KPMG

Financial Risk&Regulation

Global overview of ESG risks incorporation

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In recent years ESG risks have become increasingly important for banks, but market participants have faced several challenges in integrating them into normal operations. KPMG has therefore conducted research in 2023 to provide transparency and understanding of the main trends and challenges: Unlike previous studies focusing only on European markets, 111 banks from 24 countries participated in the research. The study's questions addressed understanding the drivers of ESG in banks' risk management frameworks, including business and risk strategy, risk assessment, credit risk exposure, stress testing, challenges with ESG data and reporting, and initiatives to address greenwashing.

Compliance takes a long time, not expected before 2025

Most banks' responses indicate that they see ESG risk compliance as a long-term process. While respondents have already made significant progress, particularly in more developed, more strictly regulated markets, full regulatory compliance with ESG risk aspects is mostly only achievable by 2025 or later. ESG risks is an entirely new area for both banks and supervisors, making compliance particularly complex, resource-intensive, and fraught with uncertainty. The more mature institutions with a longer presence in the market have successfully overcome the obstacles of changing regulatory expectations, as they have had greater flexibility to reorganize and prioritize the resources needed to develop new methodologies and processes. Furthermore, given their size, they have typically consulted actively with supervisors to clarify any uncertainties.

	Global			
	Already achieved	Within 2023	Achieved by 2024 to 2025	Achieved after 2025
1. Business Enviroment	3%	2%	54%	41%
2. Business Strategy	3%	2%	53%	42%
3. Management Body	14%	5%	47%	35%
4. Risk Appetite	6%	7%	59%	28%
5. Organisational Structure	9%	8%	46%	37%
6. Internal Reporting	3%	8%	54%	35%
7. Risk Mgmt Framework	5%	3%	56%	36%
8. Credit Risk Management	3%	3%	47%	48%
9. OpRisk Management	6%	9%	55%	30%
10. Market Risk Management	6%	3%	38%	53%
11. Scenario Analysis and ST	3%	6%	56%	35%
12. LiqRisk Management	7%	2%	39%	52%
13. Disclosure	2%	3%	51%	44%

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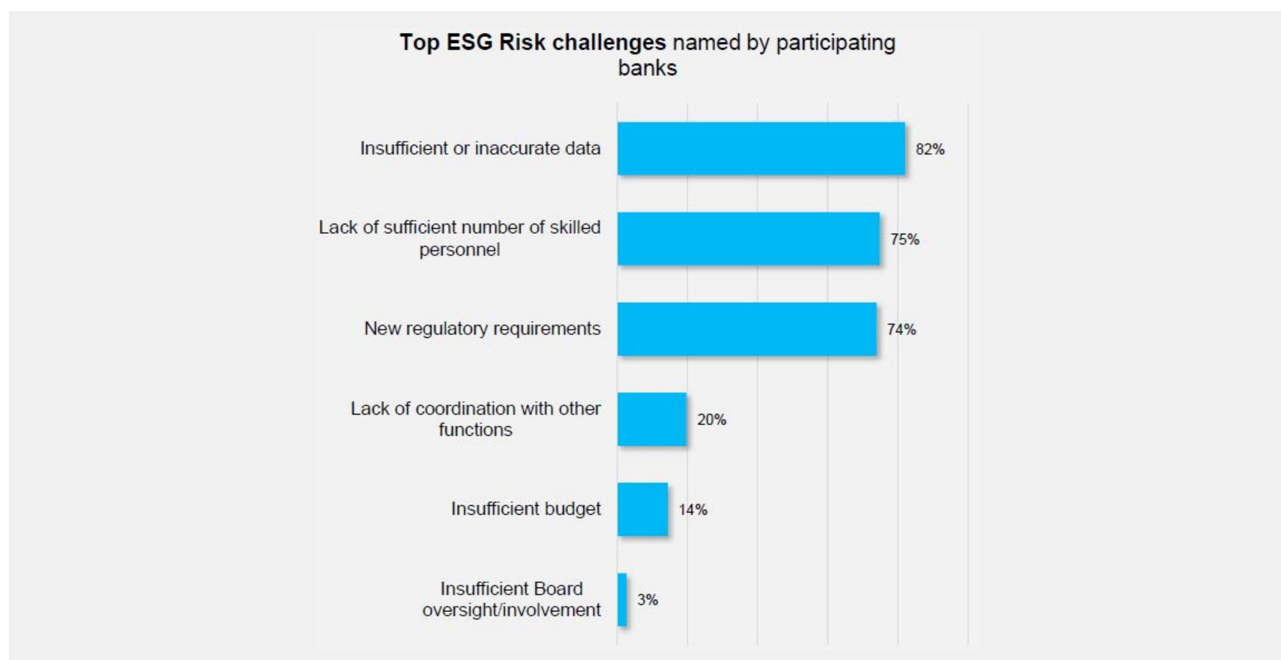
It is important to see that, compared to our last survey, the level of compliance seems to have decreased in many cases, according to the self-assessment of the participants. This is basically because, as financial institutions become more and more involved in ESG implementation tasks, they become more aware of the complexity of the task. In addition, in many cases it has become clear that the supervision expects much more complex and sophisticated solutions from the approaches that were previously considered to be appropriate, i.e., the "best practice" that supervisors also expect is constantly evolving and it is essential to keep complying with them.

Data quality and scarce resources among the main issues

A third of the banks agree that the main challenges when it comes to embedding ESG risks include data availability and quality, the ever-changing regulatory environment, and the lack of skilled staff. For banks, addressing the data problem is a key issue, which more advanced institutions have sought to address by creating flexible ESG data target operating models, thus prioritizing the identification of data sources and the transparent definition of data quality hierarchies, especially in the areas of greenhouse gas and physical climate change risks.

In addition to the challenges posed by the lack of data, the increased regulatory burden is a particular challenge for organizations, which is why banks are prioritizing the development of effective ESG risk management departments. However, for most organizations, the transfer of tasks and responsibilities between ESG implementation projects, i.e., centralized ESG resources, and operational areas such as risk management, accounting or compliance has proven to be a challenge. Banks that were the first to hire appropriately skilled staff and adhere to the objectives of their ESG operating model typically made the transition more successfully and subsequently established the roles and responsibilities of the lines of defense. In Western Europe, it can already be seen that in an increasing number of financial institutions, the primary management of ESG issues is being handled by individual disciplines, and that, proportionally, the centralized ESG function is increasingly acting as a competence center rather than an operational one, to assist financial institutions in the ESG transformation.



One of the most advanced ESG dimensions is the publication of institution-level ESG indicators. In addition to the ESG assessment of clients, banks are required to publish a range of new data on their own operations, with ESG rating, Scope 3 GHG emissions, the proportion of "green" assets being the most published environmental indicators, and top management diversity being the most commonly published social indicator. More than 80% of banks use quantitative indicators and for almost all respondents ESG indicators are part of their business strategy. Among respondents, greenhouse gas emissions are clearly the most important indicator type, both for own operations and for financed exposures.

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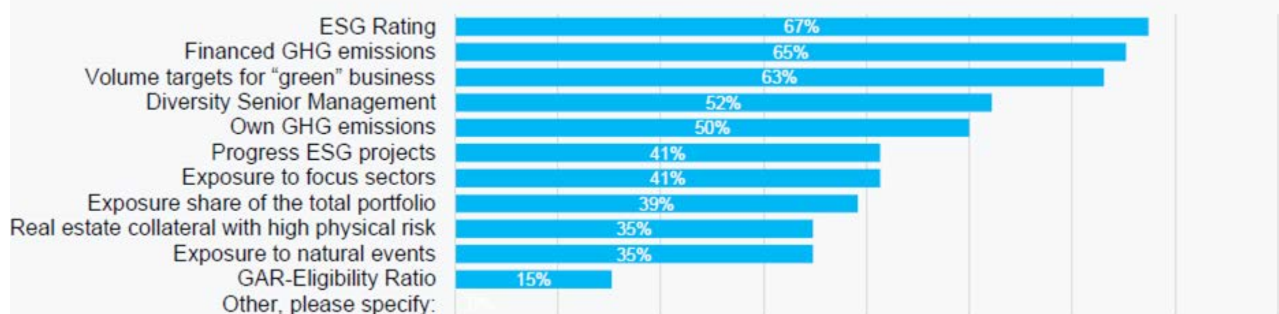
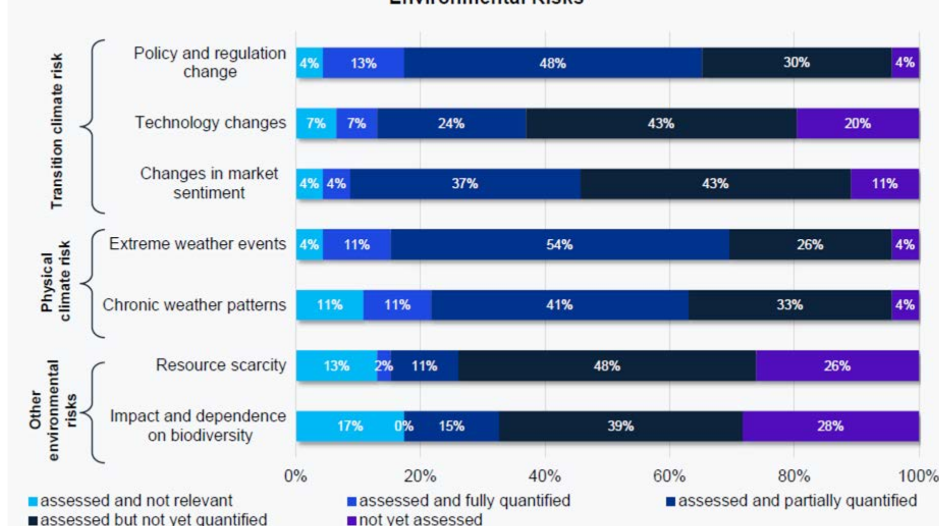


Risks arising from climate change are a priority

The research shows that banks globally continue to focus on climate risk, the most important element of ESG risk. There has also been a strong focus on biodiversity risk, social risk (e.g., human and labour rights, equal opportunities) and governance risk (e.g. supply chain management, executive remuneration), but climate risk remains a key ESG element for banks and is therefore a key focus in the risk management frameworks of more advanced institutions, with financed GHG emissions (as part of Scope 3 emissions) being one of the key performance indicators. However, there is also continued pressure from both regulators and other stakeholders for banks to develop more in-depth social and governance risk management frameworks and to assess and incorporate risks from biodiversity loss more thoroughly.



It is also crucial to address the risk of greenwashing

Only 40% of global institutions have processes in place to identify, prevent and manage the risks of greenwashing. More than 80% of banks do not have a clear definition of greenwashing that is sufficiently specific, objective or measurable. The management of greenwashing risks is typically not yet part of the risk management framework of the institutions surveyed. Nevertheless, several banks felt the need to take steps and clarify the concept of greenwashing, define related quantitative KPIs and metrics. Larger financial institutions tend to treat greenwashing as an element of reputational risk, not yet widely understood in relation to specific customers.

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Costs allocated to managing ESG risks continue to rise

Our study shows that the global banking sector continues to invest heavily in ESG risk management. With 70% of the banks surveyed expecting their budgets to increase or increase strongly compared to the previous year, we see a long-term commitment from banks worldwide to manage/achieve ESG risks and opportunities over the long term. Without exception, the banks surveyed expect their spending on ESG risk management to continue to increase. Most of this spending is on organizational understanding of ESG dimensions and implementation efforts related to regulations, with the primary catalyst being ever-increasing regulatory and supervisory pressure. In markets that are not regulated by the ECB, and are mostly laggards in regulatory compliance, there will also be strong growth in spending on ESG data, methodologies, and processes.

What can stakeholders in Hungary do?

The role of the financial sector is essential for climate change mitigation and the green economic transition, but beyond the integration of ESG into the banking organization, it seems essential to define and make available data of the right quality. At present, the priority seems to be for banks to build departments with the right layers of specialization, able to keep abreast of regulatory changes in ESG, to exercise quality control over ESG data provided by customers or identified from external sources, and to effectively manage the demands of an evolving regulatory environment. A continuous dialogue with active oversight and a flexible ESG transformation process that continuously involves the final stakeholders also seem key to successful implementation. In addition, the ESG landscape is constantly evolving, so that the best practices expected by supervisors are becoming more robust, i.e., institutions need to regularly review and revise ESG risk management methods and practices to cover the increasing regulatory and consumer expectations.

The newsletter was prepared by: Gábor Orosz, Péter Vajda, Gergő Wieder.

Contacts:

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

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

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

József Soltész
Senior Manager
M: +36 70 370 1766
E: jozsef.soltesz@kpmg.hu

Viktória Glózer-Say
Manager
M: +36 70 978 7031
E: viktoria.glozer-say@kpmg.hu

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