Comments on the Reserve Bank of India's Discussion Paper on Climate Risk and Sustainable Finance

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Introduction:

The Reserve Bank of India's (RBI) consultation paper on Climate Risk and Sustainable Finance is an important and timely step towards achieving much needed awareness regarding climate risk and its systemic implications amongst its Regulated Entities (REs). We find that the discussion questions posed in the paper have been most useful to generate ideas and concepts around an area which is still very much at a nascent stage. We have perused the 'Report of the Survey on Climate Risk and Sustainable Finance' brought out by the Sustainable Finance Group, Department of Regulation, Reserve Bank of India in July 2022. The same has been quite informative of the level of awareness and concrete steps being taken by various institutions (public sector banks, private sector banks, foreign banks, etc.) to respond to this evolving reality.

We have attempted to provide some suggestions in this context centered around objectives of formulating a common definition of climate risk and sustainable finance, joint regulatory oversight on this rapidly evolving sector, possible approaches to risk measurement and disclosures. We hope that these suggestions will add to nuanced discourse for RBI Regulated Entities (REs) around climate risk which isn't only that which affects the wellbeing of individual institutions or even financial systemic stability, but society's functioning as whole. While assessment and disclosure of climate risk is important for the stability of India's financial system, it is also perhaps a window of opportunity for financial institutions to innovate financial solutions and products to support the green transition of industry and society in an impactful way.

Discussion Question 1: What should be the immediate priorities in shaping the policy discourse on climate risk in India? What actions would help foster a more sustainable and resilient financial system?

I. Definition of climate risk as a separate risk class.:
Classically, lenders have been used to assessing the four blocks of risk for any potential exposure in the form of credit risk, market risk, liquidity risk and operational risk. There is now an evolving understanding of climate risk as a separate type of risk, with unique sources and one that warrants its own measurement paradigm. Accordingly, the RBI, in its guidelines/regulations should stipulate a formal definition of climate risk for the finance sector – sources of risks could be physical risks, transition risks, liability risks, etc. Alongwith the definition stipulation, it would also be good to have basic common disclosures of this risk class in the organization's annual reports/periodic filings.

II. End use guidance for sustainable finance for REs:
In order to spur sustainable finance participation for REs, RBI should stipulate regulations for clear definitions and tight end use monitoring for sustainable finance. Securities and Exchange Board of India's (SEBI) green debt securities framework's list of end uses is one step in this direction which prescribes 9 categories (https://www.sebi.gov.in/legal/regulations/apr-2022/securities-and-exchange-board-of-india-issue-and-listing-of-non-convertible-securities-regulations-2021-last-amended-on-april-11-2022-_58126.html). This may be utilized as a starting point for RBI to develop its own regulation keeping in mind the instrument levels nuances between bonds (longer tenors, largely capex intensive end use) and banking products (varying tenors, end uses from working capital needs to longer tenor capex needs, treasury products, non fund based products, etc). This sort of end use regulation will help achieve a two fold purpose of guiding REs towards what can constitutes sustainable financing and also curb greenwashing by REs.

III. Capacity building:
There is an urgent need for a concentrated policy effort for capacity building for ensuring well trained professionals in adequate number are available for RBI's REs for in the areas of climate

risk and sustainable finance. There are a lot many trained professionals in the private sector attached to various international bodies and consulting firms in these areas. A central training body such as the Indian Institute of Banking and Finance (IIBF) may be considered to prepare and provide regular trainings and technical skills upgradation courses for REs staff who will be part of the departments responsible for climate risk assessment and/or involved in sustainable finance initiatives. This training material may be developed by IIBF in consultation with domestic and international subject matter experts/consultants of repute. It would also be good to have formal and regular sharing of technical know how and best practices between REs through symposiums or knowledge sessions helmed by the RBI.

IV. <u>Joint steering committee approach for climate risk assessment for RBI REs:</u>
While each regulatory body will take its own steps to respond to climate risk across the financial system, given the overarching and interconnected nature of financial sector vulnerability to climate risks it may be best to consider a joint oversight approach. Ideally a joint steering committee from RBI, SEBI, The Insurance Regulatory and Development Authority (IRDA) under the aegis of Ministry of Finance (MoF) could start looking at climate risk issues together and come out with a syncretic policy response for risk measurement, risk mitigation and avoidance. This will also help evolve better insurance underwriting practices as physical risks (for collateral and other operating assets of REs), transition risks (sunset sectors) and liability risks (litigation for climate impact on certain industries from civil society) play out in reality over the near to medium term in the Indian context. This joint approach could also avoid duplication of research work, lags in knowledge sharing, etc across finance sector regulatory bodies. Insurance companies will also be encouraged to innovate newer products to respond to the evolving risks to REs.

<u>Discussion Question 2: What should be the way forward for the regulatory policy framework for climate risk in an emerging market like India keeping in view its aspects such as demography, geography, etc.? Is there any plan / contemplation in the REs to integrate climate and environmental considerations in their core activities of lending and investment?</u>

I. <u>Development of data sources for assessment of physical risks arising out of climate change:</u>
We believe that a good quality centralized public database pertaining to climate vulnerabilities such as inundation in flood prone areas, active seismic zones, heat stress, soil degradation, impact on renewable energy wind speeds, solar irradiation is key to empowering REs to carry out robust climate risk assessment for their core activities of lending and investment. The aforementioned suggestion of a joint steering committee may formally engage with the climate scientists community to build on their available data. The Ministry of Environment, Forest and Climate Change (MOEFCC) is understood to have Centres of Excellence (CoE) studying various facets of climate change. Their output and expertise may benefit formally integration into the climate risk measurement endeavour by REs.

II. <u>Market survey by RBI:</u>
We understand anecdotally that some lenders have begun offering interest rate discounts to borrowers who commit to certain sustainability initiatives in their ordinary course of business over a specified time frame. This arrangement with measurable improvements in sustainability objectives is legally enshrined in the loan documentation. This is only one example of the kind of impact financial services can have on sustainability and green transition. There could multiple such innovations already running successfully across the financing community. It would be good

for the RBI to conduct a detailed survey with lenders, the industrial sector and companies operating in green sectors. The survey findings could yield a rich source of initiatives that may be easy to emulate by other lenders as well.

Discussion Question 3: What are the main challenges in integrating the climate risk framework in Governance, Strategy and Risk Management? What is needed to overcome these? Are there plans in place / being contemplated regarding the same by the REs?

We think that the biggest hurdle to understanding and capturing insights related to climate risks is that there are several unknown unknowns. The impacts of climate change may be expected to be varying widely by geography, hyper local, difficult to translate into actually measurable risk. A robust data based, evidence based simulation of potential impact of climate risk on an RE or the financial system as a whole is the closest one can get to measuring the credit risk impact. Some suggestions on how climate risk stress testing and scenario analysis can be made more evidence based are provided below.

Discussion Question 4: What are the potential challenges in developing climate risk stress testing and a scenario analysis framework for REs? How do you think the potential effects arising out of such exercise should be analysed?

I. SEBI stipulated Business Responsibility and Sustainability Reporting (BRSR) disclosures as a data source for climate risk stress testing:
SEBI has made it mandatory for the top 1,000 listed companies by market capitalisation to publish reports with respect to reporting on ESG(Environment, Social and Governance) parameters from FY 2022-23 in the Business Responsibility and Sustainability Reporting (BRSR) format (https://www.sebi.gov.in/sebi_data/commondocs/may-2021/Business%20responsibility%20and%20sustainability%20reporting%20by%20listed%20entitiesAnnexure1_p.PDF). The reporting format is considerably detailed and has crucial information on various Green House Gas (GHG) and other emissions by the company's operations, water usage, electricity consumption by source, waste generated, impact on ecologically sensitive areas, etc. This data could serve by providing a sense of the extent of environmental and climate impact of a potential borrower's business activities. These insights could then be utilized while running climate risk stress testing simulations based on a relative scale with other companies'/sectors' operations.

II. ESG ratings (provided by SEBI approved rating providers) could also be utilized as a source of measuring relative climate/environmental impact be taken into account by REs conducting climate risk stress testing and simulations on their asset books. The ESG ratings could be utilized as a form of signaling similar to that of credit ratings today which provide vital information relative to company peers/competitors/other sectors, etc.

Discussion Question 5: What could be the overall timeline for implementation of disclosure / TCFD framework, and which recommendations should be prioritized? Should it begin with disclosure around the qualitative aspects first, followed by disclosure around quantitative aspects or both together?

We believe that encouraging REs to adopt TCFD guidelines for their disclosures is a welcome move and one that will improve REs acceptability and access to foreign funds/markets where TCFD is almost universally accepted as a disclosure norm. We only have a couple of suggestions to tweak the TCFD guidelines on two points, to make the disclosure framework more suited to the stage and maturity of India's financial sector participants.

(iii) Risk management - Disclose how the organisation identifies, assesses and manages climate-related risks.

Recommended Disclosure	*Illustrative Examples*
a) Describe the organisation's processes for identifying and assessing climate-related risks. b) Describe the organisation's processes for managing climate related risks. c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organisation's overall risk management.	REs may disclose: ▪ REs may consider characterizing their climate-related risks in the context of traditional risk categories such as credit risk, market risk, liquidity risk, and operational risk <u>PEG Comment:</u> We believe that stipulating climate risk to be disclosed as a separate risk class will help ensure that climate risk assessment is conducted rigorously and in the spirit in which it is intended while making investment decisions by REs. Subsuming climate risk into the traditional risk categories of credit risk, market risk, liquidity risk operational risk may run the risk of climate risk assessment becoming a paper based exercise.

(iv) Metrics and Targets - Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

Recommended Disclosure	*Illustrative Examples*
a) Disclose the metrics used by the organisation to assess and manage relevant climate-related risks and opportunities where such information is material. b) Disclose Scope 1, Scope 2 and, if appropriate and feasible, Scope 3 GHGs emission, and the relevant risks. c) Describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets.	REs may disclose: ▪ Risk and alignment metrics and targets used to assess the impact of (physical and transition) climate-related risks and opportunities on their business activities in the short, medium, and long term ▪ Breakdown of metrics and targets by industry, geography, credit quality and average tenor ▪ Scope 1 and 2 emissions of RE's own operation ▪ Scope 3 emissions for their lending, investing and other financial intermediary business activities where data and methodologies may allow ▪ Amount and percentage of carbon-related assets relative to total assets as well as the amount of lending and other financing connected with climate-related opportunities ▪ Methodology used in relation to such metrics and targets (e.g., calculation, standard adopted) ▪ Any verification and assurance of the disclosed metrics (e.g., emission) ▪ The extent to which their lending and other financial intermediary business activities, where relevant, are aligned with a well below 2°C scenario, using whichever approach or metrics best suited to their organizational context or capabilities <u>PEG Comment:</u> We believe that this level of disclosure may be a bit premature for some of the REs who are yet to begin their work around gaining the capacity required to conduct climate risk assessment. It would be good for RBI to ensure that this section remains optional in the near term for REs adopting the TCFD framework. Over a period of 5 years or so, once the data sources and presentation of the data becomes more mature, these disclosures may be made mandatory for all REs. This will improve the adoption of these regulations in spirit by REs.

Discussion Question 6: What measures would you suggest that the Reserve Bank of India could consider with respect to climate risk and sustainable finance?

We recommend that there should be a Special Empowered Task Force or Group within the RBI which will study the various sustainable finance instruments issued and an overview of impact assessment by the same. This Task Force may bring out half yearly or annual reports/compendium detailing observations, trends of impact assessment, etc.

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