FAST-EMERGING **CHALLENGES** FOR **FINANCIAL INSTITUTIONS**

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Financial institutions have always been that stalwart pillar to allocate capital, facilitate transactions and enable economic growth. From the turn of this century, what has become more obvious is the added responsibility of financial institutions to drive the transition towards a sustainable future.

For financial institutions, sustainability is not just an ethical decision, it has also become an economic and existential matter. Hence, environmental, social and governance (ESG) issues, in addition to the risks and opportunities they create, are becoming increasingly relevant.

Given this responsibility, financial authorities around the world have made it clear that a broad range of issues including climate change, human rights, and accountability need to be managed alongside other more traditional risks. These fast-emerging challenges have unveiled new risks that are complex and interlinked, with data sets and modelling around them still in its infancy.

For investment management and brokerage firms, international and regional financial authorities have proposed common standards and metrics for sustainability-related disclosures, to help investors understand the opportunities as well as risks of ESG investing. Such disclosure requirements emerge as ESG-related investments have exploded. The Global Sustainable Investment Alliance reported the continuing prevalence of sustainable investment around the world, with assets under management reaching USD35.3 trillion in 2020[1].

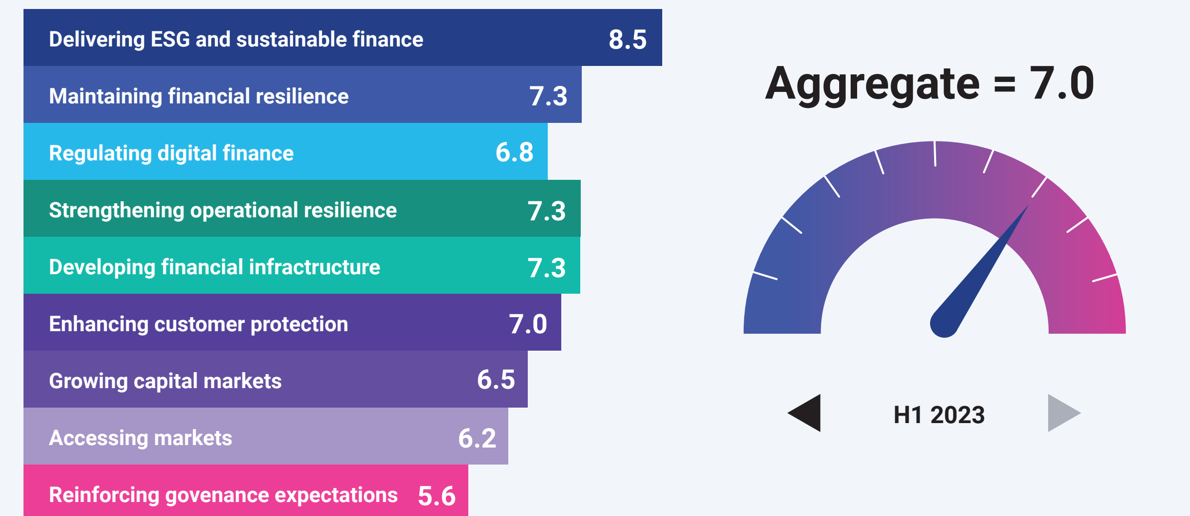
REGULATORY FRAMEWORKS

ESG and sustainability issues continue to be at the top of regulatory agendas – the European Banking Authority (EBA); European Insurance and Occupational Pensions Authority (EIOPA), an independent advisory body to the European Commission, the European Parliament and the Council of the European Union; European Securities and Markets Authority (ESMA), Bank of England, Prudential Regulation Authority (PRA), and Financial Conduct Authority (FCA) all have aspects of ESG and sustainable finance in their key priorities for the year. Greenwashing concerns are paramount and are driving regulatory initiatives on product labels, ESG data and ratings, and corporate due diligence. This is in line with the ongoing development of reporting and disclosure standards, and associated assurance requirements.

Investment managers and financial advisers are increasingly expected to consider sustainability risks in their investment and advice processes, even when they do not offer or specifically advise on green products.

New requirements for transition plans are emerging and will place additional pressures on firms already grappling with existing disclosures. Furthermore, nature and biodiversity are sharply in focus, both from a risk management and disclosure perspective.

KPMG's Regulatory Barometer shows that regulatory intensity continues to persist with significant impacts on firms across the financial sector in terms of requirements to digest, implement and plan for regulatory change.



Nine key regulatory themes, each with a regulatory impact score based on attributes such as volume of regulatory updates, complexity and time to implementation
Source: KPMG Regulatory Barometer

CLIMATE-RELATED FINANCIAL RISK FOR BANKS AND INSURERS

Climate risk measurement and management has moved firmly into the business-as-usual supervisory cycle with regulators setting clear expectations and consequences for failing to act.

Thematic feedback[2] from the European Central Bank (ECB) noted that banks are still far from adequately managing climate and environmental risks; they also lack sophisticated methodologies to manage these risks. In the UK, the PRA published similar thematic feedback, although it has not set specific management actions and was more positive about the overall progress of both banks and insurers.

The EBA was due to deliver a report on the classification and prudential treatment of assets from a sustainability perspective by 28 June 2023. It is also tasked with developing guidelines for banks to identify, measure, manage, and report on ESG risks, as well as to monitor quantifiable targets to monitor them along specific guidelines on climate-related stress testing.

EIOPA's discussion paper on the prudential treatment of sustainability risks offered a significant contribution to the debate on how insurance capital frameworks should capture these risks. It explored the potential for capital charges on assets deemed to have high levels of sustainability risks, and non-life insurance products that do not offer climate adaptation measures.

Alongside climate, there is growing recognition that nature and biodiversity risks must also be managed. The Kunming-Montreal agreement at COP 15 held in December 2022, provided more clarity on what governments expect from businesses in managing biodiversity risks.[3]

Investment managers, banks, securities firms, and their regulators face a difficult task. The risks associated with ESG issues are new and hard to quantify. For example, climate risk is unlike other financial risks. Its uniqueness, complexity, and the long-term nature of the risks make quantifying the threat one of the biggest hurdles that regulators must overcome in developing new rules and regulations.

Some financial authorities – such as those in the UK and the European Union – have made good progress toward requiring banks and insurance firms to report how they are managing climate risk. In the United States, where regulators got off to a slow start, work is gathering pace to create rules and requirements on disclosure, and incorporating the effects of climate change into risk management frameworks.

In Asia, the picture is mixed. Singapore and the Philippines are ahead with environmental risk incorporated into their supervisory expectations for banks' risk management systems. Others are still struggling given the lack of data standardisation, collection, and disclosure rules.

Internationally, regulators are increasingly aware of the critical need to continue dialogue, collaboration, and agreement on standards and metrics. Financial institutions and the industries they support will not be served by conflicting rules on climate risk, particularly for firms operating across jurisdictions.

To address such concerns, the International Organization of Securities Commissions (IOSCO) recently published a report on issuers' sustainability-related disclosures, which reiterates the urgent need to improve the consistency, comparability and reliability of sustainability reporting for investors.[4]

Meanwhile, the Network for Greening the Financial System (NGFS), a collaboration among the world's central banks to manage the risks associated with climate change, announced the creation of the Climate Training Alliance (CTA) in July 2021. The alliance aims to bring together authorities at the forefront of climate risk management, including banking and insurance supervisors, to share best practices for integrating these risks into their activities.

There is an understandable sense of urgency about climate risk. However, financial institutions are also pressed to address social problems covering employee diversity and inclusion, gender discrimination and burdensome working conditions, or larger issues such as income gaps and social inequality, particularly among poorer communities.

A more fundamental debate is bubbling up, pushing financial institutions to define their "purpose"; whether they should move away from the conventional model of maximising shareholder value towards adopting a broader, more inclusive "stakeholder" strategy, with employees, communities, and other constituents factored into company decision-making processes.

For example, regulators are taking notice of how financial firms manage their post-pandemic "back-to-work" policies. Authorities in the UK and the United States have also announced they are considering new diversity and inclusion rules.

From an international policy perspective, regulatory harmonisation remains elusive, complicating the task for financial firms. On the most pressing concerns regarding climate change, there is continued disagreement at the highest levels of government. In 2021, a gathering of energy and environment ministers from the Group of 20 (G20) nations failed to agree on the wording of climate change commitments in their final communiqué, which is seen as a major setback for much needed global progress.

HOW DOES MALAYSIA FARE?

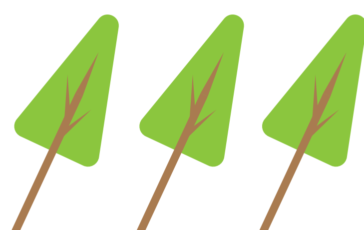
In Malaysia, efforts are being made to address climate change risks within the financial sector, principally through the central bank, Bank Negara Malaysia (BNM) in seven core areas (refer to Table 1.0).

It's important to note that the efforts to manage climate change risk in Malaysian financial institutions are evolving and will continue to develop over time. Regulatory frameworks and guidelines are likely to be refined as more research and understanding of climate risks emerge.

Financial institutions in Malaysia are observed to support their clients' transition, taking a nurturing approach instead of withdrawing support for sectors and activities deemed less green. This will help shape more focused engagements with their clients, especially those that present substantial exposures to climate risks, while also enabling financial institutions to gain a deeper understanding of their clients' business strategies and transition pathways.

One approach to determine how climate risk can be managed strategically and operationally is the use of scenario analysis. As a tool, scenario analyses are used to add value by improving decision-making, risk management, strategic planning, resource allocation, and fostering adaptability in an ever-changing environment.

Research on climate scenario analysis conducted by the Intergovernmental Panel on Climate Change, World Bank and United Nations, as well as other research institutions and government agencies dedicated to climate research and policy, has yielded several important findings. These findings have helped shape our understanding of climate change impacts and inform decision-making.



When applied in the financial sector, climate scenario analyses enable financial institutions to navigate uncertainties, align their strategies with the transition to a low-carbon and climate-resilient economy, meet regulatory requirements, enhance risk management practices, and contribute to sustainable finance initiatives.

The scope of use cases can be applied as follows:

- **Risk assessment:** Climate scenario analysis helps financial institutions assess the potential risks associated with climate change, including physical risks (e.g., damage to property from extreme weather events) and transition risks (e.g., policy changes, shifts in consumer preferences, or technological advancements). This will enable financial institutions to identify and quantify the potential impacts of different climate scenarios on their portfolios, assets and liabilities.
- **Regulatory compliance:** Regulators are increasingly urging financial institutions to assess and disclose their climate-related risks. For example, central banks and financial supervisory authorities in some jurisdictions have introduced stress testing or disclosure frameworks that include climate-related scenarios. Conducting climate scenario analysis helps financial institutions meet these obligations and ensure compliance.

Area	Description
Climate risk assessments	Financial institutions in Malaysia are encouraged to conduct climate risk assessments to evaluate the potential impacts of climate change on their operations, assets and portfolios. These assessments help identify climate-related risks and opportunities, as well as enable institutions to develop appropriate strategies and risk management frameworks.
Integration of climate risk into governance structures	Financial institutions are advised to integrate climate risk considerations into their governance frameworks. This involves incorporating climate risk oversight and management responsibilities into board-level committees, risk management processes, and strategic decision-making.
Disclosure and reporting	To enhance transparency and enable informed decision-making, financial institutions are encouraged to disclose their climate-related risks and opportunities. This includes providing information on climate risk management strategies, scenario analysis, and metrics related to climate risk exposure. Malaysia follows the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) to guide reporting practices.
Capacity building and training	Regulatory authorities and industry associations in Malaysia provide capacity building and training programmes to enhance the understanding and expertise of financial institutions in managing climate change risk. These initiatives aim to equip professionals with the necessary knowledge and tools to identify, assess, and manage climate risks effectively.
Green finance initiatives	Malaysia has been promoting green finance initiatives to support climate-friendly investments and projects. Financial institutions are encouraged to provide financing for renewable energy, energy-efficient projects, sustainable infrastructure, and other environmentally beneficial activities. This helps redirect capital towards low-carbon and climate-resilient sectors.
Collaborations and partnerships	The Malaysian government, regulatory bodies, and financial institutions collaborate with international organisations, such as the Network for Greening the Financial System (NGFS), to exchange best practices, share knowledge, and develop common frameworks for managing climate change risk. This facilitates the adoption of global standards and ensures a coordinated approach to address climate risks.
Stress testing and scenario analysis	Financial institutions are increasingly incorporating climate-related stress tests and scenario analysis into their risk assessments. These exercises evaluate the potential financial impacts of different climate-related scenarios, helping institutions understand their vulnerabilities and plan accordingly.

Table 1.0
Source: Financial Stability Review: Second Half 2022, Bank Negara Malaysia

- **Portfolio management:** By analysing different climate scenarios, they can identify climate-related risks and opportunities across their investment portfolios. This analysis allows them to adjust their asset allocation, consider climate-related factors in investment decision-making, and promote sustainable investing practices.

- **Capital allocation:** Financial institutions can allocate capital more effectively by considering climate-related risks. It helps them identify sectors or industries that may be exposed to higher climate risks and adjust their lending or investment practices accordingly. They can also identify opportunities in low-carbon and climate-resilient sectors and allocate capital to support the transition to a sustainable economy.

- **Disclosure and reporting:** Climate scenario analysis helps financial institutions communicate climate-related risks, opportunities and strategies to stakeholders, including investors, regulators and customers. Through transparent reporting, financial institutions can build trust, attract responsible investment, and meet the growing demand for climate-related information.

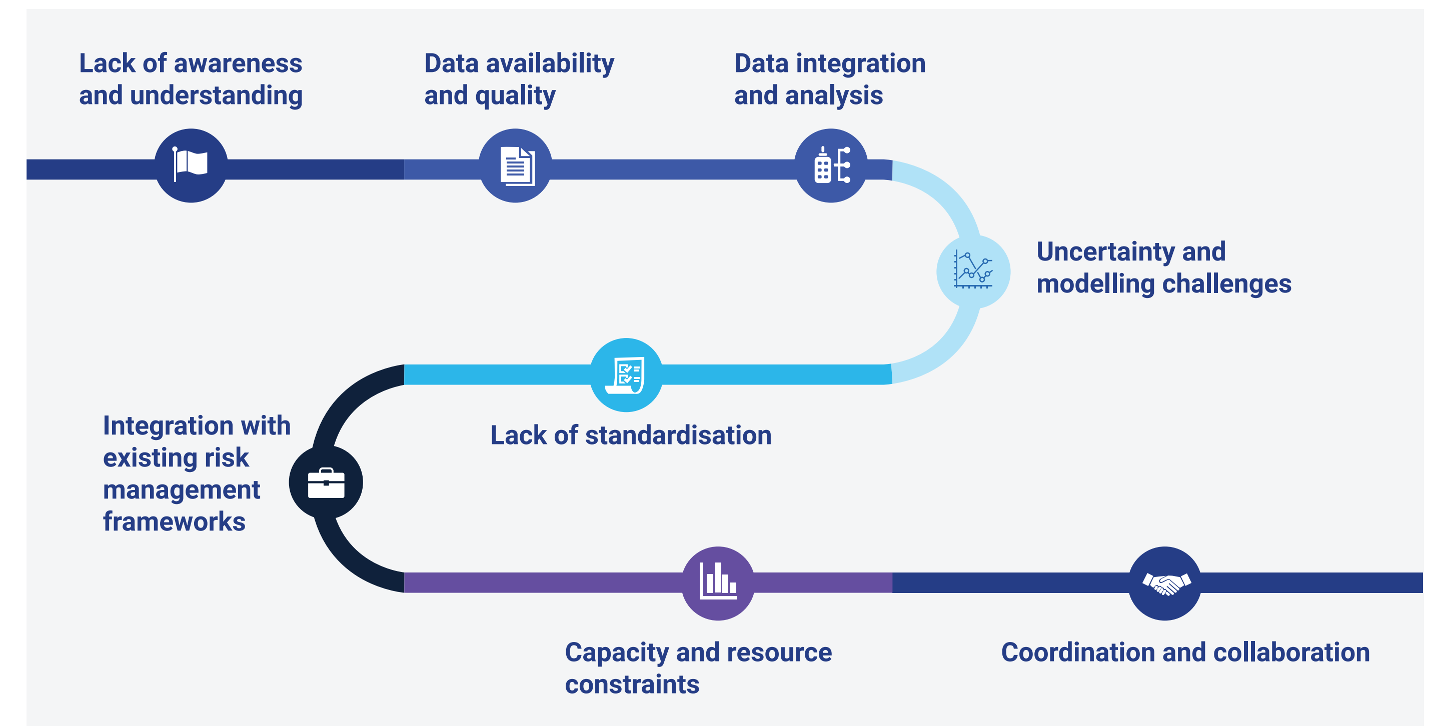
- **Stress testing and scenario planning:** This enables them to assess the potential impacts of climate-related shocks on their financial positions and evaluate their resilience. Stress testing helps financial institutions understand how different climate scenarios may affect their capital adequacy, profitability, liquidity, and overall stability.

- **Engaging with stakeholders:** Financial institutions can use the insights gained from scenario analysis to engage in dialogue, inform decision-making, and develop innovative financial products or services that address climate-related challenges and support sustainable development.

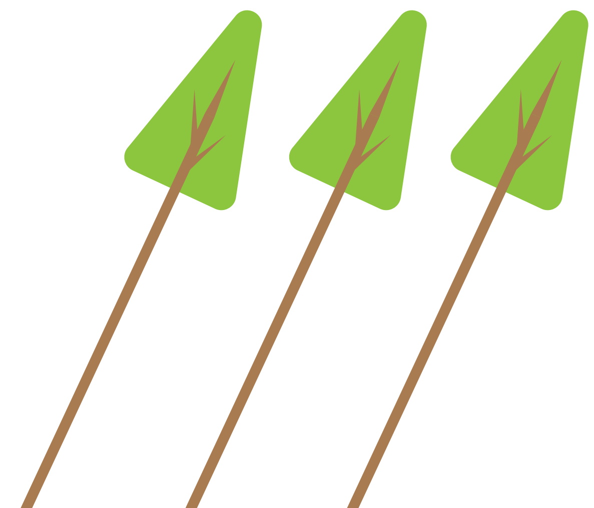
FIDE FORUM I ESG: A GLOBAL PERSPECTIVE, LOCAL OPPORTUNITY AND CHALLENGE

BEWARE THE ROADBLOCKS

Implementing BNM's Climate Risk Management and Scenario Analysis (CRMSA) requirements has not been a smooth road for Malaysian financial institutions. Based on our observations, there are common roadblocks encountered in the process of transitioning, as shown below:



Addressing these challenges requires a comprehensive and coordinated effort from financial institutions, regulators, and other stakeholders. The emphasis will be on collaboration where financial institutions and regulators each have important roles to play (refer to Table 2.0).



Here are several best practices when it comes to implementing climate risk management requirements:

Recommended best practices for implementing climate risk management requirements	
For financial institutions	**For regulators**
1. **Establish a climate risk governance framework:** This should outline the roles, responsibilities and accountability of various stakeholders involved in climate risk management, and be integrated into the overall risk governance structure of the institution. 2. **Conduct comprehensive climate risk assessments:** To identify and understand their exposure to climate-related risks, and have the capability to evaluate physical risks (such as extreme weather events) and transition risks (such as policy changes and technological shifts) that could impact their operations, assets and portfolios. 3. **Improve data collection and analysis:** Gather relevant climate-related data, including environmental, social and governance (ESG) information, which can then be leveraged to inform risk assessments and decision-making processes. 4. **Enhance risk management processes:** This involves integrating climate risk metrics and stress testing scenarios into risk models and stress tests to evaluate the potential impact of climate-related events on their financial positions. 5. **Enhance disclosure and reporting:** To provide transparent and consistent information on climate-related risks, opportunities and actions taken. This can involve aligning with international reporting frameworks, such as the Task Force on Climate-related Financial Disclosures (TCFD). 6. **Develop scenario analysis capabilities:** To assess the potential long-term impacts of different climate scenarios on their business and portfolios, thereby allowing them to understand the range of possible outcomes and make informed strategic decisions. 7. **Invest in capacity building and expertise:** This can involve training staff, recruiting specialised professionals, and collaborating with external experts. 8. **Strengthen engagement with stakeholders:** Covering regulators, shareholders, clients and communities, engagements should aim to understand their expectations and concerns regarding climate-related risks, which will then help inform risk management strategies and enhance transparency. 9. **Foster collaboration and knowledge sharing:** Collaborate with industry peers, regulators and relevant stakeholders to share best practices, knowledge and experiences in managing climate-related risks. This exercise also helps drive innovation, standardisation, and industry-wide resilience.	1. **Set clear expectations:** Regulators should provide guidelines on data collection, risk measurement methodologies, scenario analysis, stress testing and disclosure practices. By setting these expectations, regulators provide a framework for financial institutions to follow. 2. **Develop climate risk frameworks:** Outline the key elements of climate risk assessments that may include guidance on identifying and categorising climate-related risks, conducting scenario analysis, stress testing methodologies, as well as assessing the financial impacts of climate risks. 3. **Provide data and tools:** Access to relevant climate-related data, models, and tools are valuable. This can include sharing climate data collected by governmental bodies, facilitating access to research and scientific studies, as well as collaborating with other organisations to develop risk assessment tools and methodologies. 4. **Monitor compliance:** This can involve conducting regular assessments, inspections and audits, to ensure that institutions are following the prescribed guidelines and adequately managing climate-related risks. 5. **Enhance disclosure standards:** Regulators can require financial institutions to disclose their climate risk exposures, mitigation strategies, and progress towards meeting climate-related goals. An alignment with international frameworks like the TCFD will promote consistency and comparability of information. 6. **Build capacity and expertise:** This can include organising training programmes, workshops and seminars to enhance the understanding of climate-related risks, risk measurement methodologies, and data analysis techniques. 7. **Promote collaboration and knowledge sharing:** Regulators can be the enabler for industry players to share best practices and experiences in climate risk assessments. They can organise forums, workshops, and working groups to facilitate dialogue and knowledge exchange, promoting a collective approach to managing climate risks. 8. **Drive innovation and research:** Regulators can consider providing incentives, grants, or funding opportunities. They can collaborate with academic institutions, research organisations, and industry experts to develop effective methodologies and tools for assessing climate-related risks.

Table 2.0
Source: KPMG Management & Risk Consulting

By adopting these best practices, financial institutions and regulators in Malaysia can work together to strengthen risk management frameworks and ensure the resilience of the financial system to ESG-related risks. With continuing economic uncertainty – including inflationary and liquidity pressures, in addition to the potential for recession – regulators and financial institutions need to maintain robust levels of financial resilience, as well as look ahead in preparation for emerging and escalating risks.

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[1] Global Sustainable Investment Review 2020, The Global Sustainable Investment Alliance

[2] Walking the talk: Banks gearing up to manage risks from climate change and environmental degradation, European Central Bank, November 2022

[3] Kunming-Montreal Global Biodiversity Framework, the UN Convention on Biological Diversity, 19 December 2022

[4] Report on Sustainability-related Issuer Disclosures: Final Report, IOSCO, June 2021