environmental, sustainable and governance (ESG) investments from GIFT City IFSC.

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## Background to green deposit schemes

The market development of green deposit schemes as an arrangement to funnel household and corporate savings into green and sustainable projects is underway across various sectors including renewable energy, transportation, sustainable real estate, water management, waste-to-energy plants, bio-diversity conservation and agriculture.

The primary differentiator between green deposits and regular deposits is the aspect of fungibility. That is, proceeds from regular deposit schemes may be used for different investment purposes, whereas proceeds from green deposits will be earmarked for projects that specifically qualify as 'green', 'sustainable', etc. as per the bank's internal eligibility criteria.

Several banks, including IndusInd, Union Bank, HDFC and HSBC India, have launched green deposit schemes to finance the transition to a low-carbon, climate-resilient and sustainable economy. Most of these schemes were launched in 2021, but HSBC India, which launched its scheme in 2020, has already raised $400 million of green deposits.

## Future design opportunities for green deposit schemes

The RBI may, over time, review regulatory frameworks and policies covering deposits to identify areas that could assist the robust, orderly and sustainable growth of green deposit schemes.

Outside the domestic tariff area of India, GIFT City IFSC green deposit schemes regulated by the International Services Centres Authority (IFSCA) could offer more liberal design opportunities for the growth of green deposit schemes targeting certain classes of investors.

### Governance mechanisms

For instance, the RBI may consider exempting a portion of green deposits from net demand and time liabilities for the calculation of the statutory liquidity ratio. However, such measures must also consider default risks arising out of credit disbursals to nascent industries ('sunrise' sectors).

These risks must be managed through robust central bank monitoring, keen creditworthiness screenings, introducing robust disclosure norms and risk assessment modules, the engagement of trustworthy ESG assurance, audits and rating providers, and ring-fencing of riskier exposures to green and sustainable projects (if needed and relevant).

### Tenor and lock-in

Capital-raising activities for long-term projects must be based on instruments of similar tenor to avoid asset-liability mismatches. Therefore, any deposit scheme catering to these projects must be cognisant of tenor and must be designed accordingly.

Banks may decide to keep a longer lock-in period for these schemes to ensure a steady flow of finance to sustainable projects and to prevent any instances of asset-liability mismatches. However, as the market is still at a nascent stage, banks have the flexibility to test different lock-in periods while designing their deposit schemes. At present, this variance is clear: the lock-in period for Union Bank's green deposit scheme is 1,111 days (about 36 months), for IndusInd Bank it ranges from 344 days to 61 months, and for HDFC Bank from 18 months to 120 months.

Further, to ensure that deposits are not prematurely withdrawn, banks may exercise the option to offer term deposits above INR1.5 million without premature withdrawal option under paragraph 7(a)(iii)

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of the RBI (Interest Rate on Deposits) Directions, 2016 (RBI Master Direction on Deposits). The RBI may also consider reducing the INR1.5 million threshold to limit withdrawals. This would help prevent asset-liability mismatches in the case of bulk term deposits and enable proceeds from green deposits to be invested in long-term green loans with greater certainty.

In respect of the IFSCs, paragraph 4(vii) of module 10 of the IFSCA Banking Handbook Conduct of Business Directions (IFSCA COB) states that IFSC Banking Units (IBUs) must provide a premature withdrawal facility to individual depositors. The IBUs are not allowed to restrict premature withdrawal options for individual depositors beyond a certain threshold, as is the case with RBI-regulated entities. This may require re-examination by IFSCA if the IFSC is to attract offshore investors into green deposits beyond the domestic tariff area in India.

### Interest rate

Banks may elect to offer green depositors either an equal or slightly higher interest rate than under other conventional deposit schemes to balance out the uneasiness caused due to longer lock-in periods. However, this may lead to green finance becoming costlier for borrowers. Banks would also incur expenses on the green due diligence to be undertaken before and after disbursal of the loan amount. These costs may be somewhat recovered by digitising the deposit and loan-disbursal process. This would have the added benefit of contributing towards the performance of the bank on ESG parameters, while not financially disincentivising depositors.

In IFSCs, the IFSCA COB allows IBUs to determine the interest rate on term deposits and offer differential interest rates based on factors including tenor of deposits, size of deposits and availability of a premature withdrawal option. These factors are not exhaustive, and the IBU may use additional factors to arrive at an interest rate. Moreover, while the IBUs are mandated to offer the facility of premature withdrawal to individual depositors, the IFSCA COB permits them the flexibility to frame their "own policies regarding interest on premature withdrawal of Term Deposits … and penalty on premature withdrawal of Term Deposits".

In contrast to IFSCs, in non-IFSC areas, under paragraph 7(a)(ii) of the RBI Master Direction on Deposits, banks are allowed to offer differential interest rates only on bulk deposits (according to paragraph 3(1), for scheduled commercial banks, bulk deposits mean "single rupee term deposit of rupees two crore and above").

An exception may be sought under this provision providing that green deposits with a size higher than a floor amount (for example, of INR5 million, instead of the standard INR20 million and above limit) and made for a long period (for example, more than seven years), would be eligible for differential interest rates. Differential interest rate flexibility could, therefore, be linked to longer tenor in addition to the ticket size of the deposit, and the RBI may undertake certain changes to the existing differential interest rate framework to attract higher participation in the green deposit scheme.

The RBI may review paragraph 7(a)(i) of the RBI Master Direction on Deposits, which fixes the minimum tenor of the deposit at seven days. In the event of premature withdrawal of any deposit, banks must pay interest though at the rate applicable to the amount and period for which the deposit remained and not the contracted rate. Therefore, if the RBI amends paragraph 7(a)(i) to fix a higher

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minimum tenor for green deposits, for instance 12 months, it may create a deterrent against premature withdrawal of deposits (as no interest will be paid for any deposit withdrawn before completion of the minimum period under paragraph 7(b)(ii) of the RBI Master Direction on Deposits) and help banks in asset-liability management. This will also help guard against any bank runs on green deposits.

### Special contractual arrangements

Green deposits will be covered by the Deposit Insurance and Credit Guarantee Corporation deposit insurance cover of up to INR500,000. However, in the case of defaults in the green or sustainable finance activities undertaken by the bank, the use of other depositors' money towards writing off the bad debts on the accounting books may involve a moral hazard.

Therefore, green deposits may require special contractual arrangements allowing for their write-downs or tenor roll-overs in cases where green investments by the bank default on repayment. This would ensure that any higher credit risk on account of exposure to green and sustainable projects is managed entirely through a ring-fenced green deposit pool. Globally, however, there is an emerging discourse towards limiting the rigidity of ring-fencing in prudential regulation.

### Leveraging structured deposits

The IFSCA COB allows the IBUs to design 'structured deposits', which are term deposits fully repayable on maturity with interest rates that are linked to the underlying performance of reference assets, indices or other factors including financial instruments, commodities, physical assets and foreign exchange rates.

The IBUs may consider pegging the interest payable on green deposit on the performance of any eligible project or pool of projects and allow retail investors to finance a part of such projects through technologies such as real estate tokenisation. This also offers an opportunity for the IBUs to integrate blockchain applications into their commercial business activities and may offer lessons for the banking sector in India.

### Restricting flow of deposits

While green and sustainable projects are gaining traction in India, there might be a situation where banks might not find enough *eligible* projects to utilise the deposits received. Therefore, the flow of deposits may be managed based on demand, taking into account market conditions and other industry-specific developments.

A scheme may be designed by which banks could offer funds through special windows or through necessary quantitative limits.

### Restricting certain banking services to green deposits

Certain banking services such as overdraft facilities may not be appropriate against green deposits, given the need to have longer tenors for such deposits and to avoid premature withdrawals.

Banks may need to think about which ancillary services are feasible to be bundled with green deposits. They are likely to continue to innovate and experiment with market offerings, including allowing conversion of long-term deposits into green deposits.

### Green certificates

A bank may choose to offer 'green certificates' to its depositors upon crossing a set limit of investment in its green deposit scheme, with the facility of utilising such green certificates to seek certain benefits against other products offered by the bank. This would enhance the overall market appeal of the green deposit scheme.

## Towards a mature ESG market

Although green deposits are still a nascent investment vehicle for banks to finance green and sustainable projects, there is tremendous scope to develop them by leveraging household and corporate savings.

While a supportive central banking policy on green deposits is important, other structural measures – such as a common taxonomy for financial institutions in classifying 'green' and/or 'sustainable' is needed to mitigate instances of greenwashing. The RBI may also set in place foundational post-disbursal disclosure requirements for banks and financial institutions extending credits based on green deposits to ensure that the use of proceeds is consistent with ESG objectives.

In addition, and beyond the RBI policy, conducting pilot experimentation of green deposit scheme designs under the supervision of the IFSCA is also useful. Carefully calibrated adjustments to the RBI and the IFSCA regulations can do much to encourage the maturing of the ESG marketplace in India and attract more cross-border activity in the sector with the possibility of greater participation from offshore investors.