Financializing Climate Compliance: The Strategic Role of Derivatives in Carbon Portfolio Management Within the Indian Economy

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DOI: https://doi.org/10.47772/IJRISS.2026.10190065

Received: 20 January 2026; Accepted: 23 January 2026; Published: 19 February 2026

ABSTRACT

The Indian economy is currently in an escalating growth phase aligned with pioneering climate commitments, specifically the goal of achieving Net Zero emissions by 2070. This transition necessitates the development of trailblazing financial tools to manage the cost volatility linked to decarbonization. This article explores the emergent role of carbon derivatives within the context of India's market mechanisms, such as the Perform, Achieve, and Trade (PAT) scheme and the planned Carbon Credit Trading Scheme (CCTS), as critical instruments for risk management. It examines the specific market, regulatory, and credit risks encountered by Indian industries and proposes a robust framework utilizing futures, options, and centralized clearing. These instruments are presented as essential for corroborating predictable compliance costs, magnifying market liquidity, and protecting competitiveness during the metamorphosis toward a low-carbon economy. Ultimately, the paper argues that transforming carbon management into a strategic financial function, supported by Value-at-Risk analysis, is vital for decoupling climate compliance from economic expansion.

Keywords: Carbon Derivatives, Risk Management, Indian Economy, Carbon Portfolio Management, Climate Compliance.

INTRODUCTION: THE NECESSITY FOR CARBON DERIVATIVES

The climate action of India is first and foremostly navigated by its Nationally Determined Contributions (NDCs) and domestic policies, which constructively foist an imputed cost on carbon. Market-based apparatus such as the Perform, Achieve, and Trade (PAT) scheme for energy efficiency, and the imminent Carbon Credit Trading Scheme (CCTS), introduce inaugurated traded compliance products (like Energy Savings Certificates or ESCs) whose levy oscillates.

This price unpredictability, operated by transpose in stratagem, global energy prices, and industrial performance, produces significant financial unpredictability for energy-intensive sectors (e.g., power, cement, steel). Carbon derivatives financial contracts whose desirability is obtained from the asking price of a carbon allowance or credit are thus indispensable appliances for hedging this precariousness, empower companies to lock in compliance costs and facilitate deep-rooted investment planning.

India's Market Mechanisms and Derivative Proxies

India's present-day market contrivance hitherto use derivative-like instruments, even if a national cap-and-trade mechanism is still being underway:

- **Energy Savings Certificates (ESCs):** Under the PAT scheme, those industries which are outstanding energy efficiency targets give rise to ESCs, which can be hawk. The forwards and futures market for ESCs provinces as a carbon derivative market, empower adherence entities to superintend short-term costs.
- **Renewable Energy Certificates (RECs):** Mostly these certificates are traded to achieve Renewable Purchase Obligations (RPOs), REC oversee the cost of green energy sourcing.[2] Price volatility here is a catastrophic factor handled by exchanges.

- **Voluntary Carbon Market:** The architects of the Indian projects are major suppliers of Verified Carbon Units (VCUs) all around the world. Futures and forward contracts are indispensable here to cushion against the capricious global VCU prices.

The impending CCTS will set in motion the postulation of tradable carbon credits, ratifying a large-scale, unwavering carbon derivatives market under the administration of the Bureau of Energy Efficiency (BEE) and quiescent the Securities and Exchange Board of India (SEBI).

Pinpointing of Core Risks

Efficacious risk management begins with putting one's finger on the ultimatum specific to the Indian context:

Risk of Price Volatility

- **Provenance:** Undulation in put a figure on carbon compliance products (ESCs, RECs, future CCTS credits) on account of macro trends, specifically global fossil fuel price instabilities, or domestic factors, such as unlooked for industrial output fluctuations.
- **Collision:** Unpredictable acquiescence costs steer to highly changeable operating brinks, obstruct capital disbursement in obligatory low-carbon technologies.

Regulatory and Policy Menace

- **Provenance:** The lofty jeopardize in a nascent market. Interchanges may encompass amendments to emission reduction targets, incorporation/prohibition of sectors, or acclimatizations to scheme reasonableness and grandfathering rules.
- **Collision:** An unanticipated relocation in policy can furnish draw breath certificates worthless or exorbitantly hypervigilant future compliance inescapable, fabricating "stranded assets" (e.g., excess ESCs that look right on non-marketable).

Liquidity and Counterparty Risk

- **Provenance:** Stunted partaking or high single-mindedness of traders in the present limited ESC/REC market shepherd to deficient volume of operations.
- **Collision:** Awkwardness in carry through of encircle strategies (liquidity risk) and a sky scrapping probability of risk of failure on over-the-counter (OTC) agreements (counterparty risk).

Application of Carbon Derivatives for Risk Mitigation

Derivatives offer mechanisms to hedge the risks identified above:

Figure 4.1: Derivative Application Matrix

Derivative Type	Risk Mitigated	Mechanism
Futures & Forwards	Price Volatility Risk	Permits a compliance company to lock in today the future purchase price of an ESC months in advance, thereby guaranteeing the cost of fulfilling its requirement.
Call Options	Positive Price Risk	Enables the holder the right to purchase the underlying certificate at a fixed price called the strike. The maximum cost of compliance is thereby limited.

Put Options	Negative Price Risk	It allows the seller to select a strike price at which certificates are sold. For organizations generating surplus credits, this assures a minimum revenue floor.
Carbon Swaps	Bureaucratic Risk (via Customization)	Private agreements to exchange fixed-for-floating price streams, which allow for blending multiple certificate types or tailored hedging against specific regulatory outcomes.

Proposed Risk Management Framework for Indian Industries

For Indian industry to flourish under the forthcoming CCTS, a two-tiered substructure is proposed:

Intramural Corporate Masterplan

- **Value-at-Risk (VaR) Analysis:** Companies must embrace enlightened financial benchmarks like VaR to evaluate the maximum prospective loss of their carbon portfolio (physical credits + derivatives) countenance over a set time horizon and credibility level. This relocated carbon management from an operational piece of work to a strategic financial function.
- **Definition of Hedging Strategy:** Establishing an understandable internal rules framework for conflict obligations. Expect derivative contracts and over-the-counter contracts to be used in hedging to establish maximum exposure limits.
- **Capital Planning Integration:** The capital planning process can incorporate information about hedging cost and benefit, with a preference given to low-carbon options when financial risk is reduced.

Centralized Clearing and Exchange Trading

As per SEBI regulation, most of the standardized contracts and options in carbon futures will have to be traded and cleared on existing exchanges such as MCX. In case of exchange-traded contracts, margin, standardization, and removal of counterparty risk would be achieved.

- **Enhancement of Liquidity:** Perhaps encouraging a broad variety of participation in the market, such as financial intermediaries, fund managers, and speculators, may be one of the aims of regulation.
- **Transparency & Disclosure:** For encouraging transparency in market players and ensuring that investors do not indulge in excessive market speculations, it is important to make derivative investment disclosures mandatory.

FINDINGS

- **Financial Risk Materiality:** Owing to market variations in the cost of compliance documents such as ESCs and RECs, being climate compliant stands as a fundamental financial risk for energy-consuming sectors in India.
- **Dominance of Regulatory Risk:** Uncertainty concerning future CCTS regulation, targets, and validity of existing credits strongly discourages participation in derivative markets, leading to "stranded assets."
- **Liquidity Constraint:** Low participation and depth are a direct consequence of a lack of regulatory certainty, which leads to increased counterparty and liquidity risk.
- **Structural Gap:** Carbon management is often considered an operations/technical problem rather than a strategic financial function requiring portfolio management tools like VaR.

SUGGESTIONS

- **Predictability of Policy:** Make it mandatory for BEE/SEBI to come up with a five-year rolling roadmap on CCTS to enhance certainty and promote long-duration hedging.

- **Market Infrastructure:** Centralized clearing must be mandatory for standardized future contracts and options on national exchanges like MCX to create a safe, efficient, and liquid derivative market.
- **Corporate Governance Shift:** Move responsibility for managing carbon risk from operating teams to the CFO/Risk Committee.
- **Enhance Market Depth:** Introduce products like composite index futures on a basket of compliance certificates (ESCs, CCTS, RECs) to attract financial institutions and inject liquidity.

CONCLUSION

Carbon pricing will increasingly affect the balance sheets of businesses as the Indian economy approaches Net Zero targets. Carbon derivative contracts have a vital role in a risk management toolkit in a climate change policy approach, rather than being a gambit in which speculators trade. Risk volatility in Indian climate change compliance risk management can be decoupled from achieving targets in economic expansion with a guaranteed smooth transition with excellent risk management capabilities and a transparent derivative market based on CCTS imminent in this emerging new paradigm.

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A Professional MBA Graduate,**UGC NET** Qualified in the category of ASST.PROF, **APSET qualified** ,A **certified career mentor** from **CBMA** Talent matrix,worked as faculty and project guide and training and placement officer and an author who acquired multiple certifications from **SWAYAM NPTEL** multiple international certifications in the stream of finance and marketing and on teaching pedagogies ,Contributed nearly 8 years of multiple services in the academic industry,organized national educational fairs and participated in various national and international events and programmes and currently working as a lecturer in a reputed institute. Taking initiative to train versatile skills in upcoming young entrepreneurs. Also taking part in organizing competitive events at national level in the institute to encourage an advantage over worthy development in the personality of Gen. Z.

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