

Managing climate risks

A guide for financial institutions in Malaysia

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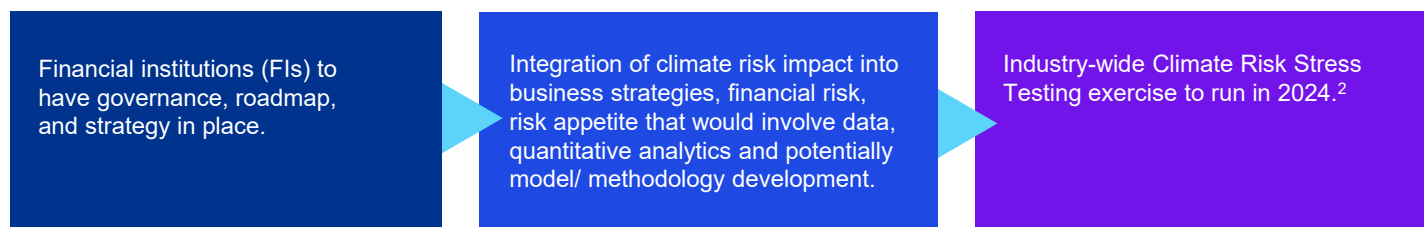


Bank Negara Malaysia (BNM) issued the “Climate Risk Management and Scenario Analysis” on 30 November 2022, with the aim to enhance the resilience of Financial Institutions (“FIs”) against climate-related risks, while facilitating the transition to a low-carbon economy to support global and national commitments (i.e., Paris Agreement and the 12th Malaysia Plan). The focus has been predominantly on ensuring FI resilience, while the initiatives to shift to a low-carbon economy were provided as guidance [refer to policy document 8.10, 11.11, 11.13].¹

Compliance with this policy has taken industry feedback into consideration and is expected to become effective in stages based on these transitional specifications [refer to 4.1 & 4.2]:

- 31 December 2023: Governance, Strategy, Risk Appetite and Management
- 31 December 2024: Scenario Analysis, Metrics, Targets and Disclosures

The timeline above allows FIs to integrate climate risk on a gradual basis as shown here:



FIs are expected to provide their gap assessment of the various requirements and a **board-approved implementation plan** [14.2] by 31 May 2023 [14.3]. While there were previous instances of feedback collected via the Exposure Draft in December 2021 and the 2024 Climate Risk Stress Testing Discussion Paper in June 2022, there is still a journey for FIs to fulfil this. Planning would be required to manage this in conjunction with the ongoing Financial Year End and the Malaysia Financial Reporting Standard (MFRS 17) going live in 2023.

¹ [Climate Risk Management and Scenario Analysis](#), Bank Negara Malaysia, 30 November 2022

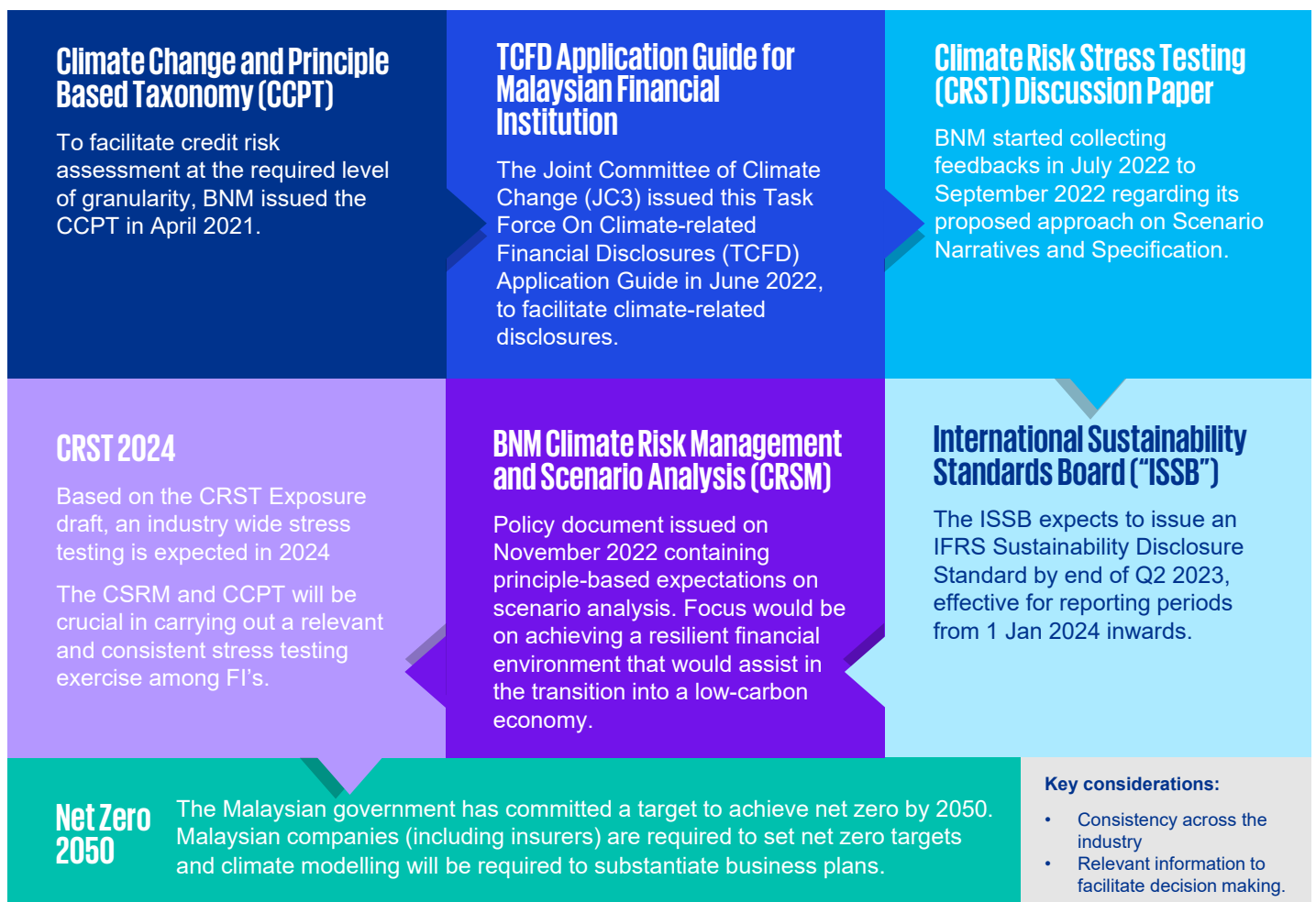
² [2024 Climate Risk Stress Testing Exercise - Discussion Paper](#), Bank Negara Malaysia, 30 June 2022

Some of the key requirements from the policy include:

- **Effective oversight by the Board and Senior Management** with regards to climate risk resilience. While not mandatory, the Board may appoint a Chief Sustainability Officer (CSO), depending on the size of the FI to ensure effective oversight on climate-related risks [8.2].
- **Consideration of climate-related risks when developing business strategies** to assist in decision-making during the transition into low-carbon economy [9.1].
- **Continuous development of capabilities** including technical and data capabilities to report material climate-related risks [11.4]. That the bank has considered various aspects and provides guidance to allow development of these tools over time and is incorporating existing models for current assessments [11.6]. FIs may consider leveraging existing credit models by incorporating climate-related aspects or develop climate risk models to better understand the implications of climate risk on credit risk.
- **Comprehensive and reliable disclosures** to keep stakeholders informed on the practices to manage relevant climate-related risks and opportunities, including metrics and targets used to assess the effectiveness of such practices [13.4].
- Assessment of climate-related risks on the existing risk types for FIs, with some guidance on performing **Scenario Analysis and Risk Management for Specific Risk Types**. For credit risk management, this would entail recalibration of credit risk indicators [11.17]. As for scenario analysis, this would involve global climate scenarios from the NGFS (Network for Greening the Financial System), the IPCC (Intergovernmental Panel on Climate Change) and the IEA (International Energy Agency) [12.10].

Regulatory development of Climate Modelling - Malaysia

This Climate Risk Management and Scenario Analysis Policy forms part of the various regulatory developments in Malaysia's journey to achieve Net Zero by 2050, as outlined below:



Climate-related data challenges

While understanding the position of FIs and their ability to face the impending climate-related risks is vital, it poses some challenges as well. Quoting Principle 12.3, FIs shall conduct climate-related scenario analysis when developing business strategies, and as part of risk management, there is a need to quantify the impact of climate-related risks effectively, which could pose a challenge

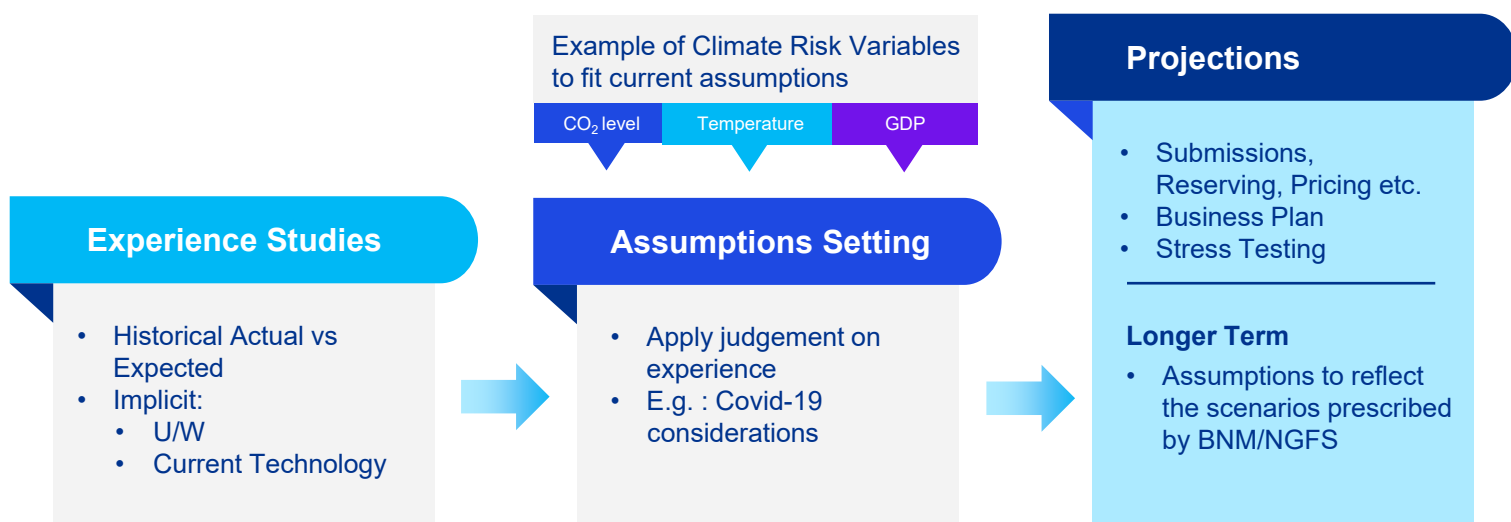
For banks, the biggest risk is credit risk, which is generally estimated by probability of default (PD), loss given default (LGD) and exposure at default (EAD). There is the impact of climate risk towards these components, such as the shift in consumer preference, flood risk, investment in technological advances, and litigation risk which affects business operations. However, banks might lack readily accessible information for statistical conclusion, thus requiring judgement assessment which could be restricted **by limitation of industry standard and research**.

It will be a journey for the bank to initiate data gathering such as internal data collection, third-party data provided and continuous assumptions and/or model refinement.

BNM provides the climate-adjusted Macroeconomic Environment Variables (MEV) for stress testing, which could be a starting point for banks. However, if the MEV provided are deemed insufficient, Subject Matter Experts will need to carry out additional adjustments to forecast the required climate-adjusted MEV for stress testing to cater for their specific businesses.

For life insurers, due to the indirect and longer term nature of its insurance risk, it would be **challenging to confidently quantify** these risks. While much research has substantiated the statement in the policy document [11.31 (c)] that climate change could increase mortality and morbidity risk, the magnitude is expected to differ across the region and potentially specific locations within a country.

An approach that insurers could consider is observing the scenarios identified in existing climate risk models and linking those climate-related parameters to current insurance risks as shown below:

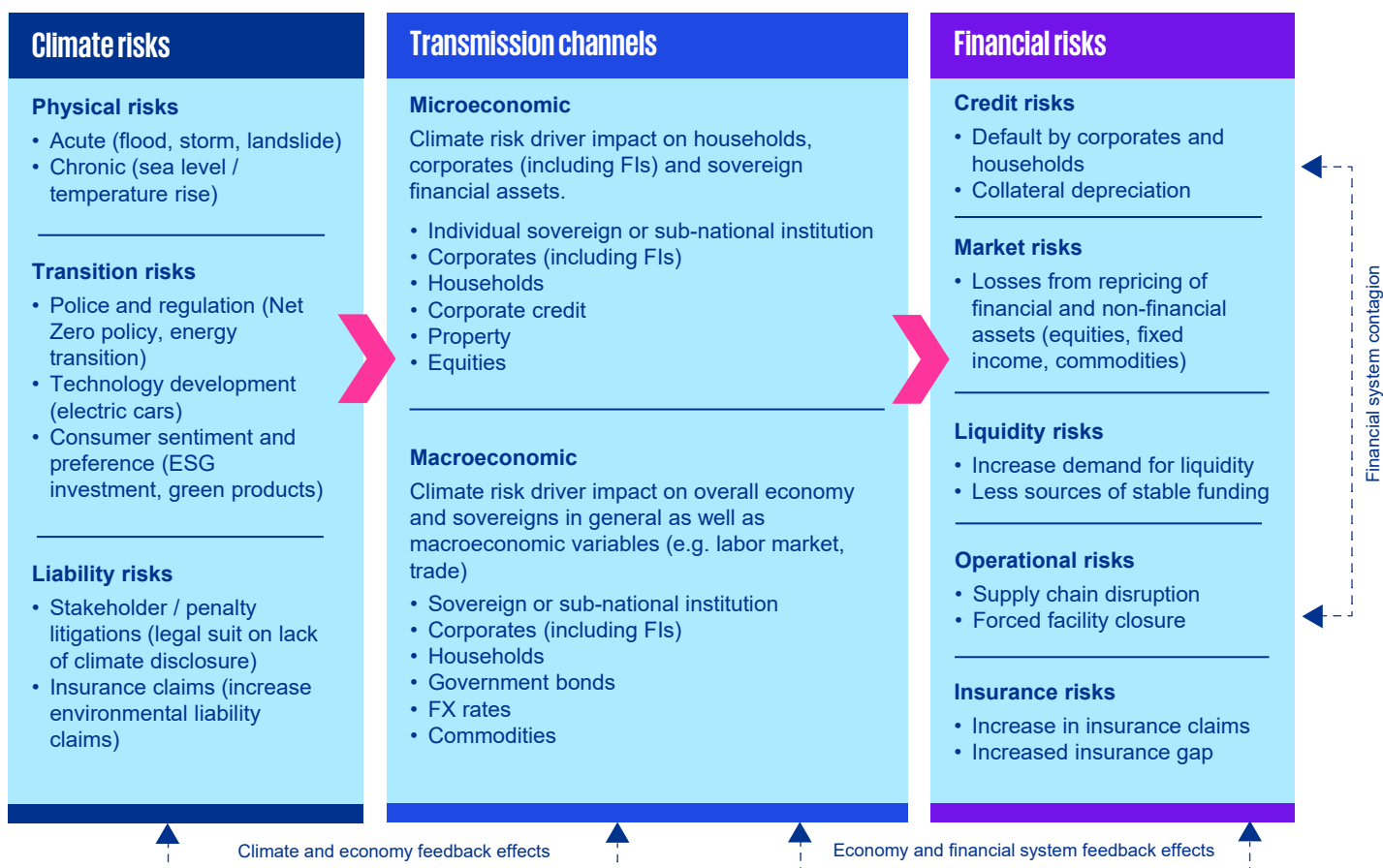


- The existing approach of assumptions setting (e.g., mortality, morbidity, etc.) would have to be enhanced to **fit climate-related risk variables** (e.g., greenhouse gas emissions, temperature etc.) to reflect the various climate scenarios.
- These climate scenarios with projected climate risk variables have been developed by international bodies, including the International Panel on Climate Change (IPCC), or the Network for Greening the Financial System (NGFS).
- The French regulator, Autorité de contrôle prudentiel et de résolution (ACPR), conducted a pilot climate exercise in 2020. As part of this exercise, the ACPR provided the stresses for mortality and hospitalisation by regions within the country, which shows a possibility of linking physical climate-related risk to insurance risk. These insurance risk stress parameters were then adopted for the purpose of calculating the results for this pilot exercise.

Catalyst for progress

BNM has placed importance in the FIs role to facilitate the transition into a low-carbon economy [8.1]. This is also consistent with BNM’s expected outcome of “Financial system as enabler & facilitator for an orderly transition to a low-carbon economy.”³

The diagram below illustrates the focus of climate risks and transmission channels to the FIs’ financial risks, while also showing the feedback effects of the economy and financial system on the climate.



Source: BNM Climate Risk and Scenario Analysis policy document

Some of the guidance to promote an orderly transition includes reducing premiums for customers who have achieved a transition milestone [11.13 (b)]. While this would incentivize behavioural change towards a low-carbon economy, **a less than coordinated effort could result in a muted overall outcome.** Traditionally, improved behaviour has resulted in lower claims (e.g., no claims discount), improving the financial position of the FI.

However, achieving a climate-related milestone (e.g., reducing carbon footprint) would potentially have a reduced impact on claims. For example, a factory with lower carbon emissions is unlikely to result in lower fire or flood incidents, compared to another factory with higher carbon emissions.

Therefore, a lower premium to a customer who reduced their GHG emissions would unlikely result in lower claims from that customer. To ensure the overall financial outcome for the insurer is maintained, there would be an increment in another customer’s premium. Without a concerted effort across the industry, this would result in the penalized customer with an increased premium leaving for better premiums elsewhere. It could be argued that actions to help climate change would improve overall claims (e.g., lower temperatures, or less flooding results in lower claims overall). However, this would be longer term and difficult to quantify. Additionally, it would require capitalizing highly uncertain claims improvements in the future, which is a substantial investment for the FI.

³ [Towards a Greener Malaysian Financial System](#), Bank Negara Malaysia, 9 July 2021

Is compliance sufficient in our journey to save the world?

Apart from the FI's resiliency, there is also consideration of ensuring the feedback from the FI is playing an active role in encouraging the transition to achieve national targets (1.6d, 8.10, 11.13), which are stated as guidance in the current policy document.

While there is significant work to be done to cater to the requirements to ensure resiliency, the outcome of climate-related change would also be dependent on the FI's ability to initiate key strategic decisions in achieving climate targets through innovative solutions to consumers.

From the [KPMG 2022 CEO Outlook](#) survey, **38% will invest 6 to 10% of revenue** to enable their organization to be more sustainable. While that signals strong commitment from organizations, capital investments would accelerate this further. About 28% of respondents believe that a higher cost of and/or difficulty in raising finance will be a major downside of failing to meet stakeholder expectations when it comes to ESG. Hence, a proactive environment that assists organizations in meeting their ESG ambitions would catalyze the transition into a low-carbon economy, while spurring growth in the financial industry.



As the industry matures from regulatory compliance towards innovative products/processes to serve policyholders better, the Societal and Governance aspects of the overall ESG would be expected to take effect as well. Although the route for ESG is an admirable one, it would be imperative to ensure that Environment (especially emissions) remains a critical goal in the overall ESG strategy of organizations, to ensure a successful transition into a low-carbon economy.

While the longer-term ESG journey matures, this BNM Climate Risk Management and Scenario Analysis policy key requirements with some action steps for consideration are:

May 2023	December 2023	December 2024
<p>Board Approved Plan</p> <ul style="list-style-type: none"> Conduct Gap Analysis Assess current state of climate related practices and exposures Compare these against recognised guidelines or frameworks Develop a viable implementation plan/roadmap to address the identified gaps Action plans based on various timelines to ensure compliance with the relevant regulatory requirements. 	<p>Governance & Strategy</p> <ul style="list-style-type: none"> Review policies and procedures to improve board, Senior management's oversight and across the three lines of defence Develop trainings for Board, Senior management and process owners. Identify and monitor internal climate-related targets (Dec 2024) Set targets aligned with business strategy and national climate goals. Assess the impact of these targets to existing business processes Develop a framework to monitor and eventually achieve 	<p>Risk Appetite and Management</p> <ul style="list-style-type: none"> Update policies and procedures including risk appetite statements (RAS). Enhance current ICAAP by using the RAS and considering material climate-related risk. Assess internal capabilities, especially data. Produce templates with key reporting indicators for respective process owners.
		<p>Scenario Analysis</p> <ul style="list-style-type: none"> Define climate scenarios, by leveraging on external frameworks Identify and link climate parameters to existing KPI's. Enhance existing stress test models to capture climate-related risk parameters. <p>Disclosure</p> <ul style="list-style-type: none"> Fulfill requirements of TCFD reporting Design the reports for internal and external stakeholders. Enhance current data and processes to extract the required information.

Contact us

To explore the implications of this climate risk and scenario analysis requirement in your organization, reach out to KPMG's professionals:



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