# Financial Risk&Regulation

**New MNB recommendation for green finances**

**Newsletter – April 2021**

In the recent period, several regulations related to sustainability, measurement and management of environmental risks have appeared in European regulations. These include, for example, the Taxonomy Regulation or the European Banking Authority's (EBA) Guidelines on Lending Processes, which also address the integration of ESG factors into lending processes. However, these regulations are just the beginning of the rise of green finances, the EU is aiming to achieve carbon neutrality by 2050, but further action is needed to reach this goal. In case of the financial sector, sustainability risks are also becoming more and more perceptible, the physical risks caused by weather events are becoming more visible in banks' balance sheets, and the risk of switching business processes in the future is also growing. Beside all of that, the responsibility of key players in the financial sector to facilitate the green transition has increased. In the interim period before the completion of the EU regulatory toolbox, the Hungarian National Bank recognized the importance of ESG risks, so at the end of last year it issued a draft Green Recommendation, which, based on international "best practice", allows the domestic banking sector to be prepared to wait for coercive measures. Based on the longer social consensus, the recently issued final recommendation has been modified on several points.

In addition to the expectations set in connection with the management of environmental risks, the MNB document also covers the enforcement of environmental sustainability aspects in the business activities of credit institutions. With the recommendation it is a declared goal of the central bank to increase transparency and predictability in line with the MNB's Green Program, to promote the uniform application of relevant legislation, and to improve the awareness and preparedness of the banking sector in relation to the above risks. The vast majority of the provisions of the Recommendation will apply from 1 June 2021, while a smaller part will apply from 30 June 2021.

## Regulation of the lending process

The EBA recommendation on lending and credit monitoring deals in detail with the lending and credit assessment process. As a result of the recommendation, banks should incorporate ESG factors into their risk management frameworks. As part of this, inter alia of credit risk policy and the review of risk management policies and procedures should take into account the risks associated with ESG factors in their risk strategy, but in particular the possible effects of environmental factors and climate change on borrowers' financial situation.

With regard to ESG factors, it is important to see that the risk of climate change in terms of borrowers' financial performance can materialize in two forms. One is the financial risk due to physical risks, which can be triggered by, for example, more volatile weather due to climate change, or the rise in sea levels in the longer term. The other risk element stems from transition risks, which are risks arising from the transition to a sustainable economic model. These include lignite mining companies, which are suffering losses due to ever-tightening environmental standards, or even companies using outdated technologies, or products whose popularity is declining significantly due to changing consumer demands (e.g. single-use plastics companies). At the end of the lending process, companies that are at a competitive disadvantage through green innovation are still emerging, but they pose an increasing risk in the medium to long term through the expected deterioration in their financial performance.

### Identification of ESG risks

As part of the identification of ESG risks and the development of a reliable reporting and indicator system on them, the World Economic Forum and the International Business Council, launched in 2020 with the participation of several market participants – including KPMG – Measuring Stakeholder Capitalism – Towards Common metrics and consistent reporting of sustainable value creation manifesto can help. The Recommendation organizes the currently common reporting recommendations and standards, such as the indicators developed by the GRI or TCFD, into a four-dimensional structure that can be applied across industries, in the implementation of which it is recommended to follow the implementation guide developed by KPMG.

## New MNB regulations

The MNB's current recommendation sets many new requirements for the identification, measurement and management of environmental sustainability risks, and also implements the requirements of the EBA recommendation on lending and credit monitoring for ESG factors. The main requirements are:

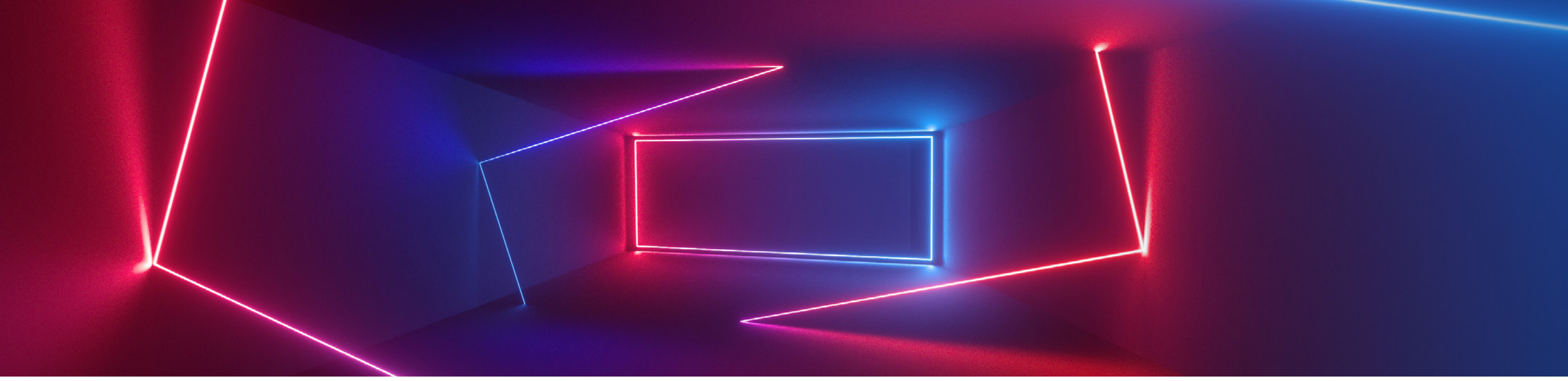
**Organizational requirements:** To be properly authorized – together with the provision of adequate financial and human resources – the MNB expects that a new organizational unit/function related to climate change and environmental risks will be established – responsible to the governing board – or in compliance with the relevant internal lines of defence, a responsible leader should be appointed. In addition, the governing board and key personnel will be expected to have the appropriate knowledge, skills, and experience about climate change and environmental risks. To this end, even within the framework of regular risk management education and strengthening of risk culture, it will be a task to provide pieces of training of sufficient depth for the affected employees. In addition, the MNB considers it important that banks strive to reduce their ecological footprint as a fundamental step towards green operations, for example by prioritizing paperless administration or cashless payment methods.

**Remuneration:** The Supervision considers it necessary to define KPIs for climate and environmental risks in the remuneration policies, which would thus be reflected in the financial motivation system of the stakeholders.

**Reporting system:** Adequate data is also needed for proper decision-making, so banks need to start developing external and internal reporting systems related to climate and environmental risks. Accurate reporting is still hampered in many cases by data gaps or data stored in an unstructured form, so these will need to be assessed first to address the gaps.

**Business model, strategy:** Banks will need to document the impact of climate change and environmental risks on their business model and strategy. For example, a new task will be to define and monitor properly quantifiable and measurable key risk indicators (KRIs) and limits related to these risks. In particular, the conscious application of the limit system can help prevent an increase in credit risk due to future switchover risks by, for example, gradually reducing the funding of regulated fossil energy companies.

**Risk Management Framework:** Climate and environmental risks affect credit risk, the most significant risk for banks. In addition to credit risks, these sustainability risks have a proportionately greater impact on operational risk and only a smaller share on market and liquidity risks. For all these reasons, although the recommendation contains requirements for all of them, the emphasis is on credit risk. In line with the general expectations of the MNB's ICAAP-ILAAP-BMA Handbook, climate change and environmental risks cannot be excluded from the assessment simply because they are difficult to quantify or because the relevant data are not available. Based on this, it will also be an important task to quantify the risks related to climate change and the environment, which is necessary, but there is a lot



of room for manoeuvre in the applicable methodology. Institutions should consider several things when selecting the appropriate methodology(s), from the type of portfolios involved, through the range of data and the level of complexity of the methodologies which are available.

**Credit risk management:** In line with the EBA recommendation, the lending strategy and policy should be reviewed to be in line with the business strategic plans for sustainable financing. As a result of the recommendation, credit risk-taking processes need to be modified to provide the information needed to assess sustainability risks. Based on this data, it will be necessary to examine in the future whether a financing project is environmentally sustainable, and to carry out a climate change and environmental risk screening of customers before taking a risk. The credit risk assessment will also need to assess how climate and environmental risks affect the borrower's probability of default (PD) and the average loss given default (LGD). For example, due to climate change, farmers may be more exposed to physical risks and this may increase their PD, while, for example, the LGD of a zero-emission property may be more favourable. Effective monitoring procedures must also be established to check that these are met.

**Stress testing, scenario analysis:** Given the high level of uncertainty to the extent of the risks, stress tests and scenario analyses will play an important role in the analysis of sustainability risks. In implementing these, it is necessary to pay attention to the fact that on the one hand, we do not have past observations that adequately represent the effects of climate change and environmental risks, and on the other hand, the choice of methodologies is challenging, that the time horizon of climate models is well beyond the usual time frame, up to 20-30 years.

**Disclosure:** Under the Taxonomy Decree, banks will be required to publish information on a number of sustainability risks from 2022 onwards, but the new MNB recommendation also requires additional information, such as the proportion of green assets or green bonds in portfolios. In addition, policies for economic (sub) sectors, geographical exposures, and numerical indicators should be published, if there is any. Disclosure of environmental risks will help market participants to better understand the financial implications of climate change and to better assess their physical and transition risks.

**Developing a system of indicators:** Banks will also be tasked with monitoring and publishing current data on climate change and environmental risk exposures based on a combination of past facts and forward-looking estimates. Such numerical indicators could be, for example, greenhouse gas emissions (at the Scope 1,2,3 level), energy intensity, or even the rate of hazardous waste production.

**Gap analysis:** The cornerstone of the recommendation is that credit institutions should conduct a gap analysis to assess compliance and develop an ambitious but feasible plan to address the shortcomings by 30 September 2021, which should be sent to the MNB by now.

## Taxonomy Regulation

One of the background rules of the MNB's Green Recommendation is the Taxonomy Decree, which unifies economic activities that can be classified as green and their principles, naming seven sectors for the time being. Green activities should support six main environmental objectives: climate change mitigation; adaptation to climate change; sustainable use and protection of water and marine resources; the transition to a circular economy; prevention and reduction of pollution; and the protection and restoration of biodiversity and ecosystems. However, support for one objective must not seriously undermine any other objective, and certain minimum social and governance conditions must be met in all cases.

The Taxonomy Regulation provides an opportunity for a homogeneous and more rigorous environmental assessment of customers, supporting sustainable financing through a consistent and transparent classification system. The main challenges for financial actors during implementation are proper data collection and integration into current operational processes. The regulation also imposes a new obligation on financial sector players and large companies to report regularly in the future on what proportion of their activities and portfolios qualify as green.

******

The role of the financial sector will be very important in providing the huge investment and development resources of the carbon-neutral transition - according to ITM's calculations - HUF 50,000 billion by 2050 - which will not only have a task for banks, but will also open up new business opportunities. The green operation of financial institutions at the process level is key, as appropriate management of climate risk exposures improves the financing of sustainable companies at the national level, while companies engaged in harmful activities find it increasingly difficult to access funding through the risk reflected in their bank calculations. KPMG's latest global CEO research also shows that a significant proportion of executives are planning more stringent ESG compliance measures. Several measures have been taken at both the European and national levels to encourage all this. In Hungary, the MNB has set clear expectations for the integration of climate and environmental risks into banks' governance and risk management frameworks and has established incentives for banks to support green financial products, leading the way in European financial regulation.

---

Participants in the preparation of the newsletter: Ágnes Deme, Viktor Kiss, István Szabó, Péter Vajda and Gergő Wieder.

# Contact:

**Ágnes Rakó**
**Partner**
**M:** +36 70 370 1792
**E:** agnes.rako@kpmg.hu

**Péter Szalai**
**Director**
**M:** +36 70 370 1739
**E:** peter.szalai@kpmg.hu

**István Szabó**
**Senior Manager**
**M:** +36 70 370 1812
**E:** istvan.szabo@kpmg.hu

**Gergő Wieder**
**Senior Manager**
**M:** +36 70 333 1471
**E:** gergo.wieder@kpmg.hu

**KPMG.hu**

BLOG