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CLIMATE FINANCE GAINS MOMENTUM WITH RBI'S CLIMATE RISK DRAFT DISCLOSURE

[A] Introduction:

The Reserve Bank of India (RBI) on 28 February 2024, came up with draft Disclosure framework on Climate-related Financial Risks for Schedule Commercial Banks (excl. Local Area Banks, Payment Banks, and Regional Rural Banks), All Tier-IV Primary (Urban) Co-operative Banks, All-India Financial Institutions (viz., EXIM Bank, NABARD, NHB, SIDBI etc.) and All Top and Upper Layer Non-Banking Financial Companies (NBFCs). This completes a circle that started with RBI joining the Central Banks and Supervisors in the Network for Greening the Financial System (NGFS) as a Member on April 23, 2021.

One of the initial attempts for structured voluntary reporting on climate-related financial disclosures was the Task Force on Climate-Related Financial Disclosures (TCFD) established in 2015 by Switzerland-based Financial Stability Board (FSB). This was to better inform investors, shareholders and the public of their climate-related financial risks. In 2017, the TCFD issued a 'Final Report' detailing 11 voluntary recommendations, known as the TCFD framework. Subsequent annual status reports guide implementing the TCFD recommendations and track their worldwide adoption. TCFD presently has 4,900 supporters in 139 jurisdictions, including India.

While the TCFD recommendations started as voluntary disclosure guidelines, they rapidly became part of the mandatory regulatory framework in many jurisdictions, including the European Union, Singapore, Canada, Japan and South Africa. New Zealand and the United Kingdom mandating climate risk disclosures in line with the TCFD framework by 2023 and 2025 respectively. In March 2022, the U.S. Securities and Exchange Commission (SEC) published proposed legislation on climate-related risk disclosures that incorporates key aspects of the TCFD framework.

In June 2023, the International Sustainability Standards Board (ISSB) issued its first two IFRS® Sustainability Disclosure Standards, IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2 Climate-related Disclosures that came into effect from 1 January 2024. While the overall requirements of both IFRS S2 and TCFD are aligned for the most part, IFRS S2 will require climate-related information to be incorporated into financial reports.

The timing of India's RBI guidelines is ideal for addressing climate-related risks and creating a resilience plan for an economy that is both highly susceptible to natural disasters and on a fast development track. While IFRS S2 requires climate-related information to be included in your annual financial statements, the RBI's guidelines at a minimum, require Regulated Entities (REs) to disclose information about their climate-related financial risks and opportunities aligned with TCFD recommendations.

[B] Impacts on Indian Financial Institution's structure and function due to climate-related disclosure guidelines:

Some progressive larger FIs have been working on aspects like (i) GHG inventorisation including financed emission measurement, (ii) assigned carbon neutrality targets, and (iii) disclosing TCFD ambitions under the ambit of their non-financial disclosure(s), e.g. e.g., SBI, HDFC, Axis, and ICICI Bank.

Now the question arises of what the implications on smaller banks will be, small NBFCs, housing finance companies, etc.

(a) Impact on FIs structure:

a. Emerging role of CROs and RMC:

- CRO's and/or Enterprise Risk Management Committee's role has been traditionally linked with pre-emptively identifying, evaluating, and mitigating financial risks, compliance risks, operational risks reputation risks and strategic risks. As per the RBI notification dated 27 April 2017, the CRO is mandated to report to the Board through the Risk Management Committee of the Board (RMCB).

- With the mounting pressure from RBI and some investors, CROs and RMCBs are becoming more focused on climate-related risks. However, many find themselves severely underprepared to evaluate, measure and address such risks.

b. ESG Risk officer's role to be augmented:

- Some of the large Banks and NBFCs have had an Environmental, Social and Governance (ESG) risk committee and a dedicated ESG officer for long. The role of the ESG risk officer has been primarily to (i) develop E&S risk policy(s), (ii) conduct E&S due diligence of new/existing transactions, (iii) conduct periodic reporting to Bank's RMCB / Board, (iv) assist in preparation on regulatory / non-regulatory disclosures and (v) assist in the external rating process.

  However, in most FIs, this role is played by a senior officer in credit risk or similar role. With the introduction of the draft climate-related disclosure norms, the ESG officer's role is now enhanced. ESG Risk Officer will have to assist the CRO / RMC in the identification and assessment of climate-related risks.

- Hence, this could mean, (i) a significant push towards enhancement of the ESG officer's role, and; (ii) the Bank's non-financial disclosure will have to be strengthened from FY26 onwards.

(b) Key Operational Challenges for FIs:

- Absence of (i) micro-level India-specific data, (ii) off-the-shelf micro-scale model(s) and (iii) requisite skill set in the market in quantifying climate risk for FIs;
- Difficulty in integrating climate risk into credit risk framework in determining spread;
- Absence of quick and easy methods for climate models to 'talk to' Rating model / Core Banking System (CBS) for the ease of credit analysts;
- Long-term horizon of climate risk (20-30 years) vis-à-vis much shorter time horizon over which credit risk (5-7 years) is spread;
- Changing Board/ Risk Management Committee's perspective on a 'risk' that could seldom be modelled.

(c) Key Opportunities to FIs:

- Banks/NBFCs may quantify their Scope 1 (direct), Scope 2 (indirect) and Scope 3 (upstream / downstream indirect esp. financed emission) from FY26 onwards (at the portfolio level). This will provide a scope for excellent peer comparison. ESG mutual funds/ ESG-conscious investors could base their investment decisions on these.
- Financial Institutions (FIs) could identify their (i) physical and (ii) transition risk at the portfolio level. Some FIs may be motivated to 'reward' and/or 'penalize' some specific sectors based on the risk associated.
- FIs could use long-term climate models and scenario analysis to develop a climate-resilient business model in the mid- and long-term. This may help FI's to de-risk their portfolio to a certain extent.
- FI could use the climate model(s) to rework their operational risk model under Pillar 1 under the Basel III framework. FIs could further use climate models to calculate climate-related Probability of Default (PD)-Loss Given Default (LGD) and Expected Credit Loss (ECL) and Capital to Risk (Weighted) Assets Ratio (CRAR) under Pillar 2 of BASEL III framework.

Unlike the larger FIs, the smaller FIs may find meeting climate disclosure challenging at first. They should make good use of the time till FY26, and start with the baseline disclosures to begin with.

[C] Infrastructure demand to meet the RBI requirement(s):

It'll be interesting to see how FIs respond to the need to institutionalize / mainstream climate risk modelling and climate risk information systems within their core banking system (CBS) and risk rating model (RM). A few of the challenges before disclosures have been listed below:

- Climate damage model & database: Banks need to use: (i) meso-scale climate models, (ii) robust climate-related databases, and; (iii) statistical software to scale down the climate results.
- Integration of climate risk model in Bank's risk models: output from off-the-shelf climate risk models is inherently difficult to integrate into CBS / RMs. The output needs to be pre-processed before it could be effectively serve as an input to the RM, and help the FIs determine the spread.
- Using Geographic Information Systems (GIS) to evaluate physical climate risks: currently very few FIs use Geographic Information Systems (GIS) to geo-tag their client's or client cluster's location(s). However physical climate-related risks, such as floods, sea level rise, heat waves or droughts are highly concentrated. To understand the near- and mid-term impact of physical risk on FI's asset pool understanding its geographic extent is important.

[D] Market's response to the climate risk-related disclosure:

(a) Balancing Development vs. Net-Zero Ambitions:

FIs have a strong financing mandate which in turn fuels India's growth story. On the other hand, many progressive FIs have adopted net zero goals and aligned with India's net zero target by 2070 or even earlier.

Some FIs may have lent heavily to GHG-intensive sectors like thermal power, cement, iron & steel, aluminium, fertiliser, petrochemicals, etc. Financed emissions from these sectors may impair the FIs target to achieve the net zero target in the mid- and long-term.

As a result, these industrial sectors may see limited capital and/or elevated borrowing costs in mid- to long term. Such market pressure may eventually propel some of these GHG-intensive adopt 'greener' production technologies.

FIs may need to have countermeasures as GHG inventorisation, fossil fuel exclusion list, stringent ESG action plans and long-term net zero strategies.

On the other hand, 'greener' sectors like renewable energy, projects related to energy efficiency, pollution prevention & control, climate adaptation, sustainable use of water resources may gain momentum in near future.

(b) Availability of skilled person-power:

Climate risk management professionals, both seasoned and at entry-level are limited in number. As stated above very few FIs have dedicated ESG officers, and even fewer report on climate risk.

Demand for skill sets in climate finance going to be intense in the short term as supply constraints may prevail. Universities which already offer courses on sustainability need to rise to this occasion. This also calls for huge capacity building, training and standardised reporting.

[E] Way forward:

A few suggestions are listed below which mid-size and / or small FIs could adopt and benefit from the RBI's climate-related disclosure requirement:

(a) Form a dedicated Climate Risk Committee: FIs could form a dedicated Climate Risk Committee under the ambit of Enterprise Risk and/or ESG committee reporting to the Board through the RMCB. This committee will measure and report the portfolio-level variation of physical and transition risk on a Q-o-Q basis.

(b) Create Scope 1, Scope 2 and Scope 3 GHG emission inventory: FIs should endeavour to develop (and preferably verify through reputed third-party) their Scope 1, Scope 2 and Scope 3 GHG emission(s).

(c) Develop physical and transition risk heatmap of the back book: FIs could develop physical (acute) and transition risk (heatmap (policy, technology, reputation, market & legal risk) heatmap of their back book to understand which sector(s) and which geographies. Any significant events (e.g. Mumbai flash flood of 26 July 2005, Chennai flood of 2015, Kerala flood of 2018 etc.) and/or changes in policy and/or technology will mandate the

(d) Develop model from evaluating physical and transition risks for new transactions: FI's could use simple deterministic models to develop local scale physical and transition risk identification and screening for new transactions. This will help them to (i) identify associated risks, (ii) pre-emptively reject some transactions if risks cross a certain threshold, (iii) build in countermeasures (see Section D).

(e) Conduct Climate Scenario Analysis: FIs should conduct climate scenarios analysis using Network for Greening of Financial System (NGFS) scenarios and Shared Socio-economic Pathways (SSPs) developed by IPCC. This will help them identify possible future scenarios which lie between two extreme chosen scenarios.

(f) Using Climate Damage models to evaluate portfolio level impact in mid- to long-term: FI should use off-the-shelf / customized downscaled climate damage models to evaluate the mid- and long-term portfolio level impact(s).

(g) Develop in-house capacity: In long term, FIs should consider developing the in-house capacity to meet the everchanging landscape of non-financial disclosures.

(h) Put your money where your mouth is: India does not have a Govt. of India-recognized green taxonomy yet. However, (i) RBI's green deposit framework dt. 11 April 2023, (ii) and International Finance Service Centre Authority Guidance Framework on Sustainable and Sustainability-linked linked lending dt. 26 April 2022 provides a general direction. Both of these guidelines are aligned with the International Capital Market Association (ICMA) and Loan Market Association (LMA) green / social / sustainability-linked financing bond and loan taxonomy. This indicated that FIs should take a cue from this, and slowly but gradually increase their portfolio share in green / social / sustainability-linked projects in the long-run.

[F] Conclusion

The two-step prolonged approach of baseline and enhanced disclosure included in the draft disclosure framework provides a clear roadmap as well as breathing space for the FIs to step their non-financial disclosures. Mid- and small-size FIs may initially find it difficult to meet the challenges of enhanced disclosures. Nevertheless, they are urged to capitalize on the time until FY26 and commence with baseline disclosures.

The global banking community has been building adaptive capacity through investments in resilient infrastructure, early warning systems, and targeted social safety nets. India's proactiveness can be seen as a step towards prudential regulation and supervision to ensure financial stability and strengthen disclosing information about climate-related risks and opportunities that could reasonably be expected to impact the assessment of cash flows, access to finance or cost of capital over the medium to long term. The new reporting requirements are expected to impose stringency into the location and timing of climate-related disclosures while aligning them with annual financial statements.

With the first disclosures starting from FY26, RBI has provided sufficient time to mid-size / smaller FIs to prepare for this complex but enriching journey.

This is a step in the right direction, and just at the nick of time. Time to step up your climate risk game FIs.

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