

Financial Risk&Regulation

MNB has issued a new Green Recommendation and supplemented its recommendation on the assumption, measurement, management, and control of credit risk

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MNB has recently published a revision of its Green Recommendation for financial institutions, clarifying several points of the April 2021 draft and added five new points to the MNB Recommendation of 2021 on the assumption, measurement, management and control of credit risk. As in the previous version, the Green Recommendation sets out expectations on climate change and environmental risk management and sets specific deadlines for more detailed expectations. MNB expects the expectations of the Recommendation to be met from by three different dates, 15.09.2022, 01.07.2023, and, for certain requirements, 2025. The concentration risk part of the MNB Recommendation on the assumption, measurement, management and control of credit risk has been amended, with effect from 1 October 2022. You can subscribe to our monthly FRR newsletter [here](#).

Green recommendation

General, comprehensive changes:

The addressees of the Recommendation have been amended, so that in addition to credit institutions domiciled in Hungary, it now explicitly applies to Hungarian branches of credit institutions domiciled in countries outside the EEA (third countries).

In several points, the new Recommendation advises the monitoring of the “For Financial Institutions”, “For Researchers” and “Green Legislation” sections of the website www.zoldpenzugyek.hu, where documents can be found to help implement the listed expectations.

The Taxonomy Regulation has been added to the group of sectoral legislation, and the provision of related supervisory regulatory instruments has also been expanded.

The Central Bank clarifies the threats to the environment and specifies that not all environmental risks are due to climate change, for example, certain agricultural activities may cause the destruction of living organisms. It stresses that biodiversity loss may also entail physical or adaptation risks, e.g. increased pollination costs or reduced natural resilience, all of which cause economic and financial losses, and the resulting change in consumer preferences may entail additional risks.

An important change compared to the previous recommendation is that MNB has tightened the classification of the measures from recommended to expected.

Key changes affecting the business model and strategy

A significant change in the incorporation of climate change and environmental risks and opportunities

into the business model and strategy is the need to include these aspects and assumptions in detail and in a documented manner to the strategy, the business plan, and the risk appetite of the institution. The new Recommendation expects that the data, assumptions, and methodologies used are well developed and documented. Credit institutions should identify the main competitive advantages, vulnerabilities and implementation risks related to climate change, environmental risks, and opportunities in their strategy and business plan, and document them appropriately.

Financial institutions will need to identify the short, medium and long term (at least 10 year) risks and opportunities arising from climate change and environmental degradation that are part of the business environment and will also need to identify which climate change and environmental risks are substantial over this timeframe.

Key changes in corporate governance

Regarding corporate governance rules, the new Recommendation contains clarifications and more detailed definitions, for example on training and knowledge, not only for managers but also for employees in related fields and includes the promotion of awareness-raising. In addition, the new rules place a greater focus on well-documented internal processes, such as the expectation that internal controls should prepare for climate change risks and assess compliance with the objectives set. MNB expects the Board of Directors to receive a report on the implementation of the Green Recommendation Action Plan submitted to it at least every six months.

Key changes in risk management

As per the new Recommendation, the Supervisor now expects credit institutions to set objectives and standards for their environmentally sustainable lending activities. One element of this is that the credit file should include elements of climate change risk screening of customers and counterparties, and that the credit risk underwriting decision documentation should also include the results of climate change and environmental risk screening and contractual and disbursement conditions for mitigating this risk. However, the new

Recommendation does not expect the incorporation of the former into PD and LGD. Also, exposures with an increased climate risk should be given special attention, e.g. in line with the planned addition to the EU Taxonomy (“red”, “amber”, “neutral” exposures).

MNB has also refined its previous recommendation and no longer expects, but only recommends, that a combination of historical facts and forward-looking estimates should be used to monitor current data on climate and environmental risk exposures, preferably in the form of numerical metrics.

Further expectations have been set out in the operational risk assessment. Credit institutions will be required to consider climate change and environmental risks (also including transition risks) in their operational risk management framework. This should include, for example, the collection of loss data at least for those loss events due to climate change whose impact can be detected in the accounting records, and it is highlighted that scenario analyses should assess the risk of climate change and environmental events that impact operational risk, and that various mitigation procedures should be developed.

Credit institutions subject to the complex SREP will be expected to assess both climate and environmental risks by conducting sensitivity and scenario analysis, and stress testing. In addition, for all institutions, it is now not merely recommended but expected to consider multiple scenarios.

Publication

MNB has brought the new Recommendation in line with the publication rules that have changed since the previous recommendation was issued, and which are expected to appear within 1-3 years, and, in accordance with the EU Taxonomy Regulation, has specified the dates related to the mandatory data reporting.

Dates of entry into force of the measures

The measures are grouped by themes and deadlines in the table below. Actions that will take effect from 15 September 2022 include identifying climate change and environmental

risks, building resilience into the strategy, training the management board, establishing responsible departments, assessing missing data, developing a risk framework, quantification steps, building climate risks into credit risks, setting sustainable lending targets and publishing Scope 1 and 2 emissions. The expectations, which will be effective from 1 July 2023, include forecasting and incorporating climate risks into strategy, training of key staff, oversight of climate risks, risk management procedures, assessment of climate risks of customers and counterparties, estimation of transition and physical risks, assessment of critical

functions and disclosure of Scope 3 emissions. And from 1 January 2025, MNB will also expect financial institutions to separate short- and long-term climate risks, apply performance indicators in strategy and assess governance, develop data taxonomy, monitor counterparties and portfolios, take climate risks into account in the calculation of internal capital requirements and at all stages of credit risk management, including pricing, incorporate environmental risks in the assessment of market and liquidity risks, calculate loss data, conduct scenario analyses and develop risk mitigation procedures.

	From 15.09.2022	From 01.07.2023	From 2025.01.01
Business plan, strategy	Identifying climate risks, strategy resilience, building into strategy	Forecasting – assumptions regarding climate risk, building into D14 strategy	Concrete plan - short, medium and long term, monitoring and managing risks
			Climate risks: key performance indicators in the strategy
Risk management framework	Assessment of its responsibilities in relation to climate risks.: knows, understands climate risk, risk appetite + risk taking in line, regulatory compliance	Exercising supervision over climate change and environmental risks	Climate risks - the responsibility of people exercising internal management and internal control functions
	Management Board: provides human and financial resources for training on climate risks	Preparing and training the post holders on climate risks	The Management Board’s assessment of the responsibilities in relation to climate risks.
	Establishment of a department responsible for ESG management and control, reporting at least half-yearly to the board	Providing human and financial resources for the relevant areas: climate change, awareness raising	Extending the internal audit trail to cover short, medium and long-term climate risks
	The Board to receive a report on the implementation of the Green Recommendation Action Plan	ERP on climate risks	Remuneration policies + practices for climate risk mitigation
	Strategy + risk management: data needs, missing data	Testing and transformation of IT systems - with data collection in mind	Climate risk reports
			Climate risk data taxonomy
Risk management framework	Climate risks: risk framework, strategy, and policy	Develop procedures, tools, and methods to measure and mitigate risks	Climate risk management culture
			Climate risk monitoring - client and portfolio
	Climate risks: indicators, limits, measures		
	Internal capital requirement - climate risks		
Climate risks: risk framework, strategy, and policy			

	From 15.09.2022	From 01.07.2023	From 2025.01.01
Credit risk management	Integrating climate risks into credit risk policy	Include the results of climate risk screening of clients in the decision-making process	Climate risk reduction, mitigation and adaptation
	Targets for environmentally sustainable lending		Climate risks: credit underwriting and management at all stages.
	Environmentally sustainable financing targets, standards		Customer and partner qualification: providing climate risk information
	Assessment of borrower sustainability targets, criteria, monitoring	Adding climate risks to the customer and partner rating process	Monitoring climate risks in its loan portfolios when determining collateral, pricing, cost factors
	Climate risk due diligence documentation, credit terms		
	Climate risk screening for clients and partners.		
	Monitoring of exposures with increased climate risk		
Operational, market, and liquidity risk, scenario analysis	Calculating of Scope 1 and Scope 2 emissions	Own operations - transition and physical risks	Measure the significance of climate and environmental risks for market and liquidity risk
		Assessing critical functions along climate risks (also).	
		Climate risk - operational risk management framework	
		Impact on the operating and business environment - legal and reputational risk	Collecting climate risk loss data, scenario analysis and developing risk mitigation procedures.
	Calculating Scope 3		

MNB recommendation on the assumption, measurement, management and control of credit risk

An updated Recommendation on the assumption, measurement, management and control of credit risk has been issued alongside the Green Recommendation. In the general introduction section, reference is made to the new European Banking Authority (EBA) guidelines which MNB will follow from 1 October 2022. The Recommendation adds the case for exceeding the large exposures

limits, as well as the criteria for assessing the timeframe for returning to compliance and the measures to be taken to achieve compliance, based on the latest EBA guidance. In addition, there have been legislative updates and replacements in places, regarding points 123 and 230 of the Recommendation.

It is important to highlight that the points added in the chapter on concentration risk chapter concern only institutions subject to CRR.

Concentration risk:

The Recommendation requires institutions subject

to the CRR to notify the Supervisory Authority if their exposures exceed the newly imposed limit.

Information to be reported:

- Amount of overrun, its size in relation to capital
- General customer information (optionally customer group name)
- Date of overrun
- Available collateral
- Reason for exceeding the limit
- Corrective measures
- Date set for compliance with the new limit

If a financial institution has been in an over-limit condition for more than three months, it is required to submit to MNB a plan for re-compliance with the large exposure limits, which must include the information set out below.

The content of the compliance plan:

- Remedial measures, such as measures to reduce the exposure or to increase the solvency margin

- Strengthening and, if necessary, modifying risk management and internal controls
- Procedures to ensure the implementation of the measures
- Detailed timetable for the measures
- Risks and potential obstacles to the compliance plan

In addition, the MNB expects the financial institution to define the body that will perform the plan's governance and internal control functions.

The MNB expects financial institutions to comply with this Recommendation if they have changed the terms and conditions of credit exposures entered into prior to 1 October 2021 by entering into a new contract after 1 October 2022. The new Recommendation is expected to be applied from 1 October 2022, subject to the exceptions described above. In addition, last year's MNB Recommendation 14/2021 (IX. 16.) on the assumption, measurement, management and control of credit risk will expire on 1 October 2022.

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