

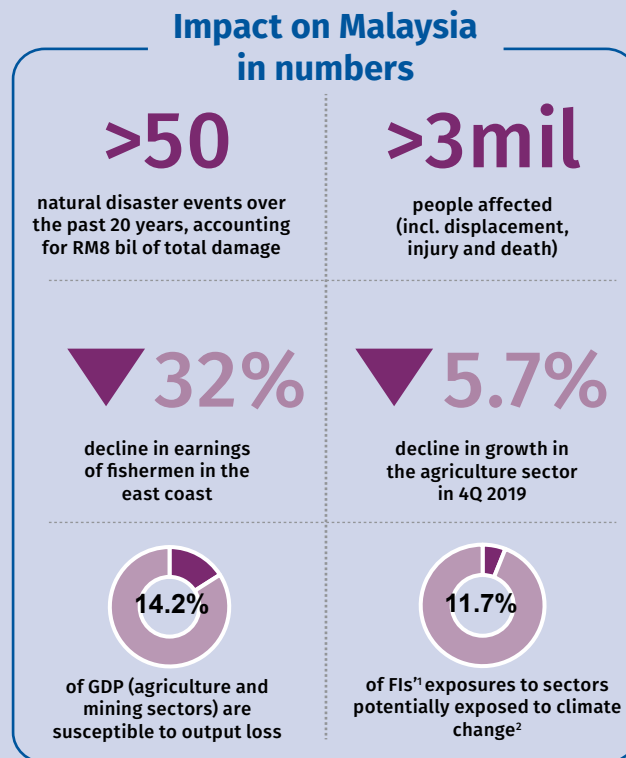
Climate Change Risks and Opportunities: Respond, Not React

Climate change poses real risks to the economy

Climate change poses significant and growing risks to our collective future. Rising sea-levels, floods and droughts have displaced people from their homes, disrupted commerce and threatened natural resources and the livelihoods of many. Malaysia too, is not spared from the physical and transition risks arising from climate change.

The growing intensity and frequency of climate-related events are increasing physical and liability risks to our economy. In the last two decades, we experienced more than 50 natural disasters, affecting more than three million people through displacements, injury and death. The increasing severity and frequency of major floods and dry spells have severely affected livelihoods – particularly those in the agriculture sector. Between 1998 and 2018, the Malaysian economy sustained a total damage of approximately RM8 billion due to these events (Chart 1).

Chart 1: Impact of climate-related events on Malaysia



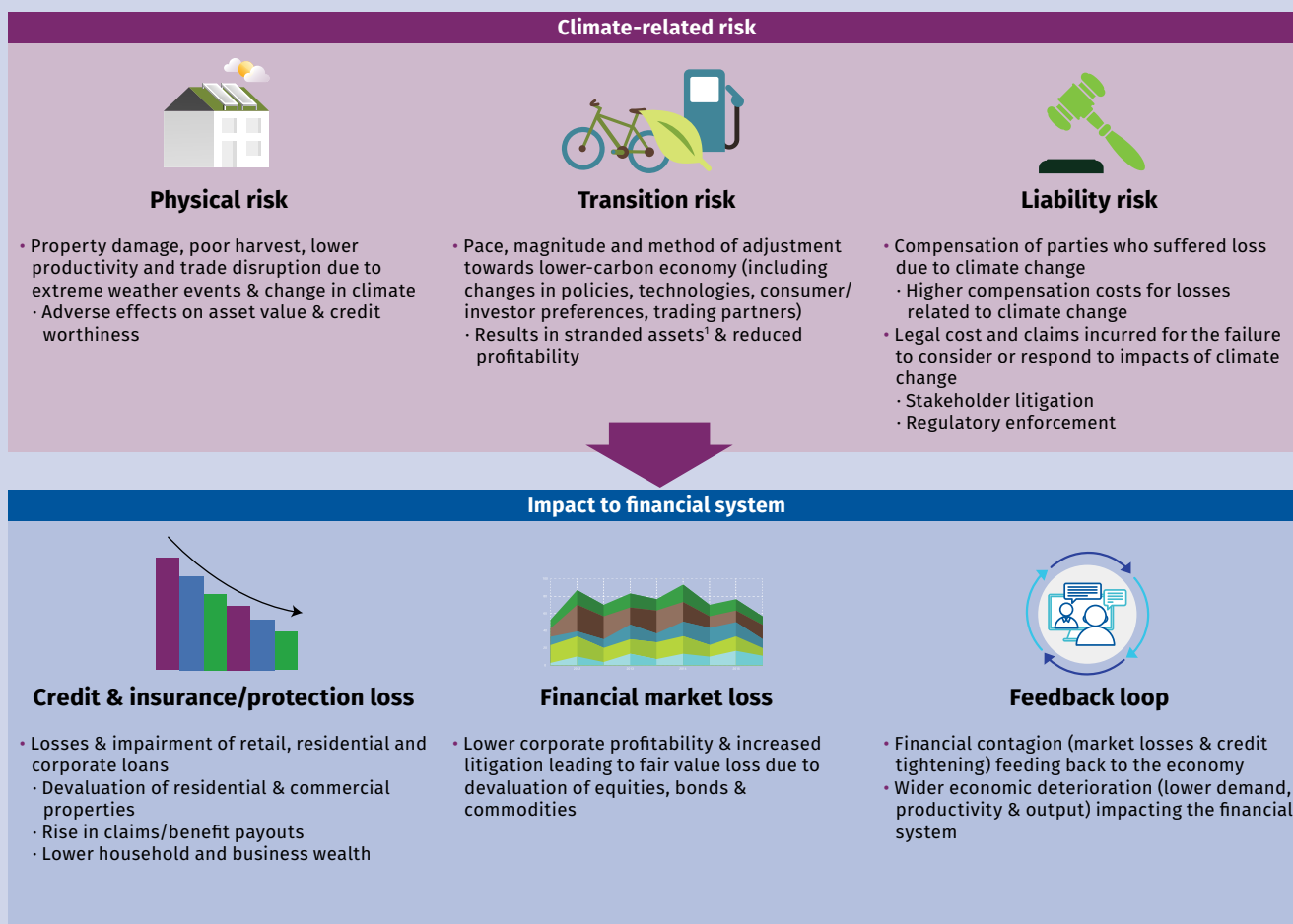
¹ Refer to banks, insurers and takaful operators

² Including construction, oil and gas, utilities, transport, automotive manufacturing, rubber and plastics manufacturing, and primary agriculture sectors

Source: Zurairi, A.R. (2018); Yaacob, O. & Chau, Q.P. (2005), Bank Negara Malaysia estimates

The journey to a greener future also poses immediate transition risks to an array of jobs and industries. If not managed well, policy, technology and market changes can affect asset valuations and significantly increase business risks in industries such as the coal, oil and gas and energy industries. This in turn could lead to sudden and material losses in the investments held or loans extended by financial institutions in these industries, thus exposing them to risks of capital and balance sheet erosion.

Diagram 1: Impact of physical, transition and liability risks on the financial system



¹ Stranded assets are assets that suffer from unanticipated or premature write-downs

Source: The Central Banks and Supervisors Network for Greening the Financial System (NGFS) 1st Comprehensive Report

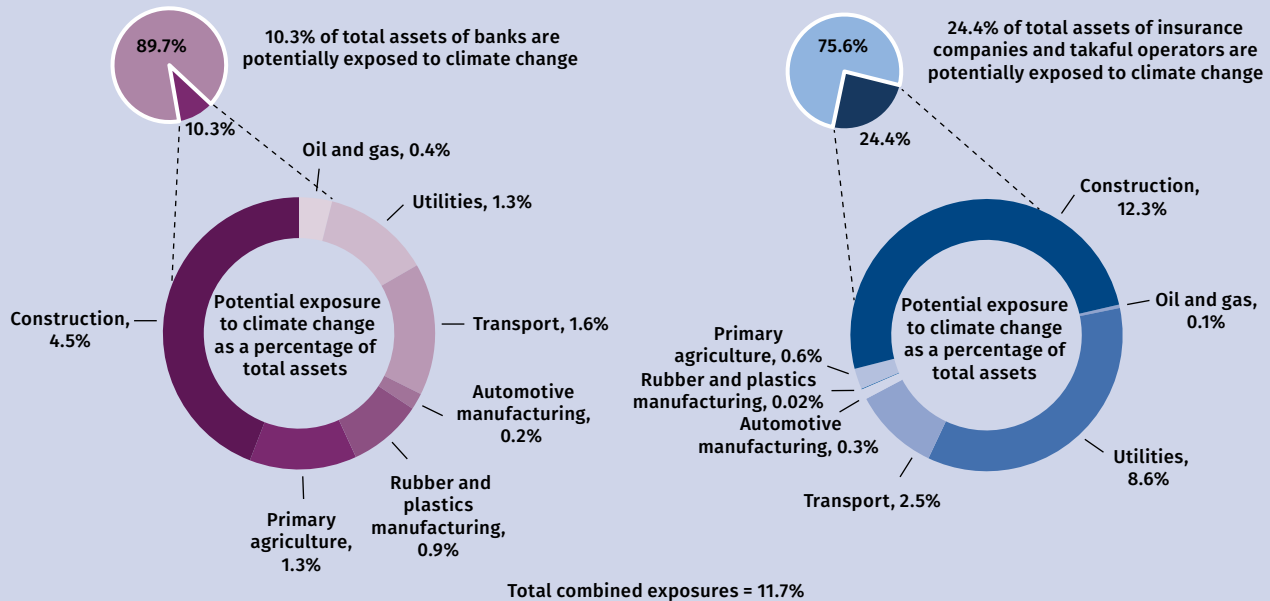
Climate risks are also felt in the economy and financial system

Climate change and its effects therefore matter to the economy and the financial system. Banks, insurance and takaful operators are exposed to liability risks, asset impairment, and rising claims (Diagram 1). With about 11.7% of their assets in sectors potentially exposed to climate change (Chart 2), it is important that Malaysian financial institutions treat climate risk like any other financial risk which has the potential to affect their profitability and balance sheets that in turn may affect the ability of financial institutions in raising funds. If not dealt with adequately, climate change can also pose a systemic risk. Collectively, these could lead to a contraction in important financial activities that support the economy.

Significant or persistent climate events can also directly affect overall growth. A recent example is the prolonged drought last year which led to supply disruptions in palm oil production and had a visible impact on the growth of the Malaysian economy particularly in the fourth quarter of 2019. A decline in the national and international supply of commodities or food products caused by weather-related events can also lead to inflationary pressures.

For these reasons, climate change has direct relevance to the Bank’s mandate to preserve monetary and financial stability in several ways (Diagram 2).

Chart 2: Exposures of Malaysian financial institutions in sectors potentially exposed to climate change



Preliminary data as at November 2019

Construction includes civil engineering, infrastructures, residential & non-residential; utilities include power & water; transport includes land, water & air transports; primary agriculture includes mainly palm oil.
 Note: Exposures based on existing reporting requirements and may be refined once green taxonomy is developed.

Source: Bank Negara Malaysia estimates

Responding to climate risks – and opportunities

As part of efforts to build climate resilience among financial institutions, we are taking steps to systematically identify and quantify climate risk exposures. In December 2019, we issued the Climate Change and Principle-based Taxonomy Discussion Paper to solicit feedback on the classification of assets associated with fund raising, lending and investment activities in a consistent manner, based on their exposure to climate risk. This aims to address the absence of agreed common definitions and data nationally to enable the quantification of climate risk impacts on individual financial institutions and the broader financial system. The implementation of the taxonomy is key to support informed decisions and analysis of exposures in the financial system.

With better data and insights into climate-related risks, the taxonomy is also expected to increase financial flows to activities that will support the transition to a low-carbon and climate resilient economy. A number of banks currently already offer preferential rates or discounts for the financing of sustainable projects in areas such as green manufacturing and clean and renewable energy. Sustainability-linked financing is also available to assist transition of corporate borrowers to become more sustainable, where those that achieve their sustainability performance targets would benefit from favourable interest or profit rates in the form of rebates. The taxonomy will enable financial institutions to identify and expand similar opportunities, and to do so more confidently on a well-informed basis.

While we expect to see a system-wide response to tackle the climate challenge, we also recognise that Islamic financial institutions are well-positioned to provide leadership in this area. This is given Shariah underpinnings which call on Islamic financial institutions to adopt practices that generate a positive and sustainable impact to the economy, community and environment. In assessing the impact of their financing and investment decisions, the Value-based Intermediation Financing and Investment Impact Assessment Framework (VBIAF) issued in 2019 provides broad guidance to Islamic financial institutions on the development of an impact-based risk management framework which extends traditional risk management approaches to capture environmental

Diagram 2: Climate change and the Bank's function



and social impacts¹. The industry, with support of the Bank is now finalising sectoral guidance documents on implementation of impact-based risk management that will focus on the efficient energy, renewable energy and palm oil sectors. To date, Islamic financial institutions are starting to offer products and solutions aligned with sustainable finance, such as preferential financing rates for hybrid vehicles and green-certified properties. Both Islamic and conventional financial institutions are also assisting oil palm smallholders to obtain the Malaysian Sustainable Palm Oil (MSPO) Certification.

In parallel, we are directing efforts towards developing research, tools and frameworks to assess climate-related risks to financial stability. Work is underway to develop an analytical framework to size the impact of climate change on the financial system and economy. We are also working closely with other regulators and institutional investors to encourage disclosure practices to improve transparency on how climate risk considerations are integrated into business decisions of financial institutions. Climate-related issues are also

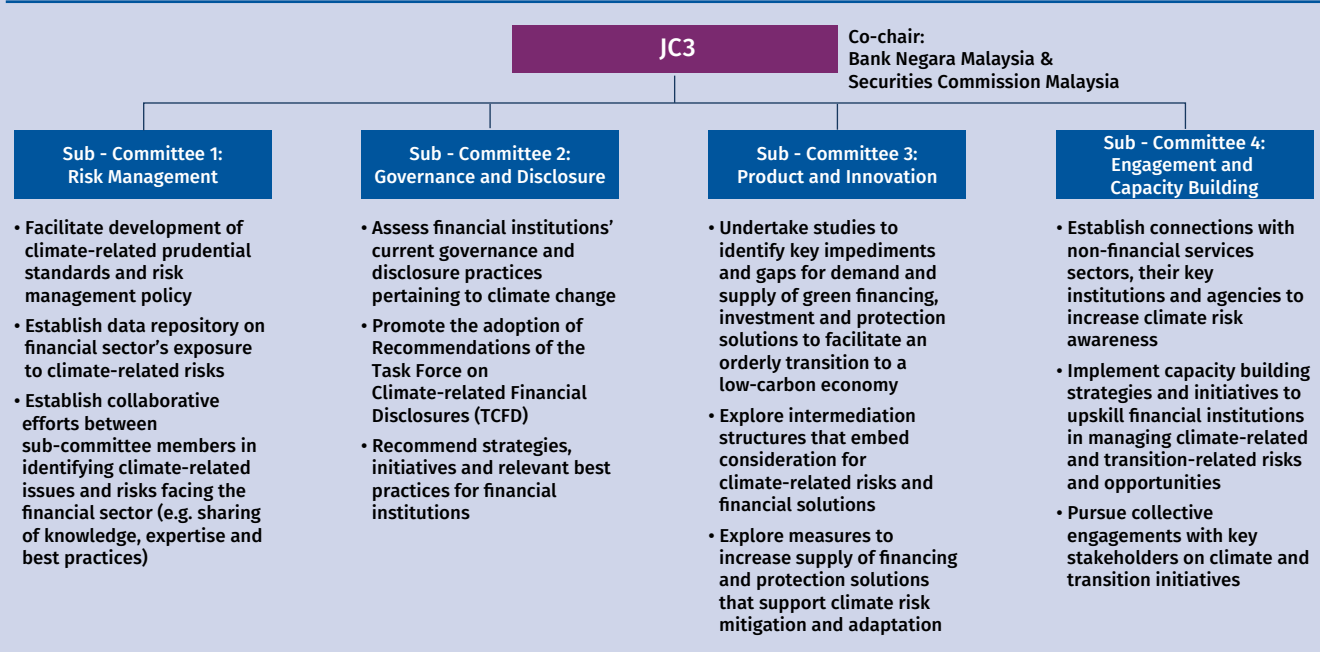
¹ For further information, refer to BNM Annual Report 2019 Chapter titled 'Promoting & Inclusive Financial System: Encouraging Diverse and Sustainable Financial Product Offerings'.

being more actively discussed in our supervisory engagements with licensed financial institutions to better understand how financial institutions are managing these risks.

Partnering with others

Climate risks are complex, with many moving parts. The Bank therefore partners with the Government, industry and other domestic regulators in responding to climate risk. In September 2019, the Bank and Securities Commission Malaysia established the Joint Committee on Climate Change (JC3) to drive and coordinate the financial industry’s collective response to climate risks. The objectives of the JC3 are to: (i) build capacity through the sharing of knowledge, expertise and best practices in assessing and managing climate-related risk; (ii) identify issues, challenges and priorities facing the financial sector in managing the transition towards a low-carbon economy; (iii) facilitate coordinated responses to challenges and issues; and (iv) support financial institutions’ integration of climate risk considerations in their business operations. Its members and observers include representatives from across the financial sector, key Government agencies and institutional investors (Diagram 3).

Diagram 3: Joint Committee on Climate Change (JC3)



The Bank is also part of the Malaysian Green Financing Taskforce, which is chaired by Securities Commission Malaysia to spur private sector financing in the renewable energy sector. We continue to engage with the relevant ministries and agencies to promote alignment between the Government and financial sector responses to climate risk.

On the international front, we became a member of the Central Banks and Supervisors Network for Greening the Financial System (NGFS) in October 2018. The NGFS membership comprises 55 other central banks and supervisors both from the advanced and emerging economies. The network enables us to tap into a deep pool of knowledge and experience on climate and environment-related risks and share best practices to support our response to climate risks and opportunities. We actively contribute to the work of the NGFS, including by lending an important developing economy perspective to its deliberations and publications.