THE EVOLVING LANDSCAPE OF SUSTAINABILITY IN INDIAN BANKING

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Abstract

The article examines the integration of sustainability-related developments in the banking sector in India. The article traces regulatory developments across the world, including the Paris Agreement and the Task Force on Climate-related Financial Disclosures (TCFD) and their impact on banks' sustainability, climate risk and opportunities journey. On the domestic front, various steps taken by Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI) and relevant Ministries.

The governance-related aspects are well established in most banks. However, there are divergent practices related to ownership of these initiatives at the execution level in banks. In terms of strategy, the alignment between financial planning and climate risk and opportunity assessment has not yet begun. Scenario analysis, which is an important tool under strategy, is still in its nascent stage, with most banks having basic exposure through some exercises conducted by RBI.

Banks have started to acknowledge physical and transition risks, but their integration with the decision-making process is not yet mainstream. In terms of targets, some banks have set sustainability targets for their own operations. However, portfolio-related targets are still limited. Although there are a few portfolio-level targets, they lack scientific and logical backing.

Different banks are experimenting with sustainable finance using different sources of funds such as green deposits, bonds and lines of credit; and different avenues of utilization like green energy and mobility, while using instruments like sustainability-linked loans. However, these initiatives are at the initial stages and have yet to form a material part of banks' business.

The decision-making process of credit assessment has started incorporating environmental and social assessments and sustainability assessments in a few cases. However, the integration of these assessments with decision-making, pricing or rating has not yet begun.

Numerous capacity development activities are in underway. RBI has conducted several training programs and is developing standardized datasets to help banks in their scenario analysis journey. Work on taxonomy is actively progressing, with the Ministry of Finance releasing their draft taxonomy. With these efforts and the increasing understanding of banks, sustainability and climate-related assessments of risks and opportunities will become a major factor in banks' decision-making processes.

The Global Regulatory Landscape

Environmental, Social and Governance (ESG) frameworks, along with related concepts such as sustainability and climate change, have recently captured significant attention from all sections of society. The sustainability journey began when the Brundtland Commission introduced this concept in 1987, but gained substantial momentum following the 2015 Paris Agreement, which established the

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critical goal of limiting global temperature increase to below 2 degrees Celsius, with an aspirational target of 1.5 degrees Celsius below pre-industrial levels.

The impact of the Paris Agreement reached corporate boardrooms through the introduction of the Task Force on Climate-related Financial Disclosures (TCFD) in 2017. The TCFD framework established comprehensive disclosure requirements across four key pillars: governance, strategy, risk management, and metrics and targets. As sustainability reporting has matured, the International Financial Reporting Standards (IFRS) Foundation has developed IFRS S2, which builds upon the TCFD framework and IFRS S1, which focuses on the financial implications of sustainability initiatives.

Basel Committee on Banking Supervision (BCBS) published principles for the effective management and supervision of climate-related financial risks in June 2022 and issued a public consultation paper on a Pillar 3 disclosure framework for climate-related financial risks in November 2023 for banks. Today, climate risk ranks among the most significant emerging risks identified by the World Economic Forum in their risk outlook reports.

India's Regulatory Evolution

In the Indian context, the sustainability focus intensified when the Securities and Exchange Board of India (SEBI) introduced Business Responsibility and Sustainability Reporting (BRSR) requirements in 2021 which became applicable to the top 1000 listed entities.

The banking sector in India began acknowledging climate change induced challenges more systematically in 2022 when the Reserve Bank of India (RBI) published its discussion paper on climate change. This document acknowledged climate risk as a major emerging threat for regulated entities and recommended that these institutions develop methodologies for identifying and measuring climate risk within their portfolios. The paper advocates for assessing climate risk as part of Pillar 2 risks under the banking regulatory framework.

More recently, the RBI has introduced draft guidelines on climate risk disclosure aligned with International Sustainability Standards Board (ISSB) S2 standards, requiring banks to report on climate-related risks and opportunities. These disclosures are scheduled to commence from 2025-26 for governance, strategy and risk management components, with metrics and targets reporting to follow from 2027-28. Additionally, the RBI has issued guidelines on green deposits, while the Ministry of Finance has taken significant initiatives in sustainable finance by bringing "Draft Framework of India's Climate Finance Taxonomy". The proposed taxonomy has defined objectives on transition, adaptation and support transition in hard-to-abate sectors and proposes to cover sectors like power, mobility, buildings, agriculture, food and security.

Objectives

The objectives of this study are:

i. To examine the current state of sustainability integration in the Indian banking sector.

ii. Assess the current state of governance structures for sustainability and climate related across Indian banks.

iii. Identify key impediments to effective ESG and climate risk management in Indian banking.

Methodology

The methodology triangulates insights from the comprehensive review of policy documents from RBI (discussion papers on climate change, draft disclosure requirements, green deposits), BRSR guidelines, SEBI and Draft climate finance taxonomy framework, Ministry of Finance, TCFD recommendations, IFRS S1/S2 guidelines and BCBS climate risk principles, to provide a comprehensive evaluation of sustainability integration in Indian banking, contextualized within the global regulatory landscape.

Current State of Implementation

Governance Structures

In response to these regulatory developments, Indian banks have begun acknowledging climate risks and opportunities by implementing appropriate governance structures. Most institutions have established a three-tiered framework where the Board maintains ultimate responsibility while delegating operational governance to a specialized sub-committee. Additionally, banks have formed executive-level committees to manage detailed implementation.

Interestingly, the organizational ownership of climate and ESG initiatives varies significantly across institutions. Different banks have assigned responsibility to diverse departments including risk management, finance, compliance and Corporate Social Responsibility (CSR). To support these initiatives, banks have introduced various policies addressing ESG integration, climate risk management, sustainable finance mechanisms, environmental and social due diligence protocols and operational sustainability measures.

Strategic Approaches

There remains a significant disconnect between traditional financial planning cycles and the timelines necessary for addressing climate risks and opportunities effectively. There is a need to develop a clear understanding of appropriate time horizons for climate planning.

On the opportunity side, several banks have launched green deposit products, though these have achieved limited success due to various challenges. Banks typically need to price these products at lower rates to account for different implementation costs, which the current regulatory framework does not adequately accommodate. Similarly, in lending activities, some banks have secured credit lines from Multilateral Development Banks, but these initiatives have struggled due to higher borrowing costs resulting from substantial hedging expenses.

While banks have begun acknowledging climate factors, formal integration into corporate strategy remains limited. Scenario development capabilities are still in nascent stages, with most banks' primary exposure to climate scenario analysis occurring through RBI's pilot Climate Vulnerability Assessment and Stress Testing (VAST). Significant capacity building is required to develop robust climate scenario analysis capabilities that can meaningfully inform decision-making processes. The proposed Climate Risk Information System (CRIS) by RBI represents a positive step in this direction, potentially providing essential infrastructure for conducting standardized scenario analyses that improve result comparability across institutions. The initiative will provide standardized datasets for physical risk (including hazards and vulnerability) and transition risk.

Risk Management Integration

Sustainability and climate risk have gained recognition as emerging risk factors, though their formal integration into comprehensive risk management frameworks remains limited. Environmental and Social Due Diligence (ESDD) or Environmental and Social Management System (ESMS) has seen significant adoption, primarily driven by requirements from international financing agencies that link credit lines to ESDD or ESMS implementation.

Banks have begun integrating climate considerations into credit risk assessments. ESG assessment of the customers especially listed and other bigger corporates is one of the ways in which the banks have started integrating ESG in their credit assessment. However, the way ESG assessment is to be linked with credit rating is in underway. This is also important considering the fact that international ESG rating providers have divergent views on the ESG rating of the same companies. Hence, the ESG assessment is a standalone exercise being conducted by few of the banks. Also, institutions currently lack empirical data demonstrating causal relationships between increasing climate risk and subsequent credit risk elevation. A critical area for development involves building databases that identify Non-Performing Asset (NPA) root causes and potential linkages to climate factors.

Limited progress has been made in connecting climate risk to market risk assessments. For operational risk, banks' existing business continuity plans generally address climate-induced physical risk events, though more sophisticated approaches are needed. Institutions must develop specific processes to manage climate-induced reputational risks, particularly for high-value exposures vulnerable to climate impacts.

The impact of biodiversity and nature risk on companies and vice-versa is seeing a lot of attention from regulatory bodies. Task Force on Nature-related Financial Risks (TNFD) has come out with disclosure requirements related to nature risk.

Metrics and Targets

In terms of measurement and goal-setting, banks have begun establishing net-zero targets for their operational activities. Regarding financed emissions, numerous Indian banks have become signatories to the Partnership for Carbon Accounting Financials (PCAF). However, PCAF's coverage remains limited to seven asset classes, insufficient for capturing the full breadth of Indian banking sector offerings.

Available emission factors from various data providers often lack India-specific context, creating an urgent need for developing country-specific emission benchmarks to improve measurement accuracy. Recently, some banks have started declaring net-zero targets for their financed emissions, but there is a need for substantiating disclosures regarding emission calculation methodologies, sectoral emissions profiles and transition planning. With these supporting elements, net-zero target declarations risk can become more meaningful.

Transition planning, a key requirement at international levels that many global banks and corporates have embraced, remains challenging in the Indian context due to limited clarity on sectoral transition pathways. With the proposed taxonomy and more sector specific transition pathways being developed, banks would be in a better position to declare their transition plan in future.

Sustainable Finance Initiatives

On the sustainable finance front, banks have begun utilizing various resources including green bonds, green deposits and credit lines from multilateral development institutions. To enhance capital flows at competitive rates, banks require overall cost reductions through decreased hedging expenses or sovereign guarantees.

In lending activities, banks are exploring sustainability-linked loan products. However, greater clarity regarding pre-issuance and post-issuance compliance requirements is essential to mitigate greenwashing risks. A comprehensive taxonomy serves as the foundational document for identifying climate-beneficial activities. The Government of India's green bond framework and RBI's green deposit guidelines currently provide basic reference points for banks. The recent draft climate finance taxonomy introduced by the Ministry of Finance represents a positive development that will provide clearer guidelines for banks to identify mitigation, transition and adaptation activities.

Sustainability in Own Operations

Banks have started taking several steps to promote sustainability in their own operations. Most of the banks are disclosing their scope 1 and 2 emissions and increasing number of banks have started disclosing their value chain scope 3 emissions. Increasing number of banks are adopting targets related to net zero or carbon neutrality in own operations. The various strategies being used by banks to promote sustainability include adopting green building standards, energy efficiency equipment, electric vehicles, green power purchase agreements, rooftop solar and waste segregation to name a few.

Sustainability Adoption

In terms of ownership, the majority of private sector banks have either their Corporate Social Responsibility (CSR) teams or the Departments responsible for filing regulatory returns taking ownership of sustainability-related roles. Among Public Sector Banks (PSBs), the ownership is either with risk management or with an independent vertical within the Bank. Regarding net zero targets for their own operations, both PSBs and private sector banks have set operational targets. However, for financed emissions, PSBs have established targets and notably, the majority of PCAF members are PSBs.

The work related to ESDD is being undertaken by banks across both sectors when extending lines of credit. In terms of risk management, public sector banks have taken proactive steps in measuring physical and transition risks and are actively collaborating with external consultants and solution providers.

Impediments to Effective ESG and Climate Risk Management

The most significant policy bottleneck in India, at present, is the lack of a comprehensive taxonomy. The development of taxonomy, along with RBI disclosure requirements and stress testing guidelines, will accelerate ESG adoption in banks. There is also a pressing need for regulatory synchronization across different authorities.

Such alignment would benefit both the investor community by increasing the comparability of disclosures across jurisdictions and banks themselves.

The Path Forward

While sustainability has gained acknowledgment across banks, regulatory bodies and policymakers, still there is a long way to go. There is a need to establish a more coordinated regulations among regulators and policymakers to effectively manage climate risk. The integration of sustainability and climate considerations into decision-making processes is the need of the hour.

Physical risk assessments for collateral and borrowers' production facilities must be incorporated into loan sanctioning processes. Transition risks arising from emissions—where carbon taxes might serve as proxies—should inform lending decisions. The relationship between climate-related risks and opportunities requires further examination and clarification.

Scenario analysis offers a valuable tool for banks to identify potential risk areas and interventions that could transform challenges into opportunities. Banks must integrate scenario planning, financial and business forecasting, climate risk assessment methodologies and appropriate metrics and targets to effectively manage climate risk in the coming years. As this transition continues, Indian banks stand at a crucial juncture where early adoption of comprehensive sustainability frameworks could yield significant competitive advantages in an increasingly climate-conscious global financial landscape.

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