Climate Change – The Emerging Challenge[1]

Good afternoon ladies and gentlemen,

At the outset, let me thank the organisers for inviting me to deliver this address and convey my thoughts at this prestigious event. We, as central bankers, interact with various stakeholders on different occasions and diverse gatherings like this provide us an opportunity to reflect on issues which straddle not just the world of finance but also impinges on wider scheme of things. The idea is to flag issues which have wider ramifications beyond the conventional financial risks. Therefore, while I would dwell upon the Indian financial outlook, I would like to avail of this opportunity also to discuss on the issue of climate change and the role of financial entities in the transition process towards a more sustainable growth.

Indian banking and financial sector outlook

The global financial system is facing strong headwinds from various quarters, including high levels of public debt, stretched asset valuations, economic and financial fragmentation, geopolitical tensions, and risks arising from increasing cyber threats. Amidst these global challenges, the Indian economy is an outlier which shows strong macroeconomic fundamentals. Economic activity is growing steadily, supported by a financial system that looks stronger than in the past.

If we exclude post-COVID rebound in 2021-22, India's real GDP growth in 2023-24 surged to its highest since 2016-17, surpassing expectations. The period marked a shift in growth trajectory from an average of 7 per cent pre-2020[2] to an average of 8 per cent or higher during the subsequent period, driven largely by domestic factors. Inflation is currently forecast to average around 4.5 per cent in 2024-25 and 4.1 per cent in 2025-26[3]. These macroeconomic conditions could, therefore, lay the foundation for sustainable future growth, improve consumption conditions, strengthen the investment climate, and enhance external competitiveness.

The Indian banking sector, in particular, has demonstrated significant improvement in key metrics such as capital adequacy, asset quality, and profitability, supported by robust macroeconomic fundamentals and business confidence. There has been sustained growth in credit expansion, primarily driven by personal loans and loans to services sector. As of the end of March 2024, scheduled commercial banks (SCBs) reported a capital to risk-weighted assets ratio (CRAR) of 16.8 per cent and a common equity tier 1 (CET1) ratio of 13.9 per cent. Additionally, SCBs achieved a multi-year low in their gross non-performing assets (GNPA) ratio at 2.8 per cent and net non-performing assets (NNPA) ratio at 0.6 per cent, underscoring strong performance across various indicators. Profitability of banks also remained strong, evidenced by their Return on Equity (RoE) at 13.8 per cent and Return on Assets (RoA) at 1.3 per cent as of March 31, 2024.

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[1] Remarks delivered by Shri M. Rajeshwar Rao, Deputy Governor on July 19, 2024, at J P Morgan India Leadership Series Lecture in Mumbai. Inputs for preparing these remarks were provided by Manoj Kumar Poddar, Pradeep Kumar, Kavita Gangwal and Rupesh Kanaujiya.

[2] RBI Bulletin June 2024, State of Indian Economy

[3] Future Readying India’s Monetary Policy speech delivered by M D Patra, Deputy Governor on July 12, 2024

At an aggregated level, Non-banking financial companies (NBFCs) also continue to maintain robust health indicators as of end-March 2024, with a CRAR of 26.6 per cent, GNPA ratio at 4.0 percent, and RoA at 3.3 per cent.

However, despite the financial system exhibiting strong performance and healthy financials, as a regulator and supervisor, we need to remain vigilant to the risks on the horizons. We have been flagging our concerns on strong credit growth in certain segments of unsecured retail loans. Increase in use of technology has also increased threat of cyber risks. We have also been sensitising regulated entities on these issues during our periodic interactions. The regulatory thrust also continues on conduct related matters to enhance transparency and improve customer experience.

Climate risks and the leadership challenge

But let me now focus on an area which is going to significantly impact us going forward, which is the issue of climate change and its impact on our economy and the financial system. These changes transcends segmental, geographical and ideological boundaries. As leaders you have to take a strategic view and take a long term perspective. More importantly, you must provide the necessary inspiration, conviction and guidance on the path to achieve sustainable growth outcomes while being mindful of emerging challenges. Tackling the issue of climate demands such a visionary leadership from the collective diaspora of leaders as individuals efforts are likely to fall short or may prove ineffective.

The current times present us several leadership challenges – in fact, the term 'polycrisis' has come to represent the intertwined challenges from climate, geopolitics, *etc.* Amongst all these issues, the issue of climate change is all pervasive and is most likely test the leadership ability in every sphere of our lives –financial, social and global. The impacts of climate change may cause damage to lives and livelihoods for several communities and a challenge of this magnitude demands a cohesive and extraordinary response from the leaders in every field.

However, I would limit my remarks today to the financial aspects of the climate challenge and why financial community should play a major role in tackling the impact of climate change. While the obvious risks of climate change relate to the physical world, such risks have the potential to swiftly transcend from physical to financial, bringing into focus the role of the financial sector. At times, there is a debate regarding role of financial sector regulators, especially central banks *vis-à-vis* issues on climate front. I, for one, do believe that there are clear linkages of climate events on growth and inflation – the two macro variables which most of the central banks are deeply concerned about. Since the climate events impact the real sector and by extension bank's exposure to these sectors, it has a direct bearing on risk management frameworks for banks and other financial institutions. Therefore, from both monetary policy as well as prudential policy perspectives, central banks will have a key role to play on the issues related to climate risks. As climate change has the potential to create shocks to monetary stability, growth, financial stability, and the safety and soundness of regulated entities, in a way it influences the action of central banks and regulators.

From an Indian perspective, our diverse topography, with snow-clad mountains, fertile plains, deserts and a long coastline with different temperature and precipitation patterns, generates diverse set of risks with attendant challenges for growth and inflation. The agricultural sector, heavily reliant on monsoon rains, plays a critical role in India's economy and food security. The El Niño event of 2023-24 exemplifies this vulnerability, leading to hotter summers, reduced productivity, inadequate monsoons affecting reservoir levels, and lower agricultural production. These factors have cascading effect on inflation due to food price fluctuations. An added element is the dependence on agriculture which has bearing on their spending patterns and resultantly impact growth of country at large. Climate-related events also adversely impact the credit quality and loan-repayment capabilities of the borrowers. They can wipe out the assets created from institutional finance thereby impacting health of financial institutions.

An important point to ponder is that the traditional ways of risk management, *viz.,* risk avoidance, risk mitigation, risk sharing and risk transfer may not be fully effective as the financial and other risks from climate change wouldn't materialise in part or on individual basis but manifest and impact collectively in a region or industry. Traditional instruments like insurance alone may not be enough to manage the risks arising from such an all-encompassing crystallisation of risks and can overwhelm the insurers. Therefore, we have to acknowledge that risk emanating from climate change cannot be handled by one set of actors alone. It needs a buy in from all stakeholders and to ensure a successful transition to a sustainable future, we need a multi-faceted approach that involves governments, private sector entities, financial institutions, civil society organisations and the public.

Climate vs Growth - Concept of 'Just Transition'

Proposals for tackling climate change and containing global temperature sometimes give rise to contradictory views as pro-climate actions are perceived to compromise on economic growth and employment. However, the need to act is immediate and in a calibrated manner. We cannot afford to procrastinate. The rising temperatures and climate events are already inflicting huge financial costs and causing irreparable damage to ecosystem. If we start early, the cost of transitioning to a more sustainable future would be lower and spread out over a longer time horizon.

Therefore, I believe that early work on mitigating the climate risk would support the long-term growth. The investments in climate action would pay-off well in the medium and long-term. The important point here is that the short-term impacts should not be disproportionate to some countries in the sense that they should not be worse-off during the transition process. Therefore, there is a need for more channelising of climate finance to EMDEs and firm and abiding commitments on climate funds from advanced economies to help EMDEs in the transition process is very important.

Adaptation and transition are key strategies in managing climate risks. However, the transition must be swift, equitable and just, without putting undue burden on developing and underdeveloped economies. We also need to address the elephant in the room which is how to finance the transition towards a low carbon economy. Given the significant funding gaps and huge financing requirements of EMDEs (estimates range from 2.5 per cent of GDP annually in case of India and at $2 trillion per year by 2030 for EMDEs) access to transition finance is important.

EMDEs face significant challenges in that they are not just more vulnerable to impact of climate change but they have even higher resource constraints with predominance of small enterprises and dependencies on fossil fuels. The recently released publication by the NGFS titled "Tailoring Transition Plans: Considerations for EMDEs" aptly highlights the specific challenges faced by developing countries. Though the concept of ‘Just Transition’ has gained prominence in climate policies of various jurisdictions it’s important that we need to apply it to the transition processes.

Given the need for transition finance, the next obvious question is how to plan for it and hence a need for credible transition plans. Despite the need for banks and financial institutions to address multiplicity of objectives, the importance of transition plan in EMDEs is very important wherein the banks and financial institutions as also non-financial firms have an important role to play. Transition plans are essential for banks and financial institutions to mobilize capital and manage financial risks that may arise from climate related financial risks.

The transition plans must be strategic and top-driven while having explicit components for geographical regions as also for industry and entity levels. Further, entities need to craft detailed plans across operations, products, services, and policies to mitigate specific risks. Similarly, industry-specific transition plans should align with sector needs by meeting regulations, adopting relevant technologies, and collaborating with stakeholders. This approach would ensure that both entities and industries contribute effectively while addressing their own set of distinct challenges.

While transitioning is crucial, we cannot overlook the immediate impacts of climate events. There is, therefore a need to look at adaptation part which is a missing link as far as climate strategies that are evolving. Adaptation involves responding to climate event impacts, which steadily deteriorate the environmental conditions essential for daily living, such as access to water, energy, air quality, and tolerable working temperatures. These conditions can be disrupted by short-term shocks like storms, floods, and wildfires, which have abrupt and devastating effects. Establishing early warning systems and disaster preparedness plans is crucial for minimizing loss and damage and therefore, adaptation financing is critical for building economic resilience and fostering sustainable development. One way to do that is by integrating the adaptation financing into resilience and disaster management frameworks.

The role of regulators becomes important as they not only set the regulations for the financial sector but also send the signals to the real sector for their future course of actions, significantly influencing them to chart their future strategies. Also, given the important role played in financing by private sources, there is a need for regulators to put in place right climate information architecture to create a conducive environment to attract private capital for climate finance. Therefore, the role of disclosure frameworks which are consistent with internationally accepted norms is crucial.

The point I wish to make is that it is possible to converge the objectives of growth and climate-protection in an optimal way. Once we are able to put in place enabling frameworks, economy would be able to create a pipeline of the viable projects as well as evolve a set of new financial instruments like adaptation finance[4], blended finance[5] as an innovative climate financing tools. Given these building blocks the possible policy direction points to strengthening regulatory and supervisory frameworks could include- (i) disclosure requirements (ii) risk management (iii) robust network of third-

[4] Adaptation finance is crucial for enhancing resilience and disaster management capacities

[5] New instrument which can help in bridging the interests of public and private capital

party verification of green credentials and impact assessment of projects to address green washing concerns and (v) periodical stress testing as part of risk mitigation measures.

As a country, India too has made significant advancements in addressing climate change and fostering sustainable development. We have submitted our Nationally Determined Contributions (NDCs) to the UNFCCC in 2015, with updates presented at COP 26 in 2021. India also has committed to ambitious targets through its comprehensive strategy known as "Panchamrit," aiming to increase non-fossil-fuel energy capacity to 500 GW by 2030, derive 50% of energy from renewable sources, and reduce GDP carbon intensity by 45% by 2030, aiming for net zero emissions by 2070. Launching of long-term low emission development strategies (LT-LEDS) at COP27, co-founding the International Solar Alliance, launching of the National Hydrogen Mission, introduction of Mission LiFE (Lifestyle for the Environment) are some of the other steps taken by the Government of India.

RBI too has taken proactive steps like including financing renewable energy projects under priority sector loans, introducing green deposits, and drafting a disclosure framework for climate-related financial risks. In near future, we plan to release guidance notes on scenario analysis, stress testing, and effective management of climate-related financial risks based on BCBS principles. RBI's aspirational goals for RBI@100[6] includes establishing a robust regulatory and supervisory framework to effectively manage challenges arising from climate change, enhance the resilience of payment systems against climate risks, and collaboration with the government for finalizing a comprehensive taxonomy.

Conclusion

India has achieved the highest climate change performance index (CCPI)[7] score among G20 members in 2024, which reflects our unwavering commitment to this cause. This also shows that by aligning economic policies with climate action, we can spur green investments, enhance energy efficiency, and foster sustainable development across the sectors. By embracing the concept of "just transition" at a global level, we can chart a course towards a sustainable future - one that ensures prosperity for all while safeguarding our planet for future generations. Economic growth pursued in a sustainable way, while treating the whole world as a family and the Earth as its only habitat, can simultaneously address the challenges of climate change. Here, it would be pertinent to quote the great vision from the Rigveda, which we propagated during our G-20 presidency:

"अयं निजः परो वेति गणना लघुचेतसाम्।
उदारचरितानां तु वसुधैव कुटुंबकम्॥"

"This is mine, that is yours — thus calculate the minds of narrow-hearted people. For the magnanimous ones, however, the whole world constitutes but a family."

It is said that you are the creator of your own future. As the leaders in our respective organisations, let's make each decision count as it is a step towards a shared and prosperous future and our actions of today will shape the reality of tomorrow. May the

[6] https://website.rbi.org.in/en/web/rbi/-/press-releases/governor-s-statement-june-7-2024
[7] https://ccpi.org/

deliberations and discussions during the course of event result in innovative ideas to achieve the shared objective of a climate sensitive growth.

Thank you. Namskaar!!