Response to feedback received

Climate Risk Stress Test

Introduction

Today, the Bank issued the Climate Risk Stress Test (CRST) methodology paper for financial institutions. This methodology paper incorporates feedback received during the consultation period following the publication of the Discussion Paper (DP) on the 2024 Climate Risk Stress Testing Exercise on 30th June 2022.

The Bank received feedback from 83 financial institutions and 8 other stakeholders such as non-financial corporates. Respondents were generally supportive of the CRST, its objectives and overall approach. They suggested for the Bank to reconsider certain parameters of the CRST including the need for greater variation in the climate scenarios selected, a reduction in the minimum number of counterparty-level analysis conducted, and greater sharing of relevant climate and macro-financial data that are calibrated to Malaysia. In addition, respondents also highlighted anticipated challenges faced by financial institutions in preparing for the climate risk stress testing and requested for the Bank to consider a more measured timeline for complying with the CRST.

This document consists of the Bank's responses to feedback on key aspects of the CRST exercise received during the consultation period.

Bank Negara Malaysia

29 February 2024

1. Selection of appropriate climate scenarios

Feedback received

Respondents agreed with the Bank's approach to adopt the Network for Greening the Financial System (NGFS) climate scenarios given the financial industry familiarity with it. However, some cited the need for more differentiated climate scenarios, as the ones proposed in the DP may lack sufficient variations and thus produce less meaningful results.

The Bank's response

In response to these comments, we have refined our approach in the CRST methodology paper to include a more differentiated suite of NGFS scenarios, while maintaining the same number in total. These scenarios, featuring sectoral details like transportation modes and industrial CO2 emissions, reflect our objective of capturing the nuanced pathways of climate risks until 2050. The chosen scenarios – Net Zero 2050, Divergent Net Zero 2050, and Nationally Determined Contributions (NDCs) – alongside a specific short-term scenario focusing on severe flooding in Malaysia[1], have been selected for their direct relevance to the Malaysian financial landscape and their incorporation of global climate commitments, notably from COP26.

The selection of these scenarios considers the diverse potential outcomes for Malaysia's financial sector, from both transition and physical risks, across key sectors of the economy. Selected climate variables based on the NGFS scenarios are provided by the Bank and have been downscaled and calibrated to Malaysia's context to derive the impact on the domestic economy. Nevertheless, there are limitations with the existing globally harmonised scenarios, which may not yet fully capture the specificities of climate related policies and developments in Malaysia. We may explore greater variations of climate scenarios including options for improved incorporation of Malaysia-specific considerations into the stress-test parameters for future iterations of the CRST.

[1] The short-term acute physical risk will focus on a one-off 1-in-200-years flood event in Malaysia, consistent with climate conditions in the Intergovernmental Panel on Climate Change (IPCC)'s Representative Concentration Pathway (RCP) 8.5 scenario in the year 2050.

2. Provision of relevant climate and macro-financial data to financial institutions

Feedback received

Some financial institutions have started to explore their own climate stress testing, some with the help of third-party service providers. Initial learnings from these exercises that were shared with the Bank were helpful in shaping the final methodology paper requirements.

A key challenge faced by financial institution when conducting their internal climate risk stress testing is the lack of relevant and granular climate and macro-financial data that are applicable to Malaysia. In such circumstances, financial institutions, some with the help of their external service providers, have had to make certain assumptions on the projected climate pathways or how certain variables could evolve in the future. While this approach is sensible and suited to a financial institution's unique circumstances, it may result in difficulties comparing results across financial institutions. To mitigate such challenges, respondents have encouraged the Bank to provide relevant climate and macro-financial data for the 2024 CRST exercise.

The Bank's response

The Bank is providing key climate and macro-financial data to financial institutions to improve comparability and consistency of stress test results across financial institutions. This covers climate data for the three long-term climate scenarios and the accompanying macro-financial data. Besides that, financial institutions will also receive indicative information on climate vulnerable economic sectors, which should be used in identifying their counterparties who may be most susceptible to climate-related risks. However, the provision of more centralised input assumptions must be balanced with the need for financial institutions to preserve a degree of flexibility to tailor scenarios to their own specific circumstances and to facilitate greater capacity building. Therefore, the Bank wishes to highlight the following important points:

a. No climate data will be provided for the short-term acute physical risk scenario (flood risk). Financial institutions are expected to source for relevant information and data to complete this exercise, as well as explore the use of flood risk-specific models that are able to establish a clearer and more direct link between flood damage in a given location and their portfolio exposures. In this regard, the Bank encourages industry to explore opportunities for coordinated effort to share experiences, resources and data, where relevant.
b. The Bank has identified certain indicative economic sectors that are most at risk to climate change. As such identification processes are novel, financial institutions should expect further refinements to the methodology, going forward. Future iterations of the CRST may include different methodologies and economic sectors from what is published in the 2024 CRST exercise.
c. The Bank encourages financial institutions to refine, calibrate or introduce more granular stress test parameters and assumptions to enhance the accuracy of their 2024 CRST results. They may expand on the above climate scenarios, with the intention to

improve the robustness and realism of the stress test. However, any new assumption or climate scenario expansion must be aligned with the long-term and short-term scenario narratives prescribed by the Bank. The additional parameters and assumptions must be clearly explained to the Bank in the reporting templates.

3. The usage of the CRST exercise as evidence of compliance with the Policy Document on Climate Risk Management and Scenario Analysis (CRMSA)

Feedback received
Some financial institutions have asked whether their participation in the 2024 CRST exercise would be considered as evidence of compliance with the requirements of the Scenario Analysis section specified in the CRMSA Policy Document. This reflects their concerns about resource challenges in having to ensure compliance with the CRMSA PD requirements, while at the same time implementing the CRST exercise.

The Bank's response

- The Bank is cognisant of the challenges faced by financial institutions in rapidly developing their climate risk management capabilities, including concerns over the dual demands of CRST and CRMSA on the prioritisation of resources. In this regard, financial institutions making reasonable progress to conduct CRST 2024 would be deemed in compliance with Paragraph 9.2 of the Policy Document on CRMSA pertaining to financial institutions' use of scenario analysis to assess climate risk and Principle 13, pertaining to the need to ensure that the scenario analysis exercise with appropriate governance, depth, rigour and proportionate to FI climate risk profile. The results of the CRST can be used to support strategies and risks management action required under principle 12. This approach is only applicable for the inaugural CRST exercise.

4. **Counterparty-level Assessment**

Feedback received

The Bank had proposed for banks[2] to complement sectoral-level assessment of business exposures with a more granular assessment of selected counterparties. For the counterparty-level analysis, the DP suggested for banks include:

- at least top 100 individual counterparties (entity level) based on exposure size, or those with exposures more than RM10 million, whichever is larger; and
- comprise the top five counterparties in each economic sector if the firm were not already part of above conditions.

Some banks have responded to indicate that this proposal could be onerous on them, as well as to their clients. This is premised on several factors, including:

- Limited availability of granular climate-related client data at this current juncture. Banks have historically not collected detailed climate-related information from their clients (e.g., SMEs' climate transition plans, location of collaterals in flood prone areas, granular client information on insurance coverage), although plans are in place to improve such data collection going forward.
- The collection of new data such as clients' GHG emissions or cash flows would in turn pose a significant challenge to banks' clients, who may not yet be familiar with the said requirements and metrics or may have poor record keeping practices for climate-related data.
- The proposed scope may require an expansion of resources, in terms of technology and manpower, in order to meet the large number of counterparty-level analysis required for the exercise

The Bank's response

We acknowledge the challenges in conducting a large number of counterparty-level analysis at this juncture, including the relative unavailability of granular client data, the difficulty in collecting new types of data and resource constraints. Considering these factors, the final requirements have been revised downwards to better align with the capabilities and circumstances of our financial institutions.

Banks will now be required to conduct a focused assessment on at least 10 individual business counterparties (at the entity level, prioritising those based on the size of exposure) within each of the economic sectors outlined in Appendix 2 of the CRST methodology paper. The list of economic sectors have also been narrowed from the initial list in the DP to focus on the sectors most vulnerable to climate-change risks.

[2] Banks refers to

a. Licensed banks, including licensed digital banks
b. Licensed investment banks
c. Licensed Islamic banks, including licensed Islamic digital banks
d. Prescribed development financial institutions

5. **Quantification of impact to financial institutions' capital from the 2024 CRST exercise**

Feedback received
Following the end of the feedback period, several respondents have reached out to the Bank seeking clarification on whether the Bank plans to use results from the 2024 CRST exercise to determine the impact on financial institutions' capital positions.

The Bank's response

Results from the 2024 CRST exercise, encompassing both quantitative and qualitative findings, is not intended to directly calibrate institution-specific capital requirements for climate-related risks.

Our supervisory review process is designed to ensure that all material risks, including those related to climate, are adequately managed. The insights gained from the CRST exercise will therefore play a crucial role in facilitating our supervisory reviews and engagements, guiding us in ensuring that financial institutions are adequately prepared and responsive to climate-related risks. Where progress by a financial institution towards strengthening its resilience to climate-related risks remain inadequate, the Bank may consider broader use of its supervisory toolkit as appropriate, including the use of capital add-ons.

6. 2024 CRST exercise timeline and financial institutions' participation.

> **Feedback received**
> Financial institutions have indicated that the proposed 12-month timeline to complete the 2024 CRST exercise as insufficient. Furthermore, requiring all financial institutions to submit their results by the end of 2024 would be problematic for some financial institutions given the size of exposures and current pace in building internal risk management capabilities to undertake effective surveillance and assessment of climate-related financial risks.

The Bank's response

The Bank has adopted a tiered submission approach split into two cohorts. Larger financial institutions and those with more developed climate risk management capabilities are placed in the first cohort with a submission deadline of 30 June 2025. Smaller or less-sophisticated institutions are placed in the second cohort with a submission deadline of 31 December 2025. The list of financial institutions in each cohort is available in the CRST methodology paper. The extended submission deadlines and tiered approach is also intended to provide more time for greater industry sharing of experiences, challenges and approaches with one another. To this end, the Bank will seek collaborative efforts from industry throughout 2024 and 2025 to organise a series of forums for financial institutions to come together to take stock of progress, discuss challenges and share learnings.