

FINANCIAL SECTOR READINESS FOR CLIMATE CHALLENGES

In addressing climate challenges, it is important that a country or an economy gauges the exposure to climate risk both in terms of physical and transitional nature. Sri Lanka is identified as a small developing island nation susceptible to high level of climate risk with 19 million of the population living in locations set to become moderate or severe climate hotspots by 2050 as highlighted by UN Climate Impact Factsheet¹ with 6 out of 10 Sri Lankans being multidimensionally vulnerable due to climate change impacts. Moreover, based on data between 1993-2022, Sri Lanka's average ranking in the Climate Risk Index compiled by GERMANWATCH² is 59 out of 171 countries while estimates by the Asian Development Bank³ Sri Lanka indicates a 1.2 percent loss of annual GDP by 2050 if measures are not taken to address climate change impacts. However, in the present context the financial sector exposure to sustainable financing is just over 1 per cent which is predominantly in the renewable energy sphere addressing climate mitigation aspect while a considerable lacuna prevails in adaptation financing.

Role of the Central Bank

While strategizing climate mitigation and adaptation actions require national level initiatives, it is equally important to ensure financial sector readiness to withstand physical and/or transitional risks of any acute or chronic climate event. Central Bank of Sri Lanka (CBSL) as the leading financial sector regulator identified the role to be played in building resilience against climate risk. The dual mandate of CBSL; maintaining price stability and financial system stability both can be potentially impacted by the occurrence of any adverse climate event. For example, loss of agricultural produce due to flash floods or a cyclone could lead to supply induced inflationary pressure on the general price levels of the country which may impact the price stability objective of CBSL. Simultaneously, inability of the agrarian community to honor their debt obligations following a crop damage situation could lead to an increase in non-performing loans posing a high credit risk to the financial institutions. Financial inclusiveness is also identified as a duty of the Central Bank under the new CBSL Act hence identifying the vulnerable groups and ensuring social justice in terms of financial sector actions and policy interventions related to climate change is another priority of CBSL.

Intervention of CBSL for driving the climate/ sustainable financing in the financial sector is justified in the outset where much of the attention is required in streamlining infrastructure and policy frameworks to be in-line with the international best practices which is an important prerequisite specially for attracting global funding within this scope. In terms of the financial instruments such as green/ climate bonds, blended financing, debt-for-nature swaps, climate insurance, etc. and related innovative financial products offered by the financial institutions, global financial markets have expanded considerably during the past decade with the heightened concerns over climate risks. Market participants as well as the international counterparts engaging in climate/ sustainable financing have demanded for adoption of the best practices and upgrading the policy frameworks to reflect climate commitments set by way of NDCs⁴ or other national strategies for combating climate change.

Policy Initiatives of CBSL

CBSL launched the Roadmap for Sustainable Finance in 2019 with the primary objective of bringing in policy cohesiveness among the financial sector stakeholders while facilitating green/ climate financing by making necessary financial resources available for mobilizing funds into the field. One of the key milestones under the first Roadmap for the financial sector in Sri Lanka is the unveiling of the Green Finance Taxonomy (GFT) in 2022 which categorized activities to be recognized as 'green' which was developed in line with the International Standard Industry Classification (ISIC) covering 8 broad areas of industries including tourism as well as the blue economy. GFT was developed based on the Common Ground Taxonomy of the International Platform for Sustainable Finance (IPSF) which harmonized taxonomies between Europe and China. At present, GFT is widely referred not only within the financial sector but across multiple sectors as a national level taxonomy which is a crucial prerequisite in avoiding possible 'green washing' that may undermine

the efforts made by the concerned stakeholders. Following the Taxonomy, CBSL issued guidance to the financial sector by way of a Direction for the Banks and similar Guidelines for the NBFIs for establishing internal risk management frameworks and reporting the facilities provided for green activities.

As a member of multiple global platforms/ networks for sustainable financing, CBSL engaged in capacity development in the area by organizing training and awareness sessions for both financial sector stakeholders, regulatory institutions as well as for other stakeholder groups involved in green finance related activities such as private sector chambers. CBSL also took part in both national level and industry level knowledge sharing, policy dialogues in shaping the climate change policies of the country and educating the stakeholders of the potential financial instruments and opportunities available for funding.

Present Challenges

In the present context where UNFCCC⁵ established the Loss and Damages Fund for vulnerable countries and agreement on carbon markets at the COP⁶, developing nations that are susceptible to climate change impacts are faced with new challenges in strategizing climate finance. Especially with

the stringent climate regulations imposed by the European Union under the 'Green Deal,' Sri Lanka as an exporter to such markets require considerable upgrades to the existing standards maintained in terms of environmental systems and carbon emissions while compliance to the international

reporting standards (IFRS S1 and S2) becoming increasingly important. Transition Financing opportunities for the financial sector and new challenges in mobilizing funds for such projects may require attention from the banking and NBFIs sectors. Further, given the fiscal constraints faced by the State any potential blended financing opportunities are to be explored by the government in partnership with the financial sector stakeholders. As the country comes out of the debt standstill conditions, the dialogue on complex sovereign debt management options such as debt-for-nature swaps may emerge however readiness of the country for such commitments should be assessed specially in terms of the required technical expertise. Capacity development in the area of climate financing both at the policy level and institutional level remains a challenge while availability of a strong database to be used by multidisciplinary stakeholders in their decision making related to climate action also needs timely attention which demands for inter-agency co-ordination.

Way Forward

Having completed a majority of the tasks laid out in the first Roadmap, while catering to the global trends and domestic market demands, CBSL developed and Sustainable Finance Roadmap 2.0 (RM 2.0) with technical and financial assistance from the IFC⁷ in partnership with the European Union, with the intention to strengthen the focus of the financial sector to fund sustainable development over the next five years as well as building resilience of the financial system by giving consideration to ESG Risk management. It is also expected to streamline reporting and disclosure requirements in line with the global best practices. The scope of RM 2.0 is expanded to address the social aspect of sustainability, especially in terms of the vulnerable groups and MSME sectors by improving financial inclusion. CBSL also expects to incorporate the social activities with necessary updates to GFT and strengthen inter-agency co-ordination by establishing working groups in key priority areas of RM 2.0. However, financial sector readiness for the climate challenges demand for building capacities and sharing knowledge and awareness across multidisciplinary stakeholder groups. CBSL in partnership with international development partners such as the IMF⁸, IFC, European Commission, etc. expects to conduct a series of capacity development programmes aimed at ESG Risk management, sustainable/ climate financing, reporting and disclosure requirements. However, the ultimate success of these initiatives will depend on the achievement of the national strategies in combating climate change which demands for national initiatives in bringing necessary reforms specifically aimed at upscaling demand-side readiness of the country.



References

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- 2 Adil, L.; Eckstein, D.; Kuenzel, V.; Schaefer, L.: Climate Risk Index 2025 – Who suffers most from extreme weather events? Available at: <http://www.germanwatch.org/en/93013>
- 3 Ahmed, M., and S. Suphachalasai. 2014. Assessing the Costs of Climate Change and Adaptation in South Asia. Asian Development Bank. <http://hdl.handle.net/11540/46>. License: CC BY 3.0 IGO
- 4 Nationally Determined Contributions: https://env.gov.lk/web/images/pdf/policies/Final_NDC_IP_-_10072023.pdf
- 5 United Nations Framework Convention on Climate Change
- 6 Conference of the Parties (UN Climate Change Conference)
- 7 International Finance Corporation
- 8 International Monetary Fund