Comments of the Reserve Bank of India on the BCBS Consultative Document on 'Principles for the effective management and supervision of climate-related financial risks'

The comments of the Reserve Bank of India on the Consultative Document are as follows:

Q1. Has the Committee appropriately captured the necessary requirements for the effective management of climate-related financial risks and the related supervision? Are there any aspects that the Committee could consider further or that would benefit from additional guidance from the Committee?

i) The Reserve Bank would like to compliment the Basel Committee on Banking Supervision (BCBS) for coming out with a comprehensive Consultative Document on 'Principles for the effective management and supervision of climate-related financial risks' after the publication of a series of analytical reports last year. In our view, the Consultative Document has broadly captured the necessary requirements for the effective management and supervision of climate-related financial risks. The fact that the proposed Principles accommodate a diverse range of banking systems and could be applied on a proportionate basis depending on the size, complexity and risk profile of the respective banking sector greatly increase its utility.

ii) In addition to the financial materiality of climate-related financial risks to banks as discussed in Para 8, the Principles could also consider looking at the double materiality[1] of the banks' effects on the climate and environment.

iii) Given that there is a mention of physical and transition risks there is also need to mention about liability risk somewhere in the principles (instead of stating other risks) as it is one of the three risks when considering climate risk. These issues could be in form of additional guidance in the respective paras

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[1] Double materiality is an extension of the key accounting concept of materiality of financial information. Information on a company is material and should therefore be disclosed if "a reasonable person would consider it [the information] important", according to the US Securities and Exchange Commission. Thanks to the work by the TCFD, it is now widely accepted within financial markets that climate-related impacts on a company can be material and therefore require disclosure. The concept of double materiality takes this notion one step further: it is not just climate-related impacts on the company that can be material but also impacts of a company on the climate – or any other dimension of sustainability, for that matter (often subsumed under the environmental, social and governance, or ESG, label).

iv) The additional guidance could mention about large exposure limits though the document does mention about concentration risk (BCP 19). Likewise, there is a need to mention about disclosure as it is very important aspect (BCP 28). These issues could be in form of additional guidance in the respective paras

Q2. Do you have any comments on the individual principles and supporting commentary?

i) **Principle 2 - Para 13-15**: The BCBS may consider suggesting as additional guidance that banks could include 'climate risk / sustainability / ESG related' Key Performance Indicators (KPIs) for the evaluation of the performance of their senior management and also including a part of the variable compensation linked to achievement of the KPIs[2]. The Principle 15 instead of stating *identifying and managing* could state *identifying, measuring, controlling and managing.*

ii) **Principle 4 - Para 17-19:** As principle 17 only mentions about sufficient awareness and understanding to identify potential climate related financial risk, we could consider mentioning need for capacity building as part of additional guidance for all three lines of defence.

iii) **Principle 8 - Para 32**: In addition to having clearly articulated credit policies and processes to address material climate-related credit risks, banks could consider incorporating climate-related aspects into climate/ESG scores in their credit decisions. They would also need to align their credit portfolio to play an enabling role in the transition to a net-zero future.

iv) **Principle 11** - This Principle rightly emphasises that banks should also understand the impact of climate-related risk drivers on other risks and put in place adequate measures to account for these risks where material. In the other risks the Principle could highlight in greater detail the growing importance of reputational risk and potential risks of climate-related litigation being faced by banks and the steps they could take to mitigate the same.

[2] This would ensure that the senior management gives greater attention to climate-related financial risks and effectively fulfils responsibilities regarding climate-related financial risk management which is fast-evolving and expectations from banks are increasing.

v) **Principle 12** - This Principle rightly emphasises that, where appropriate, banks should make use of scenario analysis, including stress testing, to assess the resilience of their business models and strategies to a range of plausible climate-related pathways and determine the impact of climate-related risk drivers on their overall risk profile. The Principle could also underscore the following aspects:

a) Scenario analysis would need to be expanded to cover broader time horizons and transition risk related exposures.

b) Need for increased Climate risk scenario analysis and quantification as also become a key pillar of the climate risk strategy of a bank.

c) Given the concern about the availability of reliable climate risk models, pricing of climate risk as also fact that expertise in modelling climate-related risks is still evolving, the banks need to scale up their efforts and develop their capabilities in this regard.

d) Over the medium-term banks would need to work towards building their climate risk resiliency.

vi) **Principle 17** - This Principle rightly emphasises that supervisors should ensure that they have adequate resources and capacity with respect to climate-related financial risks. To emphasise the same, the Principle could also underscore the need for supervisors to acquire greater sustainability and climate risk knowledge which coupled with hands-on work experience would help them to effectively assess supervised banks' management of climate-related financial risks. The Principle could also highlight that the importance of climate-related litigation would only further increase in the coming years[3]. Supervisors would, therefore, do well to improve their understanding of the risks arising from climate-related litigation as it is relevant for microprudential supervision and monitoring of financial stability as the financial implications of such cases could be substantial.

[3]Technical Document of the Network for Greening the Financial System on Climate-related litigation: Raising awareness about a growing source of risk, November 2021

Q3. How could the transmission of environmental risks to banks' risk profiles be taken into account when considering the potential application of these principles to broader environmental risks in the future? Which key aspects should be considered?

i) It is well appreciated that environmental degradation can significantly impact the real economy and the broader financial system. Banks would, therefore, need to recognise that environment-related issues could also translate into credit risk concerns. Thus, the transmission of environmental risks to banks' risk profiles would need to be necessarily taken into account. Banks would clearly need to do more to managing the environmental risks associated with their lending and formal standards and guidance in the form of Principles, for example, would help them in doing so.

ii) The above Principles could, therefore, be assessed vis-à-vis the transmission of environmental risks to banks' risk profiles and suitably expanded to include broader environmental risks in the future. The following aspects could be considered in this regard:

a) Banks should necessarily consider environmental risks during the risk assessment for lending and investment transactions above a certain threshold.

b) Management of environmental risks should address the risks when a bank takes property as collateral and where environmental issues might impact the creditworthiness of its borrowers.

c) Banks should work towards further in-house capacity building on environmental risks.

iii) By taking exposure to clients engaged in economic activities related to biodiversity, banks would be exposed to both physical and transition risks, associated with the loss of biodiversity. Therefore, going forward this aspect would also require greater attention in banks.

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