

Climate Risk Stress Testing Exercise

Climate hazards are becoming increasingly frequent and intense. They have a devastating impact on the economy and pose risk to the financial system. In addition, policies and strategies by both the Government and other economies in managing these climate challenges would result in transition risks which would pose further threats to financial stability. These require heightened attention and prompt action by financial players to ensure such risks are managed effectively, and any potential consequences to the financial system and economy are contained.

With the above in mind, the Bank in June of this year published a discussion paper on plans to conduct an industry-wide Climate Risk Stress Testing (CRST) exercise in 2024, which aims to assess the resilience of financial institutions to both physical and transition risks. The CRST is also expected to strengthen the capabilities of the Bank and financial institutions in sizing up and assessing these risks, in order to inform internal strategies for mitigating such risks. At the industry level, the collective effect of mitigation actions by financial institutions can also create important feedback loops that could reduce or amplify systemic risks. These effects are explored through the use of alternative climate scenarios as part of the CRST. Feedback to the discussion paper will be used to finalise the design and specifications for the CRST.

In this exercise, the Bank intends to use three adverse climate scenarios¹ to capture the impact from alternative pathways that are associated with a range of different transition and physical risks. These are:

- Current Policies scenario – this scenario assumes the government does not impose any new measures to address climate risk above and beyond those that have been implemented in the past, while economic agents do not alter their behaviour to reduce greenhouse gases (GHG) emissions and there is limited availability of carbon dioxide removal technology. Physical risks are severe.
- Nationally Determined Contributions scenario – this scenario assumes both implemented and pledged policy measures to be effective even though some measures have yet to be implemented. Some materialisation of moderate to severe physical risks are expected, reflecting insufficient policy actions.
- Delayed Transition scenario – this scenario captures the transition risks that may arise from a late implementation of measures to fight climate change. Efforts to lower GHG emissions are delayed until 2030, after which more stringent policy measures are suddenly introduced to make up for the delay. Economic agents are forced to drastically change their behaviour, resulting in sharp disruptions to economic activity and financial markets.

The stress test will span an assessment horizon of up to 2050, aligned with Malaysia's commitments to net zero GHG emissions.

The CRST builds on existing initiatives that the Bank has undertaken to strengthen the financial industry's management of climate-related financial risks. These include the issuance of standards and frameworks to improve climate risk management practices by financial institutions² and to promote the consistent classification of exposures to climate-related financial risks.³ These initiatives serve to strengthen the conditions that will enable financial institutions to conduct the CRST with appropriate rigour and to use its results in a meaningful way to enhance climate resilience.

¹ Please refer to the Discussion Paper on the 2024 CRST for further details (https://www.bnm.gov.my/-/dp_2024_crst).

² Climate Risk Management and Scenario Analysis exposure draft published in December 2021.

³ Climate Change and Principle-based Taxonomy which came into effect on 30 April 2021 and Value-based Intermediation Financing and Investment Impact Assessment Framework Sectoral Guides.