RBI's Framework for Climate-related Financial Risks

Why in news?

Recently Reserve Bank of India (RBI) has proposed a Disclosure framework on Climate-related Financial Risks, 2024 to address the financial risks associated with climate change.

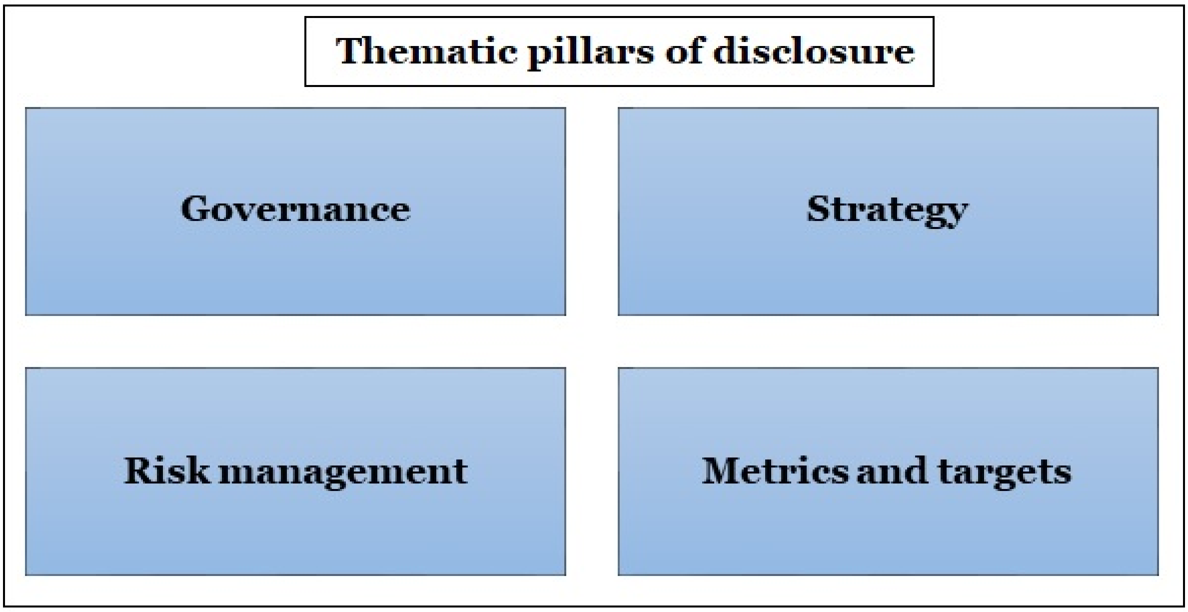
Why there is a need of disclosure framework by RBI?

- **Credit risk-** If customers' asset values decline due to climate-related factors such as damage from extreme weather events), banks could face credit risk this may impact borrowers who struggle to repay debt, leading to potential losses for lenders.
- **Supply chain impact**-Disruptions in supply chains due to climate events can affect operations, profitability, and viability which in turn impacts borrowers' ability to service debt.
- **Liquidity demand-** Consumers may need funds to cope with extreme weather events or other climate-related challenges which leads to liquidity demand.
- **Asset liquidation**-Consumers may perceive difficulties in liquidating assets affected by climate events, affecting their capacity to raise funds.
- **Claims exposure**- Banks face the risk of not meeting exposure to claims such as insurance claims from customers seeking to recover climate-related losses, it is particularly risky in vulnerable sectors such as agriculture, tourism etc.,
- **Market risks-** A shift in investor preferences toward sustainable investments can impact financial markets.
- Adverse climate effects on economic activity can lead to market risks.
- **Vulnerable NBFCs-** Non-Banking Financial Corporations extend significant credit to sectors like power and automobiles (both with high carbon footprints) and MSMEs that rely on conventional fuel.
- The interconnectedness of these sectors raises concerns about potential "large-scale default" leading to "macro financial instability".

What are the key highlights of disclosure framework by RBI?

- **Climate related financial risk-** It means the potential risks that may arise from climate change or from efforts to mitigate climate change, their related impacts and economic and financial consequences.
- **Purpose-** The regulated entities must disclose information about their climate-related financial risks and opportunities for the users of financial statements.
- **Disclosure of information-**
    - Identified climate-related risks and opportunities over short, medium and long term.
    - The impact of climate-related risks and opportunities on their businesses, strategy and financial planning.

    - The resilience of the RE's strategy taking into consideration the different climate scenarios.
- **Applicability-** The guidelines shall be applicable to the following entities, collectively referred to as Regulated Entities (REs)
    - All Scheduled Commercial Banks (excluding Local Area Banks, Payments Banks and Regional Rural Banks)
    - All Tier-IV Primary (Urban) Co-operative Banks (UCBs)
    - All All-India Financial Institutions (viz. EXIM Bank, NABARD, NaBFID, NHB and SIDBI)
    - All Top and Upper Layer Non-Banking Financial Companies (NBFCs).

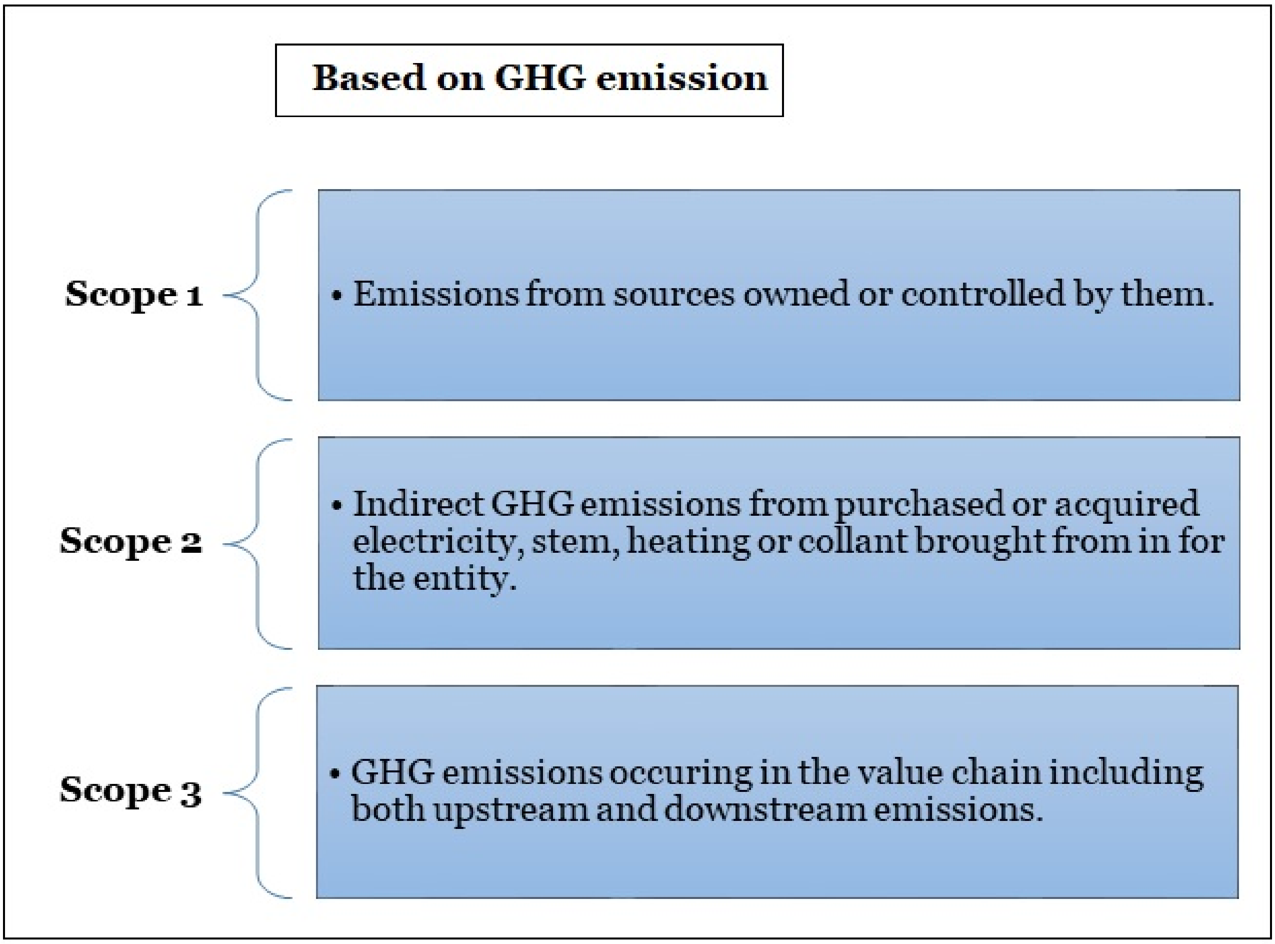


- **Governance-**It should detail the governance processes, controls and procedures used by the RE to identify, assess, manage, mitigate, monitor and oversee climate-related financial risks and opportunities.
- **Strategy-**It should detail the RE’s strategy for managing climate-related financial risks and opportunities.
- **Risk management**- It should detail the RE’s processes to identify, assess, prioritize and monitor climate-related financial risks and opportunities, including whether and how those processes are integrated into and inform the RE’s overall risk management process.

Risk categorization	
Physical risks	**Transitional risks**

• *Direct consequences* of extreme weather events such as floods, storms, or wildfires can lead to economic costs and financial losses. • *Long-term shifts* in climate patterns, such as rising sea levels or extreme weather variability, can affect the value of assets, particularly immovable property serving as collateral for loans. • Damage to properties or data centers due to severe weather events can *disrupt banking operations*, impacting services to customers. • Degradation of soil quality or marine ecology can *indirectly affect economic activities* and sectors.	• Risks associated with the transition to a low-carbon economy, including *policy changes* favouring clean energy or technological innovations. • *Downgrades in credit ratings* or financial valuation due to climate mitigation policies. • Increased costs or *operational overhauls* to comply with new regulations or adopt sustainable practices. • *Depreciation* of assets dependent on older, high-carbon technologies. • *Shifts in public sentiment* towards climate-friendly investments, impacting demand for certain financial products.

- **Metrics and targets-** It should detail the RE's performance in relation to its climate-related financial risks and opportunities, including progress towards any climate-related targets it has set, and any targets it is required to meet by statute or regulation.



References

1. The Hindu- RBI's proposal for disclosure framework
2. RBI- Draft disclosure framework on climate related financial risks