

# Financial Risk & Regulation

## Sustainability in finances – opportunities and regulatory challenges

Newsletter – March 2021

In addition to the COVID-19 pandemic, last year has been characterized by a green turnaround that involved the financial sector as well. Sustainability factors are increasingly integrated into the regulatory expectations on credit institutions and investment service providing firms, as well as new opportunities provided by capital requirement reductions. In addition to a number of green capital requirement reductions, the Hungarian National Bank (MNB) recently issued a management circular on the adequacy of the Sustainable Financial Disclosure Regulation (SFDR) applicable from March 10. In our newsletter, we cover these two topics.

### I. Green Capital Requirement Discount for Housing

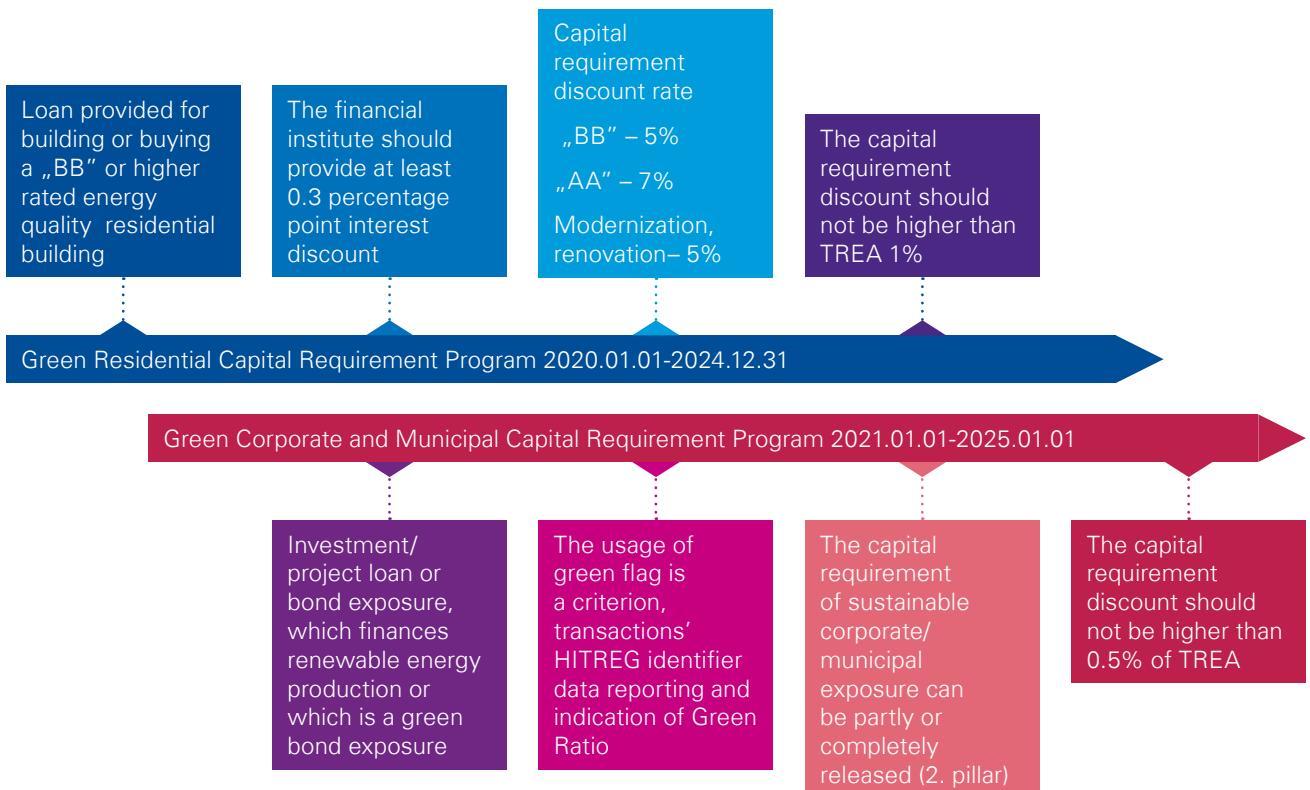
In line with the EU directive and in addition to the “green finance” program of several other central banks, MNB also announced its Green Program in 2019, which aimed to launch products for the Hungarian financial sector that support sustainability, and to mobilize the commercial banks and investment funds. All this is not only of ecological significance: under the program, banks can move towards the “green” goals by reducing their credit risk through incentives. Empirical research has shown a lower probability of default for sustainability loans and a more favourable LGD. This is due to the fact that the debtors involved tend to be more financially aware and that such homes generally are more marketable in the future than their low energy efficiency counterparts, even in times of crisis.

The Green Capital Requirement Discount Program for Housing can be adapted by domestic banks until 31 December 2024 (including the ICAAP reviews starting in 2025). The loan disbursed to individuals for the purpose of selling, buying or renovating real estate, or in the case of condominiums and housing associations for the purpose of renovation could be taken into account. In respect of property sale and

construction the real estate should have an energy rating of “BB” or better. In course of modernization the project should include at least one modernization measure specified by the MNB (e.g. installation of solar panels or solar collectors, thermal insulation, facade door and window replacement). In the case of a discounted loan disbursed this way, the central bank imposes lower capital requirement on disbursing institutions, if the interest rate or the APR (THM) on the “green” loan is at least 0.3 percentage points more favourable (compared to other similar products).

The basis for the capital requirement discount is the gross (on-balance sheet and off-balance sheet) exposure to outstanding loans at the end of the calendar year in the form of a mortgage or personal loan (having a green interest rate discount) that meets certain conditions. The capital requirement reduction in case of “BB” energy rating for sales and construction is 5%, for grade AA or better it is 7%. In case of modernization, the discount is uniformly 5%.

The maximum discount is the value of the SREP capital requirement for discounted transactions determined during the ICAAP review, but a maximum of 1% of the total risk exposure value (TREA).



## II. Green corporate and municipal capital requirement discount

Retail green financial products can also be interpreted as a strategic breakthrough for the green economy, helping to strengthen competitiveness by increasing the demand for green investments. However, corporate and municipal capital reductions may have a greater direct impact on reducing credit and market risk from socio-economic changes caused by climate change and other environmental anomalies, as sustainable companies have a more stable income-generating capacity.

Accordingly, MNB encourages banks to increase the lending for companies belonging to green industries compared to companies of more polluted, “brown” industries, which are more exposed to stricter regulations as well on the long run.

The discount can be applied in cases of investment or project loans financing renewable energy production (Taxonomy regulation needs to be considered) or green bond exposures, the credit risk capital requirement can be reduced. The discount rate shall be 5% of the total gross exposure of the relevant portfolio, up to a maximum of 0.5% of the credit institution's total risk exposure amount (TREA).

The condition for applying the discount is the application of a green flag in the credit records and the quarterly provision of data to MNB containing the

HITREG ID of the transactions concerned. It is also a condition that the Green Ratio required by MNB must be indicated in the internal records and data reporting. The Ratio must be determined by the banks, and it shows the ratio of the exposure for which the discount can be applied to. According to MNB's expectations, credit institutions must duly verify the purpose of the loan when checking the disbursement conditions, or in the framework of ex-post credit monitoring.

### Green bonds

In addition to the above mentioned cases, exposures from the purchase of a corporate or municipal green bonds are also eligible for the preferential treatment, if they comply with Green Bond Principles or Climate Bonds Standards. The condition for applying the discount for both standards is an external review performed by an approved external service provider. **KPMG has already carried out such an external review in Hungary, and for the first time in the CEE region, KPMG in Hungary obtained the accreditation from CBI.** In case of green bond exposures, the discount is automatically applied to the full amount of the exposure (i.e. Green Ratio is 100%).

## An example of a discount validation calculation

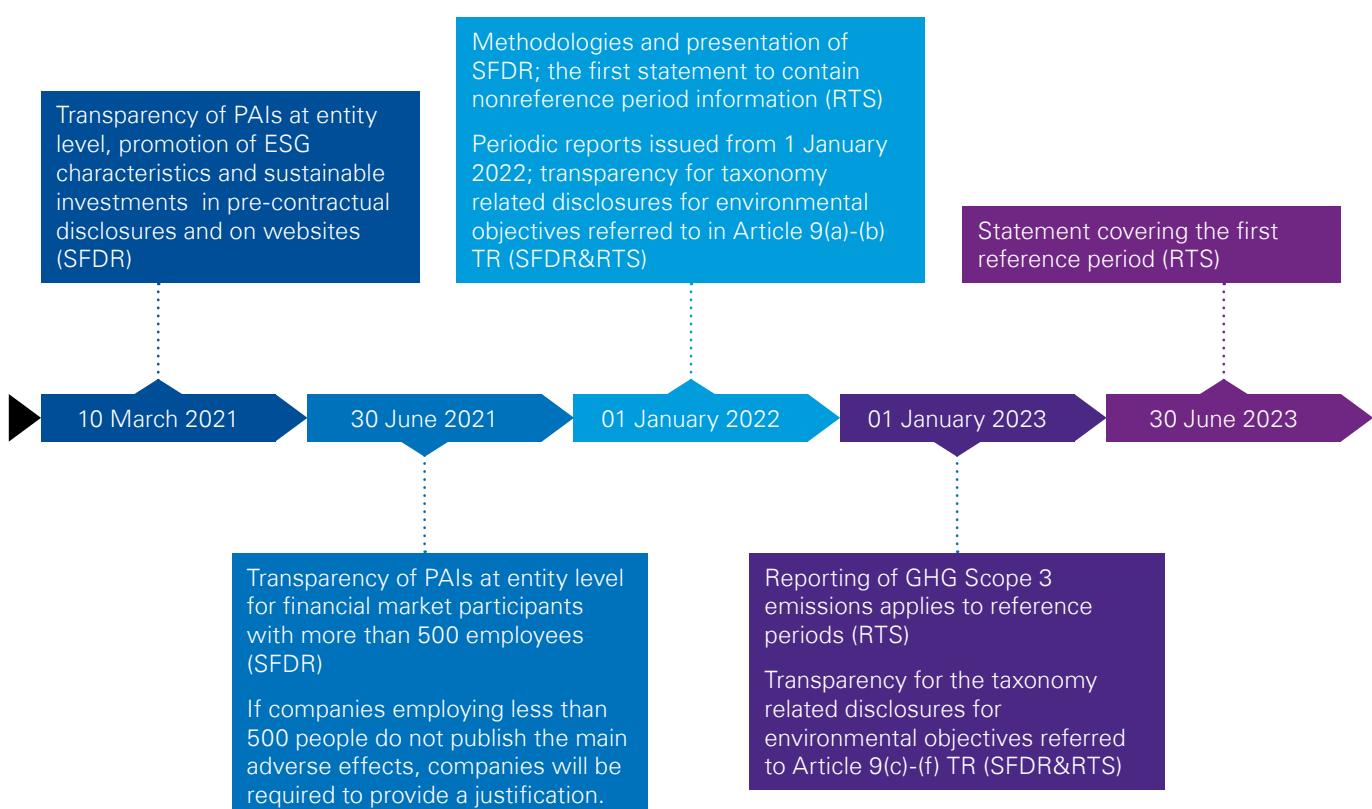
60% green investment discount:

Lending	HUF (million)	Calculation
The amount of corporate loans	1000	
The amount of green corporate loans	600	
Capital requirement (with 100% risk weight), for the green part	48	= 600×8%
Capital requirement discount	30	= 600×5%
Capital requirement after the discount for the green part	18	= 48-30

## III. SFDR - Sustainable Financial Disclosure

The Sustainable Financial Disclosure Regulation (SFDR) is applicable since March 10, but the regulatory technical standards (RTS) originally planned for the end of last year have not yet been finalized, so full compliance with the regulatory program will likely happen in multiple stages. A draft RTS has been sent to the Commission, which is expected to be finalized within three months of its submission in February. SFDR should fundamentally apply for two types of actors: financial market participants that provide financial products, such as investment product providing insurers, AIF managers, UCITS fund managers, credit institutions or investment firms; and financial advisers who provide investment or insurance advice on such products.

MNB emphasized in a recent management circular that it plans a two-step process in the field of SFDR compliance: from March 10 2021, all provisions for which no RTS will be developed must be complied with (Articles 3, 5, 6, 12); and for the articles for which the RTS is still being adopted compliance to the extent that can be reasonably expected ("at the level of principle") is anticipated. The regulatory system will be completed with the application of Regulation 2020/852 (EU Taxonomy) establishing a framework for the promotion of sustainable investment, sets out the criteria for classifying certain economic activities as sustainable. The first publication obligation set out in the Taxonomy Regulation will be due on 1 January 2023.



The Articles of the draft SFDR RTS details the following requirements:

Articles 4-12: statements published on companies' websites describing their screening policies to identify the principle adverse effects of investment decisions on sustainability factors, both in relation to climate and other environmental effects and adverse social effects. The Level 1 rules will apply from 2021, but compliance with RTS is expected for the first time in 2023 for the 2022 reference period;

- Articles 13-19 in connection with "light green" products as set out in Article 8 of SFDR: for financial products promoting among others environmental or social characteristics, pre-contractual information must indicate how products comply with environmental standards or social characteristics, and if an index has been assigned as a benchmark, whether the index is consistent with those characteristics;
- Articles 20-30 in connection to "dark green" products as set out in Article 9 of SFDR: for financial products with a sustainable investment objective, pre-contractual information must inform customers that:
  - » if the product has an index assigned as a benchmark, how the index fits into the sustainable investment objectives and an explanation of why and how the designated index differs from the market as a whole;
  - » if no index has been defined as a benchmark, an explanation of how the product achieves the above objectives.
- Articles 31-57: information published on companies' websites describing the environmental and / or social characteristics of financial products and the methods used to achieve the objectives;
- Articles 58-73 on the information contained in the periodic reports in accordance with sectoral legislation:
  - » the extent to which products with environmental and / or social characteristics meet these characteristics, and
  - » in case of sustainable investment products and CO2 reduction products, the associated emissions.

According to Article 11 of the SFDR, the periodic reports are already expected from the period starting January 2021, but the RTS will only be applicable for the reports, where the reference period is starting January 2022.

In addition to the above, the RTS also includes prescribed indicators and publication templates. Although the document is not yet finalized, it may be useful for market participants to take it into account while determining product categories and publications

## IV. MNB's special requirements in relation to SFDR

### - For asset managers

MNB considers it desirable to harmonize ESG ratings of BAMOSZ (Association of Hungarian Fund and Asset Managers) investment fund's categorization regulations with SFDR, a process which has already begun.

Asset managers can (also) provide information in accordance with Article 6 of the SFDR on how to integrate sustainability risks into investment decisions and assess the likely impact of these risks on the return on a given product in the information documents of investment funds (AIFs and UCITS). An additional requirement is that if the fund manager does not classify sustainability risks as relevant, it is obliged to provide an explanation in the prospectus and the portfolio management policy.

In the case of public investment funds, the authorization requirement to amend the portfolio management policy rules depends on whether the fund manager intends to change the fund's investment policy or risk profile solely in the context of SFDR. According to MNB no new risks will emerge due to SFDR's entry in force, only new expectations for the detailed presentation of the existing risks. Thus, according to MNB, an amendment due to SFDR is not subject to regulatory approval, unless there is a more significant change in the investment policy or the risk profile.

In case of public open-end investment funds, the management rules sections "26. Risks" and "51. Any additional information that allows investors to make an informed decision about the investment option offered" require amendment with the information laid out in SFDR.

In case of closed-end funds, it is not necessary to amend the portfolio management rules, as several pre-contractual disclosures in case of these investment funds are not applicable, nor is it possible to amend the prospectus of these funds after the closing of the subscription process.

## **– Insurers**

In case of insurers, the pre-contractual information can also be detailed in the investment policy of the funds in accordance with the Act on Insurance companies (Bit.), for which Annex 12 of Bit. contains specifications.

According to MNB's circular, supplementing the investment policy due to SFDR does not fall under Bit's restrictions laid out in Section 107 (3).

## **– Financial advisors**

As Article 17 of SFDR provides an exemption from compliance for financial advisers with less than three employees, MNB has provided guidance on who is considered to be an employee of an organization. An employee can be either a private person engaged in mediation activities (including private persons directly

employed by a broker or a multiple agent as well or employed by a subcontractor of the broker or the multiple agent). Subcontractors and natural persons carrying out ancillary insurance mediation activities are excluded.

With regard to the requirement of transparency in remuneration, MNB emphasized that when applying the SFDR to financial advisers and insurance-based investment products, market participants may also comply with it in the document containing findings and provisions on the prevention of conflicts of interest under Article 27 of the IDD Directive.

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**KPMG has significant experience in banking capital adequacy and investment services regulations and is active in the world of green finance. Our Budapest office has already conducted an external review in connection with green bond ratings, and for the first time in the region, KPMG in Hungary has obtained an accreditation from the Climate Bond Initiative. If you need more information about the newsletter, feel free to contact us.**

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