Center for Sustainable Finance India

Clarifying Concepts

CLIMATE CHANGE AND FINANCIAL INSTITUTIONS

Climate change has far-reaching social and economic impacts, necessitating urgent and immediate action from various stakeholders including governments, corporates, financial regulator, and **proactive action from financial institutions (FIs)**.

In the last few years, the momentum in the sector has built up to acknowledge that capital needs to shift to low-carbon activities. With regulatory and policy support, this has led to an increasing focus on channelling financial flows to climate action.

At the same time, there is an acknowledgement that risks posed by climate change to the economy could threaten the stability of the financial sector. Thus, FIs need to measure and manage these risks.

This brief explains some of the main ways in which FIs are responding to and participating in climate action.

A BRIEF TIMELINE OF CLIMATE ACTION IN THE FINANCIAL SECTOR

Although climate concerns are more recently becoming mainstream in the financial sector, this work has been evolving over the past few decades, including:

- Establishing the United Nations Environment Programme Finance Initiative (1992)
- The Global Reporting Initiative's (GRI) first set of sustainability guidelines (1999)
- Equator Principles (2003)
- Principles for Responsible Investing (2006)
- International Capital Markets Association's Green Bond Principles (2013)
- Task Force on Climate-related Financial Disclosures (TCFD) in 2015
- Network for Greening the Financial System (2017)
- Basel Committee on Banking Supervision (BCBS) established the Task Force on Climate-related Financial Risk (2020)
- Glasgow Financial Alliance for Net Zero (2021)

For a more comprehensive timeline on development of sustainable finance, please check: Evolution of Sustainable Finance, UNEP

WHERE DO FIs FIT IN THE NARRATIVE OF CLIMATE CHANGE?

The current conversation on climate change in the financial sector revolve around two broad themes.

1. Managing climate-related financial risk

Climate change can amplify traditional financial risks, particularly through credit, market, and operational risks.

Central banks and supervisory authorities around the world are encouraging FIs to:

- Identify climate-related financial risks
- Assess them by conducting scenario analysis and stress tests
- Manage them by setting governance structures and strategies
- Disclose information on climate related financial risks

2. Mobilising green finance

An economy-wide transition is required to address the impacts of climate change. FIs can support this by steering financial flows towards low carbon, climate resilient activities.

- **Commercially viable technologies**: Risk-return profiles for more mature green technologies, such as large-scale solar energy, can attract private commercial capital. FIs can play a major role in mobilising more finance for such technologies. One way could be through issuance of financial instruments, such as green and sustainable bonds, to attract large institutional investors.
- **Breakthrough technologies**: Newer green technologies, such as battery storage and hydrogen, are capital intensive, higher risk, and therefore not yet commercially viable. In such cases, the policy and regulatory environment plays an important role in signalling their commercial path, as well as providing incentives to develop and scale these technologies. Their financing requires patience and risk tolerance or mitigation, which can come from concessional and grant capital delivered by governments, development finance institutions, impact investors, and philanthropy.

THE DILEMMA OF MOBILISING CLIMATE FINANCE WHILE MANAGING RISK

Mobilising green finance while managing climate risk simultaneously requires a careful balance.

Several green assets are currently perceived to be riskier and therefore, regulatory and policy push for increasing green finance could lead to a higher credit risk profile for FIs. On the other hand, if FIs focus solely on managing risk, capital flows to high-risk emerging green technologies could get constrained.

Therefore, a balancing act to address is required to manage risks for FIs and simultaneously increase financial flows to green technologies.

REFERENCES

1. Climate-related risk drivers and their transmission channels, Basel Committee on Bank-ing Supervision (2021) https://www.bis.org/bcbs/publ/d517.pdf
2. Mobilizing Green Finance while Managing Climate Finance Risks in India, Climate Poli-cy Initiative (2022) https://climatepolicyinitiative.org/wp-content/uploads/2022/04/Mobilizing-Green-Finance-while-Managing-Climate-Finance-Risks-in-India.pdf

TO LEARN MORE

1. Evolution of Sustainable Finance, UNEP, https://www.unepfi.org/news/timeline/
2. Discussion paper on climate risk and sustainable finance, Reserve Bank of India. (2022) https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/CLIMATERISK46CEE62999A4424BB731066765009961.PDF
3. Financing the Transition to Net Zero, World Economic Forum (2021) https://www3.weforum.org/docs/WEF_Financing_the_Transition_to_a_Net_Zero_Future_2021.pdf

Additional Clarifying Concepts will focus on climate-related financial risk and how these risks can be managed, as well as how greater flows of green finance can be mobilised.

The Clarifying Concepts series provides short explanations of foundational ideas and terminology in sustainable finance to help professionals from different fields navigate emerging issues.

It is produced by the Center for Sustainable Finance (CSF), a knowledge and net-working hub which aims to accelerate India's financial sector towards a more sustainable future. CSF is managed by Climate Policy Initiative (CPI).