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Financial Risk&Regulation

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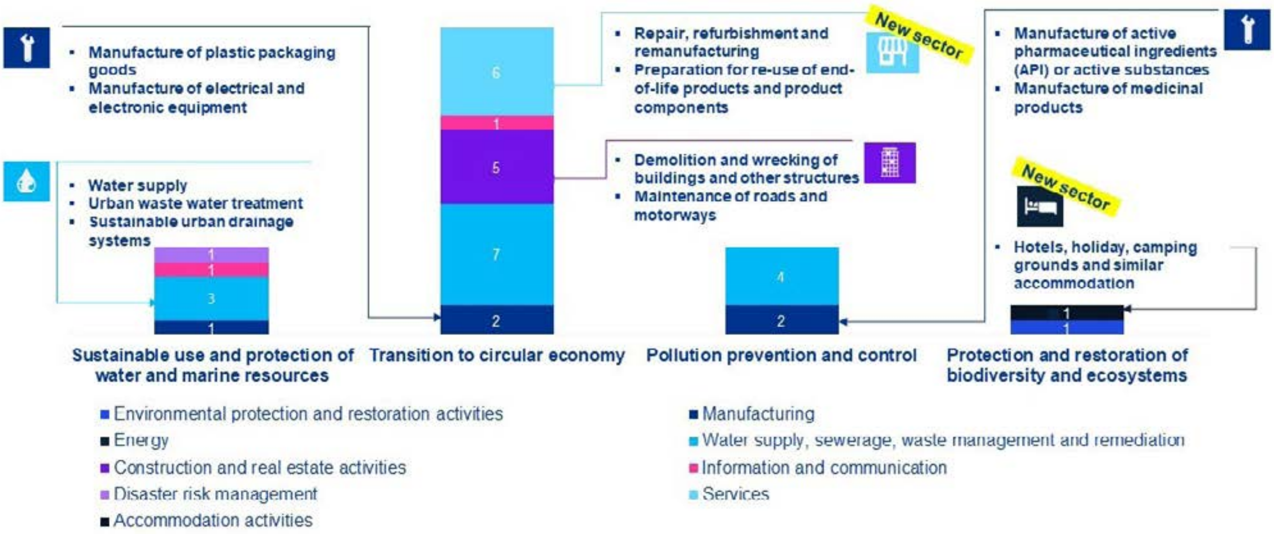
On June 27, the European Commission adopted a new package of measures on the further development of the sustainable financing framework, the aim of which is to provide additional support to companies and financial sector actors to achieve the sustainability objectives defined in the framework of the European Green Deal, while encouraging the private funding of transition projects and technologies.

Changes in the sustainable financing framework

It is expected that effective from January 1, 2024, the Commission will add additional activities to the EU Taxonomy, thereby widening the range of economic activities and industries to be assessed for substantial contribution to the EU's environmental objectives. In addition, the package proposes new regulations for rating service providers for environmental, social and governance (ESG) considerations. These proposals will likely increase transparency in the sustainable investment market.

The Environmental Delegated Act (EDA) consists of 35 new economic activities in five already existing sectors, and in three newly added economic sectors. Significant expansions took place in the case of manufacturing and construction activities, including, among others, manufacturing of plastic packaging goods, certain pharmaceutical manufacturing activities, and maintenance of roads and motorways. Among the new sectors, the service sector includes eligible activities that primarily aim to encourage the transition to a circular economy, such as repair, renovation and remanufacturing activities, or preparation for the reuse of end-of-life products and product components. The emergence of eligible accommodation service activities promotes the opportunities provided by tourism by contributing to the protection and restoration of biodiversity and ecosystems, likely boosting the appeal of financing ecotourism.

The Commission also adopted targeted amendments related to the Climate Delegated Act, which expands the range of economic activities that contribute to climate change mitigation and climate change adaptation. A total of 12 new eligible activities were defined, related to six sectors, and minor modifications were introduced in the case of several existing activities. Among the new activities are ones related to the production of automobile parts, railway rolling stock parts, and airplanes in the manufacturing sector, while the transport sector was supplemented with infrastructural activities supporting air transport. In the case of DNSH (Do no Significant Harm) criteria, new, softer mitigation criteria has been introduced in relation to environmental pollution, for instance with longer grace period for new substances or for substances where no alternative solution is available.



In addition to the expansion of activities, the Commission also accepted the amendments to the Disclosure Delegated Act, thus clarifying the disclosure obligations for financial and non-financial undertakings. These modifications contain clarifications as well as the introduction of interpretative provisions regarding the reporting template tables. Amendments include specific information relevant to financial institutions, when calculating GAR (Green Asset Ratio), thus, instead of project financing, an examination of special lending exposures is included.

Workplans of the major European regulatory authorities

For the remainder of the year, we considered it important to review the further potential changes related to regulations affecting the financial sector. We have reviewed the workplans of the European supervisory authorities (ESA), such as the European Banking authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), the European Securities and Markets Authority (ESMA) and other regulatory authorities like the European Central Bank (ECB) and the Bank for International Settlements (BIS) responsible for the development of the Basel framework.

BIS	**Bank for International Settlements**	• The primary organizer of monetary cooperation among international banks, the central bank of central banks. • The operator of the Basel Committee on Banking Supervision.
EUROPEAN CENTRAL BANK EUROSYSTEM	**European Central Bank**	• In addition to managing the Euro and maintaining price stability, it is also responsible for determining and implementing the economic and monetary policy of the EU.
eiopa EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY	**European Insurance and Occupational Pensions Authority**	• It supports coordination among national authorities and ensures consistent application of EU law in the insurance and occupational pension sectors across Union member states. • Its goal is to promote financial stability and enhance public confidence in the insurance and pension markets.
EBA The European Banking Authority	**European Banking Authority**	• Its task is to establish a unified regulatory and supervisory framework for EU financial institutions. Its aim is to ensure that the single market for EU banking products is transparent, stable, and operates efficiently.
ESMA European Securities and Markets Authority	**European Securities and Markets Authority**	• An independent EU authority, which is aimed to improve investor protection and ensure the stability and orderly operation of financial markets.

European banking supervisory expectations

An explicit goal for the ECB is to support banks in the medium-term structural transformation, including the transition to a green economy. The aim of the European Central Bank among others is to integrate the overview of climate-related and environmental risks and the results of the climate stress test into SREP.

In July, EBA launched a consultation on draft template and template guidance to prepare its one-off Fit-for-55 climate risk scenario analysis. The purpose of the draft template is to collect climate-related and financial information on credit, market, and real-estate risks. Banks are asked to collect aggregated and partner-level data in the 7 draft templates. The collection of partner-level data enables the assessment of risk concentration of large climate exposures. The aggregated data provides a broader picture of the banking sector's climate-related risks. The consultation will last until October 11, 2023, and banks are expected to start collecting data from November 2023. The data submission deadline has not yet been determined; results are expected in the first quarter of 2025.

Greenwashing remains a key risk according to regulators and supervisory authorities

The Progress Report issued by the European supervisory authorities in early June outlines the objectives related to avoiding greenwashing, with providing a more transparent view and definition to assess and identify the practice. In the report ESMA among others assessed which areas of the sustainable investment value chain (SIVC) are more exposed to the risk of greenwashing. ESA's will publish their final report on greenwashing in May 2024 and will likely consider potential changes to the EU regulatory framework. According to the ESMA report, the further clarification of what is to understood as greenwashing will continue to be a crucial element of the ESA's work.

SFDR consultation has ended, corresponding changes are expected

In early February, ESMA published its 2023 Trends, Risks and Vulnerabilities (TRV) report. According to the report, investors are increasingly distinguishing between products based on their sustainability characteristics, demonstrated in the continuous net flow into funds in accordance with Article 9 of SFDR.

In early April, European supervisory authorities initiated a consultation on the simplification and expansion of the sustainability disclosures required by the SFDR. The authorities accepted feedback to the public consultation until July 4, 2023. Feedback was sought on initiatives such as expanding the list of universal social indicators to include principle adverse impacts of investment decisions on the environment and society, such as revenue from uncooperative tax jurisdictions or interference into the formation of trade unions. Other issues subject to potential amendments include refining the content of other indicators related to adverse effects and their definitions, the applicable methodologies, calculation formulas, and the presentation of the proportion of information coming directly from the entities that are the subject of the investment, or product information related to carbon dioxide reduction objectives including intermediate goals, level of ambition and how to reach the objective.

ESA's are proposing further technical revisions to certain parts of the Delegated Regulation, such as improvement of disclosure with how sustainable investments "do no significant harm" to the environment and society, or for example how to simplify pre-contractual and periodic disclosure templates for financial products. Further technical adjustments are expected in connection with the treatment of derivative transactions, the definition of equivalent information, and the provisions regarding financial products with underlying investment options.

In early July ESMA and National Competent Authorities (NCAs) began to assess, whether supervised asset managers meet the relevant requirements of SFDR, the requirements of EU Taxonomy Regulation and the relevant implementing measures, including the relevant expectations of the integration of sustainability risks in the UCITS and in the AIFMD implementing regulations. Among the main objectives of the survey is the evaluation of whether the market participants comply in practice with the applicable rules and standards, as well as the collection of additional information on the risks of greenwashing in the investment management sector.

Stricter expectations may emerge for other sustainability-related publications

In late April, the ECB released a publication in which directed banks attention to the importance of improving their climate risk related disclosures. In the statement, the European Central Bank highlighted that European banks must prepare to comply with stricter EU rules entering into force this year on disclosing climate and environmental risks. A key element are the implementing technical standards (ITS) issued by the EBA for ESG-related information to be disclosed under Pillar 3. According to the new rules, banks in scope had to publish the first Disclosure by the end of June.

The Basel Committee also made a statement on the tasks related to the development of the disclosure framework under Pillar 3 for climate-related financial risks. The framework designed by BIS is intended to provide additional information on prudential risks and would complement ongoing disclosure initiatives by the International Sustainability Standards Board and other authorities.

In mid-March, the ECB and the authorities issued a Joint-statement calling attention to increased climate-related disclosures for structured financial products. The statement sets out the joint efforts of the ECB and authorities to facilitate access to climate change data, to improve the sustainability transparency of securitization and to promote consistent and harmonized requirements for similar instruments. This effort is intended to develop the appropriate assessment and management of climate-related risks related to the EU Taxonomy Regulation and in SFDR.

In late May, authorities submitted a proposal to the European Commission regarding simple, transparent and standardized securitization. The key recommendations in the technical standard also apply to ESG disclosures in connection with STS securitizations where the underlying exposures are residential loans, car loans or leases. The technical standards aim to ensure consistency with SFDR, thus distinguishing between the disclosure of information on mandatory indicators (e.g., energy efficiency) and additional indicators (e.g., emissions).

The legal environment related to sustainable finance is constantly changing, both in relation to the classification of loans and other financial instruments, as well as the management of risks, so it is constantly a priority area of focus for European regulatory and supervisory authorities. The amendments in the EU Taxonomy Regulation and the stricter CSRD obligations are constantly increasing the number of companies who must disclose information, which also entails obligations for credit institutions and other financial sector actors. The goal at the European level is the continuous harmonization of regulations with each other and with other industry standards, so it is extremely important that market participants implement ESG solutions that can meet supervisory expectations in the long term.

Our colleagues Attila Tuscher, Antónia Serfőző and Péter Vajda contributed to this newsletter.

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