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Demystifying Sustainable Finance and Climate Risks for Indian Banks

Introduction

The concept of sustainable finance is a multifaceted domain that has evolved significantly over the recent years. Sustainable finance is a suite of financial mechanisms strategically designed to enhance economic growth, while addressing environmental concerns and incorporating considerations of social and governance dimensions. At its core, this approach emphasizes transparent disclosure of Environmental, Social and Governance (ESG) risks that could impact the financial system. Moreover, sustainable finance involves adept governance of financial and corporate entities to effectively mitigate such risks. Essentially, it encompasses the mobilization of financial resources to promote inclusive growth, aligning financial strategies with broader ESG objectives.

The primary objective of sustainable finance lies in the integration of ESG factors with decision-making processes, aiming to champion sustainable development and tackle urgent global challenges such as climate change, biodiversity loss, social inequality and human rights concerns. In doing so, sustainable finance goes beyond merely considering financial returns, emphasizing the broader impact of investments on environment, society and corporate governance. This approach acknowledges the interconnected nature of economic, social and environmental issues, emphasizing the importance of addressing them comprehensively for achieving sustainable and inclusive development.

The global sustainable finance market is expected to grow from USD 3.6 trillion in 2021 to USD 23 trillion by 2031 (Confederation of Indian Industry [CII], 2023). Growth in sustainable finance and product issuances has been rapid globally, with ESG-oriented Assets Under Management (AUM) rising steadily as well. Globally, ESG-related AUM are expected to strike USD 33.9 trillion by 2026 from USD 18.4 trillion in 2021 (PricewaterhouseCoopers [PwC], 2022), while sustainable debt issuances globally are at USD 448 billion as of H1 2023. Although this is down 15% on a YoY basis, it remains in line with the USD 859 billion in issuances seen in CY2022. This growth puts cumulative issuances at over USD 4 trillion.

Green bond issuances have been substantial globally, worth USD 279 billion by H1 2023, that constitutes 62% of the total pie, while the cumulative amount of Green, Social and Sustainability (GSS+) bonds issued reached USD 3.8 trillion by the end of 2022 (Climate Bonds Initiative [CBI], 2023). Interestingly, in H1 2023, green bond deals supporting low-carbon energy have been on the rise, more than those originating from fossil fuel companies, which demonstrates a transition that is underway.

Importance of sustainable finance in the context of climate change

The earth's climate naturally changes over time due to unpredictable natural forces. Yet, various independent studies strongly indicate that human

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activities, especially since the Industrial Revolution, significantly contribute to worsening climate change. As per the UN Intergovernmental Panel on Climate Change [IPCC] Synthesis Report (2023), human activities, principally through emissions of greenhouse gases, have unequivocally caused global warming. Global surface temperatures in 2011-2020 reached 1.1°C above 1850-1900 levels.

A report from the Indian Ministry of Earth Sciences (2020) states that India has seen a rise in average temperature, decreased monsoon precipitation, increased extreme temperatures, droughts, sea levels and more severe cyclones since the mid-twentieth century. The impact of these changes was notably felt throughout the past year, with heightened climate incidences. Scientific evidence links these changes to human activities, emphasizing the need for immediate, large-scale reduction in greenhouse gas emissions.

Simultaneously, the global recognition of climate change as a financial risk for banks is growing (Financial Stability Board [FSB], 2022). The uncertainty surrounding the timing and severity of climate-related and environmental risks poses a direct threat to the safety, stability and resilience of individual Regulated Entities (REs) and consequently, to the overall stability of the financial system. It is imperative that REs consistently address and manage the risks and opportunities arising from climate change and environmental degradation. Moreover, the escalating threat of climate change, coupled with physical damage concerns, evolving market perceptions and a shift towards more environmental-friendly products and services, amplifies the prominence of financial, reputational and strategic risks.

Empirical data shows that in 2021 and 2022, over 300 natural disasters occurred globally, that inflicted

economic damages of about USD 300 billion (Reuters, 2023). Tropical countries such as India are increasingly exposed, with damages caused by climate-related disasters in Asia estimated at USD 36 billion last year (World Meteorological Organization [WMO], 2023). Therefore, capital needs to flow with urgency into ecological, social or economic systems, in response to actual or expected climatic stimuli and its effects. This would substantially reduce climate change costs and advance a range of other economic benefits.

Globally, the initiatives to confront climate change have been gaining momentum across various jurisdictions, with an increasing number of central banks considering or actively pursuing actions aligned with their mandates. Moreover, climate change risk is progressively being recognized as a significant threat to financial stability, both in advanced and emerging economies. Consequently, there is a pressing requirement for a robust framework to systematically identify, assess and manage risks associated with climate change.

In addition to the imperative of mitigating risks arising from extreme climate events, there is a growing emphasis on steering the financial system towards green financing. This transition is crucial, considering the broader social and developmental objectives of the country.

Significance of addressing climate risks for Indian banks

Recognizing the significance of addressing climate-related risks is imperative for Indian banks as the repercussions extend across multiple dimensions. Climate-related risks encompass potential threats arising from climate change with substantial economic and financial consequences. These risks manifest through two primary channels: physical risks and transition risks.

Physical risks involve economic costs and financial losses stemming from the increasing frequency and severity of extreme climate-related weather events, longer-term gradual shifts in climate and indirect effects such as the loss of ecosystem services. Geographical variations further influence the impact of physical risks, with potential stresses on expected cash flows and risks to collateral value.

For instance, local or regional weather events may strain cash flows to Regulated Entities (REs), while chronic flooding or landslides pose risks to collateral value held against loans. Severe weather events can also damage a RE's physical property and data centres, affecting its ability to provide financial services.

Transition risks, on the other hand, arise from the shift towards a low-carbon economy and are influenced by climate-related policies, technological advancements and shifts in public sentiment. Mitigation policies, technological innovations and changing customer preferences can significantly impact the economy and financial system. For Indian banks, this necessitates strategic considerations such as potential reduction in financial valuations, changes in credit ratings and the adoption of energy-efficient practices.

Moreover, liability risks may emerge as parties seek to recover losses incurred from physical or transition risks. Therefore, a proactive approach to manage and mitigate these climate risks is crucial for the resilience and sustainable operation of Indian banks in an evolving financial landscape.

Climate change demands focused attention and distinctive management due to several unique characteristics. Firstly, its impact is extensive, affecting various businesses, sectors and geographies. Secondly, while there is certainty that a combination of physical and transition risks will

occur, the exact timing, outcomes and pathways are uncertain and unevenly distributed globally. This unpredictability challenges the efficacy of historical data and traditional risk assessment methods. Lastly, the concentration of greenhouse gas emissions in the atmosphere holds irreversible consequences for the planet and the actions taken today will determine the magnitude and nature of future impacts. As a result, collective efforts from central banks, financial market participants, businesses, households, Governments, and sectoral regulators are crucial in addressing and mitigating these risks.

The realization of physical and transition risks hinges on intricate non-linear dynamics, interacting in complex and deeply uncertain ways. While climate-economic models have limitations, forward-looking methodologies can help uncover potential vulnerabilities. Given the collective responsibility for addressing climate change, there is a growing expectation on the financial sector, tasked with allocating capital resources and channelling finance, to actively support the transition.

Banks need to integrate climate-related risks into various risk processes, including credit concentration, underwriting, reputational and strategic risks. Consideration of these risks is vital in preparation of the Internal Capital Adequacy Assessment Process (ICAAP) document under Pillar 2, as outlined in the Master Circular on Basel III Capital Regulations by Reserve Bank of India [RBI] (2023). Recognizing the evolving nature of climate-related financial risks, their inclusion in ICAAPs also needs to be iterative and progressive. Analytical gaps can be addressed by adapting methodologies and data analysis as these risks mature over time.

Global Regulatory Landscape

International sustainable finance regulations

encompass a range of initiatives and frameworks, aimed at integrating ESG considerations into financial practices on a global scale. Global Reporting Initiative (GRI), for instance offers a standardized approach for sustainability reporting across various sectors.

Foundational Sustainable Finance Frameworks include the Principles for Responsible Banking (PRB) led by United Nations Environment Programme Finance Initiative (UNEP FI) and UN Principles for Responsible Investment (PRI), provide solid groundwork for sustainable finance. PRB focuses on integrating sustainability principles into banking operations, while PRI offers guidelines for incorporating ESG factors in investment decisions. The Task Force on Climate-related Financial Disclosures (TCFD), established by Financial Stability Board (FSB), complements these efforts by emphasizing the disclosure of information related to climate-related financial risks and promotes transparency in reporting.

Two recent developments need to be mentioned. One is the Taskforce on Nature-related Financial Disclosures (TNFD), which is a framework for disclosures on evolving nature-related dependencies, impacts, risks and opportunities. Secondly, 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. These reporting frameworks align with broader global goals, including UN SDGs and serve as a guiding framework for developing sustainable finance strategies on an international scale. With the latest developments in IFRS S2 for reporting standards, TCFD would be subsumed under IFRS and its elements that have emerged over the years and completely integrated with this standard. TNFD is

aligned to IFRS-ISSB, which encourages integrated climate and nature reporting.

European Union Sustainable Finance Initiatives too, have been underway. The EU has been at the forefront with its Sustainable Finance Action Plan. This plan includes key regulations such as EU Taxonomy Regulation, Sustainable Finance Disclosure Regulation (SFDR) and EU Green Bond Standard. These initiatives set a precedent for comprehensive frameworks, contributing significantly to the global push for environmentally conscious financial practices.

Globally, Carbon Pricing Initiatives and Risk Management Frameworks have gained momentum with International agreements such as the Kyoto Protocol and the Paris Agreement that have been underscoring the importance of addressing climate change through financial mechanisms, including carbon pricing initiatives. Risk management frameworks such as Equator Principles have been providing a structured approach for evaluating environmental and social risks in project finance. These collective efforts aim to enhance the resilience of financial systems against climate-related challenges.

Collectively, these international sustainable finance regulations contribute to a growing ecosystem that not only encourages financial institutions and businesses to adopt sustainable practices, but also pushes them towards embedding climate related risks and opportunities at the core of banking. Undoubtedly, the evolving landscape of sustainable finance plays a pivotal role in shaping the future of global finance.

Indian regulatory landscape

The Indian financial sector is gradually moving towards incorporating sustainable finance/climate transition, both in terms of risks and opportunities.

On the regulatory front, there has been much traction

over the past couple of years. The Ministry of Finance has been instrumental in setting up the Taskforce on sustainable finance in 2021, with focus on 4 elements - (I) Sustainable Finance Roadmap (II) Taxonomy (III) Regulatory Framework for Sustainable Finance (Regulations, Resilience and Disclosures) and (IV) Development of Report on Global and Domestic Best Practices on Sustainable Finance - essentially involving all relevant ministries. The taskforce involved various ecosystem players, to understand the existing landscape and eventually emerge with a common unified approach to sustainable finance.

Capital market regulator led ESG disclosures through Business Responsibility and Sustainability Reporting (BRSR) that has laid emphasis on a level of transparency and quantification. It mandates disclosure of material ESG risks and opportunities, financial implications and approaches to mitigate or adapt to the risks. These mandatory sustainability disclosures are required to obtain reasonable assurance for listed entities on 49 core KPIs within BRSR Core, which was introduced in a phased approach from FY2023-24 and is slated to enhance the quality of disclosures.

Further, measures like Stewardship Code for institutional investors are not only making the relationship between investors and their shareholders more prominent, but also emphasizing on ESG and climate as a priority, which enhances the accountability of institutional investors.

Revisions to green bond issuance guidelines with third-party assurance requirements for pre-use of proceeds, project evaluation and post-issuance stages, are set to contain green washing and provide clarity on the impacts achieved versus claims. Further, granularizing on bond categories, with additions of blue, yellow (solar) and transition bonds, would enable asset tagging and are expected to diversify

the bond issuance base and boost investment in these new securities.

The introduction of five new categories comprising exclusions, integration, positive screening, impact investing and sustainable objectives under ESG mutual fund schemes, would boost ESG investing in India. Further, within the ESG space, Rating Providers' regulation, outlining procedural requirements, disclosure obligations and guidelines, including India-specific parameters and a separate category of Core ESG Rating, would bring in market standardisation and put a stop to ESG rating shopping. This would address factors like a fragmented ESG rating market, low correlation between different ESG ratings, credibility of existing frameworks and significant divergence in ESG ratings for the same entity.

On banking regulations, RBI's formation of a Sustainable Finance Group (SFG) within its Department of Regulation is evidence of the regulators' priorities on climate risk management, including climate scenario analysis and stress testing. A potential regulation in this space would enable banks to assess their true exposure to climate risks and mitigate these at speed. RBI's recent Currency and Finance report (2023) emphasised on the state of climate risks in India, including high exposure of Indian banks to transition risk sectors like energy, transport, and metals. It prioritised climate and made references to the criticality of climate risks disclosure and climate scenario analysis, thus indicating the regulator's intent to embed climate within the macroeconomic and financial developments in India.

The introduction of framework for green deposits has provided a boost to green financial product development, with clear set rules on deployment of capital raised, thus, dissuading any erroneous claims on environmental impact or preventing greenwashing. This also includes bank loans up to a limit of INR 30

crore (USD 3.6 million) to borrowers for renewable energy generation. Since this is under Priority Sector Lending (Press Information Bureau [PIB], 2023), it serves as an effective channel to accelerate capital flows directly into climate interventions.

Towards India's net zero commitments of 2070, the recent announcement by Ministry of Power through its Energy Conservation (Amendment) Bill 2022, of establishing a framework for a Carbon Trading system, is a welcome move to create a national platform and jumpstart a domestic market for carbon credit trade.

All these regulatory initiations have led to growth in sustainable finance product development and deployment, with emergence of several debt and equity sustainable finance instruments that take ESG or climate considerations and its impacts into account. The categories include Green, Social, Sustainability and other labelled bonds (GSS+), sustainability linked loans or bonds and ESG-oriented mutual funds, ETFs or private equity funds. Moreover, this has also fuelled innovative structures such as blended finance and credit enhancement mechanisms in order to reduce the risks arising from nascent climate related sectors and increase their bankability.

The Indian market has been gradually but steadily growing. The total size of the Indian green, social and sustainability market stood at USD 19.5 billion as of December 2021 (CBI, 2022). This growth is mainly led by green bonds issued in India, aggregating at USD 6 billion in 2021 (SustainableFitch, 2023), led by Indian Renewable Energy companies. India also saw a rise in ESG-oriented equity mutual funds in 2020, with AUM by 10 ESG equity mutual funds at USD 1.24 billion in March 2023 (CNBC, 2023). However, it saw a YoY decline of 17% and a weakening in its uptake from 1.1% in March 2021 to 0.7% in March 2023, as

a percentage of total equity mutual funds.

We must also call out Indian Government's inaugural Sovereign Green Bond, that raised USD 1 billion, at a lower cost than conventional debt. India has a huge financing opportunity that needs to be leveraged with a strategic and futuristic approach, cutting across financial products, technologies and markets. A call for India's own taxonomy to define sustainable finance is not only critical to meet this capital demand, but also casts a notable focus on social and just transition guidelines. This places a unique emphasis on the human dimension and distinguishes India in its global sustainable finance endeavours.

Challenges in sustainable finance for Indian banks

While regulations and mandates have emerged, these have not led to the expected growth of sustainable finance and supply of capital continues to remain below requirements for India's energy and nature transitions. Initially, the green bonds market did scale up for utility and industrial projects, however, it has only accounted for 3.8% of the overall outstanding corporate bonds market as of January 2023 (Economic Times, 2023). It majorly remains dominated by corporate issuances and not by banks that continue to be key source of funds for large projects. This is on account of lack of authentic, reliable data and tools, capacity to identify, assess and price climate risks, develop indicators to quantify material exposures, assess links between climate and traditional risks and undertake green asset-tagging for sectors or end-uses. All this is further intensified by lack of clear definitions for green and sustainable finance. Further, technology risks such as uncertainties in solar panel energy storage and weather dependency make it challenging for financial institutions to evaluate and manage financial risks.

Limited information on environmental performance hinders the creation of finance structures.

Maturity mismatch in green or climate projects, dominated by short to medium-term investments is evident, particularly in banks relying on short-term deposits. The absence of reliable green financial policy frameworks and higher borrowing costs for green bonds pose significant challenges. Additionally, market infrastructure development for climate risks mitigation instruments is lagging. This development can be facilitated through consideration in public policy formulation, ensuring capital availability and creating an environment that incentivizes corporate collaborations in this direction.

It is estimated that India needs USD 10 trillion in financing across energy, mobility and industry to meet its net zero goal by 2070 (Climate Policy Initiative, 2023). However, the sustainable finance market has not expanded in line with the demand. This may imply that a “greenium” is also not yet visible, as sustainable capital base has not yet reached a critical mass domestically to merit price discovery of sustainable variants versus conventional products. Further, the real quantum of capital deployed to these projects also remain unknown, given the lack of a classification or unified standards.

Banks face challenges in incorporating climate considerations into their decision-making and capital allocation processes. Availability of quality climate related data and its integration in risk and valuation frameworks is difficult. Obtaining necessary granular and timely data on climate vulnerabilities, estimating changes and monitoring impacts hinders Financial Institutions (FIs) from prioritizing capital for climate sectors. Instead, they tend to allocate funds to conventional projects with readily available data or proven risk-return models. The limiting factors that

urgently need attention include:

1. **Data Deficiency:** The lack of authentic, accurate and granular quantitative data impedes informed decision-making, particularly for private sector financial flows. Developing and utilizing technology and AI-led tools that enhance physical risk assessment is essential and requires access through a common agency that provides data at affordable costs and is reliable.
2. **Climate Risk Navigation:** FIs struggle to navigate climate risks and translate them into risk pricing for ex-ante debt due to poor data availability and data complexity, often impeding prompt detection of vulnerabilities in capital intensive projects and its integration into mainstream risk assessment.
3. **Incentives and Risk Covers:** The absence of incentives or risk covers, coupled with procedural delays in releasing guarantees, creates uncertainty around project viability and its Return on Investment (RoI). Streamlining access and reducing uncertainties are critical for encouraging capital flow to vulnerable sectors.
4. **Skill Gaps:** The lack of skill sets among credit and risk managers to comprehend complex climate risks arising from climate change or rapidly evolving technologies acts as a deterrent for FIs to lend to sectors undergoing such transitions.
5. **Regulatory Framework:** The absence of a mechanism or regulation mandating the integration of climate risks into banking processes like Enterprise Risk Management (ERM), Risk Assessment Framework (RAF) and Risk Management System (RMS) poses a challenge. Additionally, there are no mandates from a Priority Sector Lending (PSL) standpoint

to deploy climate finance, as the predominant focus remains on financial feasibility, leading to a limited spread of capital for climate projects. Addressing these challenges is crucial for banks to effectively contribute to sustainable and climate-resilient finance.

Recommendations

The transformation of the banking sector in the face of evolving climate challenges demands a comprehensive approach spanning systemic, institutional and individual levels. This involves the development of a sustainable finance architecture guided by a strategic and forward-looking “risk-return-impact” vision. Key components of such a strategy would include integrating Sustainable Finance, ESG and climate risks into lending decisions, as well as strategically divesting from high carbon portfolios, while directing investments towards climate-positive projects, including technology-driven climate-smart agriculture.

Sectoral focus emerges as another critical aspect, urging banks to seize opportunities in high-impact, carbon-positive sectors. Aligning with India’s emphasis on renewable energy, sustainable infrastructure and net-zero commitment creates a prime investment environment and contributes to its sustainability goals and addressing the rising demand for sustainable finance.

Decarbonization and aligning with India’s Nationally Determined Contributions (NDCs) provide pivotal dimensions and banks need to set emission targets by mapping and reducing financed emissions that are almost 700 times higher than a bank’s own footprint. Allocating capital appropriately to high carbon emitting sectors and increasing debt to clean sectors such as renewable energy, e-mobility, water, green buildings, climate smart agriculture, green

urban infrastructure would become imperative. This approach not only protects investments but also positions banks to proactively safeguard against future risks and generate positive impacts.

For banks, data is essential for risk assessment and reduction. Digital frameworks supporting climate integration in risk and valuation processes are key. Therefore, large-scale investments in data strengthened systems and tools, enhancing climate risk evaluation and financing, become essential, thus, enhancing data authenticity, integrity and credibility.

Risk management and compliance constitute core elements, urging banks to conduct climate-related risk assessments at key operational junctures, adhere to ISO standards and respond adeptly to regulatory pressures. Embracing a 360-degree approach that represents an overarching risk identification, measurement and management system that integrates climate, would encourage banks to go beyond traditional risk-return frameworks is essential. This not only, safeguards against future risks but also positions the Indian financial system as a leader in sustainable finance, contributing positively to the environment and society.

Leveraging successful innovative financing that can draw capital at speed for climate sectors becomes imperative. Beyond impact investing, credit enhancements, blended finance, developmental finance assistance or grants, a need for catalytic capital investments or risk cover instruments that have proven to deliver on the security that banks seek are important. Towards this, expanding the role of national and state level Development Finance Institutions (DFIs) would be critical. Articulating climate related objectives at an institutional level would also help mobilize additional finance by leveraging international finance.

Human resource development emerges as a crucial pillar, necessitating the enhancement of workforce skills to include holistic ESG and climate risk analysts. Skill enhancement and training initiatives aligned with adoption of the three lines of defence model, ensuring a comprehensive and integrated approach to risk management would lead to banks contributing effectively to India's economic growth.

This multifaceted approach would ensure a holistic transformation that resonates throughout the banking sector, fostering resilience and sustainability in the face of complex and evolving climate challenges.

Finally, a systemic approach to include market standardisation such as a taxonomy, risk management instruments and currency hedging mechanisms by Government and incentivisation would be key to accelerate sustainable finance and climate transition.

Conclusion

In essence, demystifying sustainable finance and climate risks for Indian banks involves embracing a paradigm shift that aligns banking practices with the imperatives of a rapidly changing world. As financial institutions evolve to meet the challenges posed by climate change, adopting a proactive and integrated approach becomes not only a necessity but also an opportunity for innovation and leadership. By incorporating these comprehensive recommendations, Indian banks can fortify their resilience to climate-related risks and serve as key contributors to sustainable development. This transformative journey would further safeguard the financial sector from emerging threats and ensure a positive impact on the environment, society and the broader economy. In demystifying the complexities of sustainable finance, Indian banks have the potential not just to adapt but to thrive in an era where sustainability and financial viability go hand in hand.

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