

Response to feedback received

Climate Risk Management and Scenario Analysis

Introduction

The Bank issued today the *Climate Risk Management and Scenario Analysis* policy document for financial institutions. This policy document incorporated feedback received during the consultation period to refine the proposals from the exposure draft issued on 27 December 2021, including the 14 principles proposed.

The Bank received written responses from 99 respondents during the consultation period. Respondents were broadly supportive of the principles and requirements, as well as the proposed phased implementation approach which provides financial institutions sufficient time to build capacity and capability to effectively manage climate-related risks.

This document comprises key feedback received during the consultation period and the Bank's responses. Other comments and suggestions for clarification, where relevant, have been incorporated in the policy document.

Bank Negara Malaysia
30 November 2022

1. Implementation of the policy document

Feedback received

Financial institutions have been taking measures to integrate considerations of climate-related risks into risk management policies and frameworks, as well as their business operations, by establishing an appropriate governance structure, aligning business strategies, and ramping up internal capacity to manage climate-related risks. However, some respondents cited challenges that impede effective management of climate-related risks, notably:

- a. Lack of readily available data that is sufficiently granular, reliable and comparable;
- b. Limited internal and external expertise; and
- c. Lack of robust methodologies to support the identification and measurement of climate-related risks.

In this regard, some respondents have suggested a longer transitional period to comply with the requirements in the policy document.

The Bank's response

- 1.1 The Bank will **maintain** the effective date as stated in paragraph 4.1 of the policy document. However, the Bank will take an **iterative implementation approach** and work with financial institutions to ensure the end outcomes of the requirements are achieved progressively. This approach is also aligned with the approach taken by domestic and global standard setters such as the Basel Committee on Banking Supervision's (BCBS) *Principles for the effective management and supervision of climate-related financial risks*, International Sustainability Standards Board's (ISSB) exposure draft on *Climate-related Disclosures* and Bursa Malaysia's *Sustainability Reporting Guide* for listed entities.
- 1.2 Financial institutions are expected to implement the principles and requirements of the policy document in a **proportionate** manner, taking into consideration the **materiality** of their climate-related risks, and commensurate with the size, nature and complexity of their business operations. As a start, financial institutions should incorporate climate-related risk considerations into their risk management framework and prioritise their efforts to manage exposures that could materially impact them¹, while continuously building capacity to manage exposures that are less material or have less mature methodologies in place.

¹ From a financial, operational and reputational standpoint.

- 1.3 **Ongoing supervisory engagements and reviews** will be conducted to ensure financial institutions make reasonable and meaningful progress to enhance their resilience against climate-related risks. These engagements and reviews are intended to provide greater clarity on the Bank’s expectations and understand the financial institutions’ plans to comply with these expectations. The Bank **does not intend to pursue punitive actions as first resort** against financial institutions that are still developing robust frameworks and methodologies to manage climate-related risks by the effective date. Nevertheless, the Bank may consider a broader use of its supervisory toolkit as appropriate, including the use of capital add-ons, if the Bank observes inadequate progress by financial institutions to strengthen their resilience against climate risk in a timely manner.
- 1.4 Financial institutions are expected to start enhancing internal capabilities to manage climate-related risks, by leveraging the numerous initiatives and resources available domestically and internationally. These include:
- a. **Bridging data gaps:** Internationally, the ISSB will issue the baseline standards on sustainability and climate-related disclosures, which will help improve consistency and comparability of data moving forward. At the domestic front, the Bank together with the Joint Committee on Climate Change (JC3) have taken various initiatives² to improve the availability and consistency of data. In addition, the Bank has issued the *2024 Climate Risk Stress Testing (CRST)* discussion paper and will develop a subsequent methodology paper to include relevant scenario parameters and potential data sources. Financial institutions may also leverage the *Climate Change and Principles-based Taxonomy (CCPT)* classification and reporting to support assessments on climate-related risks.
 - b. **Improving technical capacities on climate-related risks:** Capacity building programmes developed by the JC3³ and other training providers are widely available to support financial institutions’ training and upskilling of staff. Certified programmes on climate change and climate risk offered by a range of academic and training institutions are also accessible and can increase financial institutions’ talent capacity.
 - c. **Guidance on methodologies to manage climate-related risks:** Financial institutions may utilise a wide range of publicly available resources⁴ to inform the development of internal climate-related risk management methodologies. Financial institutions may also engage external providers to develop

² These include (i) a data catalogue to guide financial institutions to relevant data sources, (ii) a disclosure guide for Malaysian businesses to assist financial institutions’ assessments, and (iii) a common due diligence questionnaire to provide a consistent baseline for data gathering in deriving CCPT classification.

³ JC3 Upskilling Sustainability Training Series (Link to the webpage: [JC3 \(Upskilling Sustainability Training\) Series | IBFIM Online](#))

⁴ A list of resources (not exhaustive), including case studies on practices, are available in the “*Climate Risk Management and Scenario Analysis: Supplemental Guidance*” document.

methodologies that are suited for the entity's management of climate-related risks.

2. Appointment of Chief Sustainability Officer

Feedback received

Respondents sought clarification on whether the requirement to appoint a Chief Sustainability Officer (CSO) is mandatory for all financial institutions, or if it would depend on the size, nature and complexity of the financial institution's business model. There were also concerns on the lack of suitable talent for such a role.

The Bank's response

- 2.1 The appointment of a CSO is **not a mandatory requirement**. However, financial institutions are required to designate an individual within its senior management to oversee the effective management of climate-related risks. This may entail designating an existing senior management officer to undertake this role, such as the Chief Risk Officer, or creating a new role such as the CSO. The arrangements adopted by financial institutions should be proportionate to the size, nature and complexity of their business model.
 - 2.2 The Bank recognises that managing climate-related risks is relatively new, and therefore financial institutions face challenges in hiring individuals equipped with the appropriate knowledge and skillsets. In this regard, senior management officers with roles and responsibilities on climate-related risks may gradually build their knowledge and skills, including through participating in capacity building programmes highlighted in paragraph 1.4(b) of this document.
- ## 3. Challenges to quantify climate-related risks and opportunities to support development of business strategies and setting risk appetite

Feedback received

Some respondents highlighted challenges to integrate the quantification of potential impact on climate-related risk and opportunities into business strategies without reliable and comparable data in place.

Respondents also highlighted that while financial institutions are using both qualitative and quantitative approaches in embedding climate-related risks into the risk appetite framework, it is more challenging to implement the quantitative approach at this juncture due to limited resources and reliable data.

The Bank's response

- 3.1 Recognising the complexities and the current state of enabling infrastructures, financial institutions may take a **phased approach** to develop the business strategy and risk appetite framework, starting with embedding qualitative factors while developing capabilities for more robust quantification of risks and opportunities.
 - 3.2 Financial institutions may prioritise material or high-risk sectors and/or exposures by developing sector-specific strategies where more data and technical expertise are available. For example, financial institutions may utilise sectoral-specific strategies to help posture and guide their stance on business strategy and risk appetite in the interim while developing a more holistic and robust business strategy and risk appetite framework over time.
 - 3.3 More importantly, financial institutions must show **reasonable and meaningful progress** in developing a comprehensive strategy and risk appetite framework that is evidence-based and supported by quantitative metrics and targets to enhance the financial institution's resilience against climate-related risks over time.
4. **Quantification of climate-related risks impact on capital**

Feedback received

Respondents raised concerns surrounding the quantification of the impact of climate-related risk on capital as part of the internal capital adequacy assessment process (ICAAP) particularly due to the lack of widely accepted tools and methodologies to quantify climate-related risks at this juncture.

The Bank's response

- 4.1 The Bank envisages climate-related risks will be incorporated into financial institutions' ICAAP iteratively and progressively. As a start, financial institutions should identify their material climate-related risks that need to be incorporated into their risk management framework and ultimately into ICAAP. Financial institutions may adopt qualitative approaches in the absence of widely accepted risk measurement tools and methodologies or where the financial institution is still building capacity in implementing quantitative approaches. Nonetheless, financial institutions should start building risk analysis capabilities by identifying relevant climate-related risk drivers that may materially impair their financial conditions, developing key risk indicators and metrics to quantify exposures to these risks, and assessing the interactions between climate-related risks and traditional risk types. Results from the scenario analysis, a key tool to manage

climate-related risks, could also form part of the input to the financial institution's ICAAP.

5. Time horizon for insurers and takaful operators

Feedback received

Some respondents also raised that the requirements for risk management practices to cover different time horizons should be distinguished between life insurers/family takaful operators and general insurers/takaful operators. Particularly for general insurers/takaful operators, the insurance/takaful underwriting risk is inherently short-term in nature i.e. the insured/covered risk is generally only for one year as per policy/certificate terms, where general insurers/takaful operators may revise the insurance premium/takaful contribution during the next policy/certificate renewal to reflect changes in underwriting risk.

The Bank's response

- 5.1 The time horizon used to develop an appropriate risk management framework for climate related risk should be aligned to the horizon of risk emanating from the business underwritten by the insurer. For general insurers/takaful operators, they may consider using shorter time horizons for their underwriting and reserving risks to align with the shorter-term nature of their business. However, for any long-term business underwritten, as well as other types of risks such as credit, market, liquidity and operational risks, general insurers/takaful operators should consider longer time horizons, e.g. beyond 10 years and reaching at least 30 years to more accurately reflect the impacts of climate-related risks over time.

6. Challenging to run climate-related scenario analysis

Feedback received

Respondents generally agreed that the NGFS climate scenarios are a good starting point to guide financial institutions in conducting scenario analysis.

However, respondents also highlighted that there are challenges to running scenario analysis and making risk assessments at this juncture due to operational challenges, significant data gaps (e.g. granularity and coverage of macroeconomic, financial and climate-related data), adapting the NGFS' scenarios to the local context, and limited resources (e.g. manpower, expertise, technology, time).

These challenges give rise to concerns over the quality of scenario analysis and risk assessments, and financial institutions' compliance with the requirements in the policy document.

The Bank's response

General

6.1 Given the abovementioned challenges, the Bank will continue to call for industry collaboration and leverage the JC3 Sub-committee 1 on Risk Management and JC3 Sub-committee 5 on Bridging Data Gaps to address these concerns. Besides that, financial institutions are encouraged to explore and engage with external service providers and experts to scale up their internal capacity and capability.

Additional information on conducting climate risk scenario analysis and application for the purposes of ICAAP

6.2 In conducting climate risk scenario analysis, financial institutions must consider short-term, medium-term, and long-term horizons in drawing up appropriate scenarios. Specifically, short-term climate risk scenario analysis is useful to complement business risks assessments within an ordinary business planning horizon. In this regard, financial institutions shall incorporate the impact of climate-related risks arising from such analysis in their regular stress testing exercise specified in the *Stress Testing* policy document for insurers and takaful operators as well as banking institutions issued on 30 June 2016 and 15 June 2017 respectively.

6.3 Given that the quantitative techniques to conduct climate risk scenario analysis and stress testing are still nascent, and in line with paragraph 4.1 of this document, financial institutions may at this juncture employ reasonable qualitative methodologies in their climate risk scenario analysis and stress testing in the ICAAP. Nevertheless, financial institutions should improve their technical and modelling capabilities over time and be able to demonstrate how they are progressively integrating more quantifiable and reliable methods to measure material climate-related risks in their ICAAP stress testing.

6.4 For the medium to long-term climate-related risk assessments, financial institutions shall at the minimum conduct periodic climate-related scenario analysis to identify and address longer-term vulnerabilities and build resilience. The frequency of such scenario analysis should be driven by factors, such as changes in the financial institution's climate strategy, new or updated regulations to limit greenhouse gas (GHG) emissions, emergence of new or efficient carbon capture technology, material changes to economic and climate risk outlook, and realisation of climate risk events that significantly affect the operating environment of the financial institution.

7. Reliance on group or consolidated level climate-related disclosure

Feedback received

Respondents sought clarification on whether financial institutions could rely on or reference their group and/or consolidated level climate-related disclosures to fulfil the disclosure requirements set out under paragraph 13 of the policy document.

Concerns expressed were mainly on:

- a. lack of data;
- b. onerous to require each entity under the same group to produce separate disclosures as all entities may leverage group policies at the consolidated basis; and
- c. group-level disclosures may yield better insights for global institutions with diversified business across jurisdictions.

The Bank's response

- 7.1 The objectives of the disclosure requirement are to ensure financial institutions produce reliable, meaningful and comparable climate-related disclosures, to support informed decision making by stakeholders and reinforce the effective management of material climate-related risks in the financial sector. Therefore, the requirement on disclosure of quantitative information is applicable to financial institutions at the entity and at the consolidated level.
- 7.2 However, financial institutions may consider consolidated disclosures of qualitative information for entities under the same group if such disclosures provide more meaningful insights on the group's strategies and risk management frameworks on building climate resilience.