Risk-proofing climate finance

Sonali Gokhale, Prayas (Energy Group)

RBI's efforts must be buffeted by better guidance on end-use of funds, and joint policy response by financial regulators

A version of this article was published by The Hindu Business Line on 15 February 2023, and can be accessed on the following link: https://www.thehindubusinessline.com/opinion/risk-proofing-climate-finance/article66513627.ece

The assessment and disclosure of climate risk while important for the stability of India's financial system, 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.

It is now widely accepted that financial stress emanating from climate risk isn't only that which affects the survival and health of individual lending institutions or even a country's financial systemic stability, but society's functioning as whole.

In this context, Reserve Bank of India's recent consultation paper, '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).

The 'Report of the Survey on Climate Risk and Sustainable Finance', brought out by the RBI, is indicative of the steps being taken by various institutions (low for public sector banks, higher for private sector banks, foreign banks, etc.) to respond to this evolving reality. The RBI's initial efforts need to be supported by many more steps.

Below are specific areas which the RBI needs to consider.

End-use guidance for sustainable finance for REs: There is an urgent need to provide more guidance on end use of sustainable finance by REs, especially regarding which end uses would qualify for sustainable financing as well as an approach to monitoring end use. The Securities and Exchange Board of India's green debt securities framework's list of end uses is one step in this direction.

This could be a starting point for the RBI to develop its own regulation keeping in mind the instrument level nuances between bonds (longer tenors, largely capex intensive end use) and banking products (varying tenors and end uses, treasury products, non-fund based products, etc.). This would limit the possibilities of window-dressing or green washing.

Definition of climate risk as a separate risk class and disclosures of the same: Normally, lenders are used to assessing the risk of any potential loan in terms of credit, market, liquidity and operational risks. The RBI, in its guidelines should stipulate a separate formal definition of climate risk for the finance sector — the sources of climate risks could be physical, transition, liability, etc.

Along with the definition stipulation, it would also be good for the RBI to stipulate basic common disclosures related to this risk class in the organisation's annual reports/periodic filings. Encouraging REs to adopt the Task Force on Climate-Related Financial Disclosures (TCFD) guidelines 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.

Capacity building: There is a pressing need for preparing adequate number of well-trained professionals for RBI's REs in the rapidly evolving areas of climate risk and sustainable finance. There are many trained professionals 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.

To ensure that the RBI climate risk policy is based on empirical data and cutting edge scientific research from both domestic and global sources, the following may be considered:

A joint steering committee from the RBI, SEBI and 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 joint policy response for climate risk measurement and mitigation given the interdependent nature of financial institutions and markets.

A centralised public database pertaining to climate vulnerabilities such as inundation in flood-prone areas, heat stress, etc., is key to empowering REs to carry out robust climate risk assessment. The joint steering committee may formally engage with the domestic and international climate scientists community to build on their available data..

Another source for REs for measuring relative climate/ environmental impact of their individual borrowers may be the Business Responsibility and Sustainability Report (BRSR) for ESG (Environment, Social and Governance) parameters for the top 1,000 listed Indian companies by market capitalisation (mandatory stipulation by SEBI) as well as ESG ratings (assigned by SEBI approved rating providers).

These reporting formats are fairly detailed and cover measurable parameters of climate impact such as emissions, generation of pollutants, etc. This information may be useful for REs conducting climate risk stress testing and simulations on their loan books at a total portfolio level.

The RBI can create a Special Empowered Task Force to study the various sustainable finance instruments issued. This Task Force may bring out half yearly or annual reports/compendium detailing observations, trends of impact assessment, etc. These documents could provide valuable guidance to financial institutions, both domestic and global.

The writer is Research Associate with Prayas (Energy Group), Pune

-X-