RBI and the net-zero transition — A roadmap for green India

RBI has taken a step forward by introducing the draft that aligns well with international standards. Even as regulated entities begin to respond to the regulatory shift, they must simultaneously keep a watch on the asset quality not just in fossil fuel-based sectors but also in 'green' sectors

Written by **Suranjali Tandon** March 8, 2024

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As fossil-fuel consumption is phased down over the coming decades, the financial system will need to prepare for change. The banking sector is an important actor in the financial sector. As a result, the transition to net zero will have implications for the Indian banking system. RBI estimates that banks' current exposure to utilities, metal and transport is relatively higher. While the aggregate exposure level to climate-change risk remains moderate, there are sharp contrasts between the exposures of public- and private-sector banks. At the same time, non-banking financial companies (NBFCs) extend nearly half of their gross credit to power and auto segments. Given the interconnectedness between banks and NBFCs, the risk to the financial system may be pronounced.

In the years to come, as fossil fuel-based assets and processes are phased down, there will be demand for green investments. The question is how can banking ensure that the two can be managed practically? The RBI is focussed on risk management and has signalled its intent to align policy with transition. The introduction of lending to renewable energy under priority sector lending, a framework for green deposits and the reports assessing climate risks are all efforts in this direction. The central bank has now followed through with its commitment to assessing climate change related risks in its draft disclosure framework on climate-related financial risks. The report underscores the need for comparable disclosure frameworks among Indian-regulated entities about climate-related financial risks to ensure that there is adequate information about mispricing of assets and misallocation of capital. Therefore, the framework is set to deepen the understanding of current exposures and preparedness among the various entities regulated by RBI. The regulation will cover scheduled commercial banks, Tier IV primary urban cooperative banks, all India financial institutions and all top and upper layer NBFCs. RBI's survey of regulated entities in 2022 showed that 90 per cent of the respondents considered climate risk a material threat to business. However, detailed assessment of risks among the respondents is low. A disclosure framework fills in such gap.

The draft by RBI sets three thematic pillars for reporting: Governance, strategy and risk management. The framework expects financial institutions to provide information on their internal processes to ensure capacity or understanding of climate change-related issues as well as oversight. In terms of strategy, the regulated entities will have to specify the kinds of issues and impacts that may arise over different time horizons, that is, short, medium and long term. This is particularly important as the systemic risks will be more pronounced where there is more long-term lending to sectors in transition and prone to extreme weather events. In 2023, 64.2 per cent of bank loans had maturities less than or equal to three years. While the information on maturity of loans by sector is not available, a similar profile for the loans in fossil fuels-based sectors would mean that the banks may be able to prepare better for the transition.

Transition risks can impact differently under the various scenarios. Therefore, the framework seeks information from entities on the assessment of stress through climate-scenario analysis as part of the risk management strategy. This would require banks to provide reasons for choosing the climate scenario and align it with national and state-level policies. In fact, the draft refers to scenario analysis based on nationally determined contributions. To support more robust reporting, it is important to update the scenarios to align with India's aspiration to achieve net zero. Therefore, national and sub-national governments must help provide a pathway to benefit from the disclosure framework.

Reporting of exposure and risks is not complete without metrics and targets. While reporting of information on the three pillars will begin in the financial year 2025-26, reporting of metrics and targets, which includes greenhouse gas emissions or intensity and financed emissions will begin in the financial year 2027-28.

As entities prepare to report in a year's time it is essential to recognise that the technical capacities of banks vary widely. Capacity building is key for the success of the framework. RBI has taken a step forward by introducing the draft that aligns well with international standards. Even as regulated entities begin to respond to the regulatory shift, they must simultaneously keep a watch on the asset quality not just in fossil fuel-based sectors but also in "green" sectors so as to ensure a smoother journey to net zero