Financial Risk&Regulation

Credit institutions are now in the final stages of preparing for the MNB's Green Recommendation, the National Bank has also developed expectations for insurers and money processors

Newsletter – 2024 January

The Hungarian National Bank first issued its Green Recommendation for credit institutions in 2021, which was updated in 2022 following initial feedback. The Recommendation was to be complied with in phases, with the second phase of preparation for compliance ending in July 2023, making 2024 the last year in which credit institutions have the opportunity to prepare for full compliance with the MNB's expectations. In the following we will summarize the most important and complex steps that credit institutions need to take before 1 January 2025 in order to comply with the MNB's applicable recommendations.

In 2024, in addition to credit institutions, the sustainability expectations developed by the Supervisor for insurers and money processors will also apply to the insurance sector.

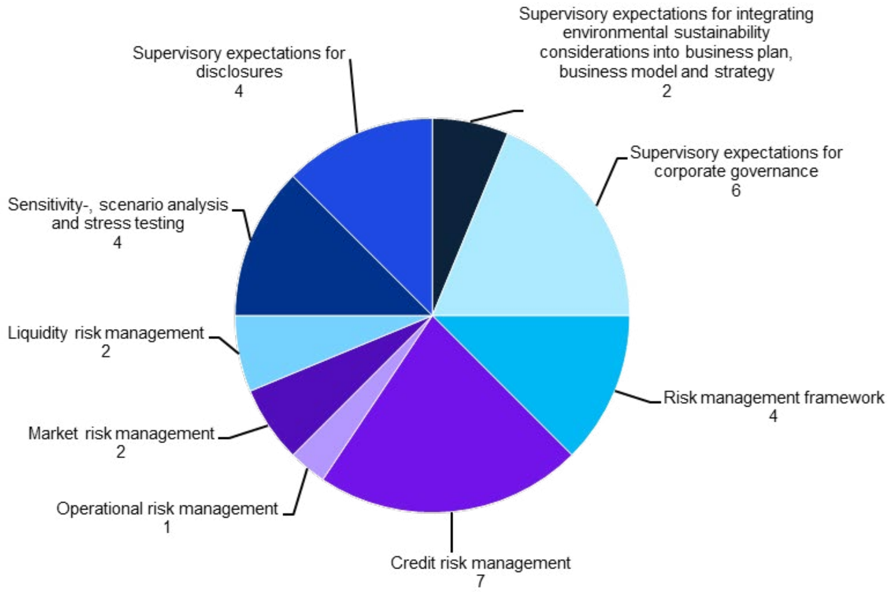
Supervisory expectations for integrating environmental sustainability considerations into business plan, business model and strategy

In order to take a comprehensive approach to climate change and environmental risks, the MNB expects credit institutions to develop a concrete plan to monitor and manage – the already identified - short, medium and long-term risks that may arise from the institution's failure to meet its sustainability objectives. Along the lines of the risks identified, from the following year, companies will have to set out their expectations in their business plans in relation to climate change and environmental key performance indicators (KPIs) and key risk indicators (KRIs).

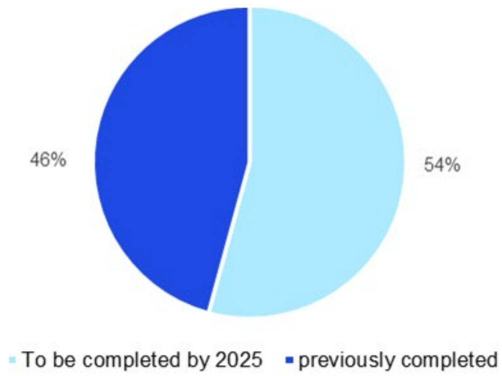
Expectations for corporate governance

Credit institutions are expected to clearly define the responsibilities of each of their internal management and control functions with regard to both climate change and environmental risks. It is the responsibility of the management body with governance powers to ensure that the relevant responsibilities are transparent, well defined, consistent and adequately documented. By the end of the year, the management bodies of credit institutions should have adequate collective knowledge, skills and experience of climate change and environmental risks, for which corporate trainings are recommended according to the specific responsibilities. Furthermore, the MNB expects that remuneration policies and practices of credit institutions contribute to a long-term approach to addressing climate and environmental risks, therefore executive remuneration is expected to reflect specific risk or performance indicators related to sustainability.

Distribution of expectations to be met by 2025



Distribution of tasks completed and to be completed by 2025



Expectations for the risk management framework

From the following year, credit institutions will be expected to develop appropriate risk indicators, set appropriate limits and develop specific procedures to be followed in case of exceeding the limits set, in order to identify and manage climate and environmental risks identified during the previous compliance phases. There will also be a new requirement for credit institutions to assess the impact of climate change and environmental risks when calculating their internal capital requirements, so that sustainability-related risks are expected to be reflected in the ICAAP process and documentation. Credit institutions are also expected to consider the impact and implications of these risks on their business plan when determining their risk appetite and in their business strategy.

Expectations for credit risk management

From 2025, the MNB also expects credit institutions to apply specific risk mitigation techniques to mitigate climate change and environmental risks, therefore to design their credit risk limit framework to include sustainability risks and the corresponding quantified risk appetite. The MNB expects financial institutions to take all reasonable steps to assess the customer's exposure to climate change and environmental risks when rating customers and counterparties. In this context, they should continue to carry out regular climate and environmental risk screening of their customers and counterparties after underwriting, the results of which should be included in the credit file.

From 2025, credit institutions will be expected to take climate change and environmental risks into account when assessing and re-assessing collateral, as they may affect the value of the collateral (e.g. energy-efficient or poorly energy-efficient real estate collateral). Credit institutions' pricing frameworks will also be expected to reflect climate change and environmental risks and to reflect them in the credit risk appetite and business strategy of credit institutions. Financial institutions should also monitor and manage climate and environmental risks in their loan portfolios. To this end, it is essential that credit institutions differentiate their green, thus environmentally sustainable exposures.

Expectations for liquidity risk management

In addition to credit and operational risks, from 2025 credit institutions will be expected to identify whether climate change and environmental risks are material to their liquidity risk. Such risks could include, among others, sudden withdrawals of funds due to extreme weather events, for example in the case of flooding in the retail portfolio, or increased corporate borrowing requirements to finance new climate change-related adaptation measures or possible penalties. Where these risks are significant, credit institutions should take steps to integrate climate change and environmental risks into various related processes, such as identifying, measuring, managing and monitoring liquidity risk over appropriate time horizons and maintaining adequate liquidity buffers, measuring and managing all material sources and effects of market liquidity risk, and managing the risk of liquidity shortfalls arising from the maturity of a short position before a long position. These processes should be set out in writing by the institutions or be traceable to other relevant internal policies.

MNB Green Recommendation for insurers

The MNB has reviewed its climate change responsibilities for the sectors under its supervision. As with the banking sector, it assessed that the insurance sector has a very important role to play in improving resilience to the negative impacts of climate change and in addressing climate risks and opportunities. As a result of this assessment, it issued a so-called "Insurance Green Recommendation", which applies to insurers domiciled in Hungary. The Recommendation sets out recommendations and expectations for insurers in four main areas. The integration of sustainability factors into the daily practice of insurers is a major challenge for the whole insurance sector, as it is necessary to take a long-term, forward-looking approach to climate risks and opportunities, as opposed to the way things have been done so far. In order for market players to be able to tackle the challenges effectively and successfully, it is important to start addressing the challenges set out in the Recommendation as soon as possible.

Sensitivity-, scenario analysis and stress testing

From 2025, credit institutions will also be required to assess climate and environmental risks by carrying out sensitivity-, scenario analysis or stress testing. Credit institutions subject to a full SREP are expected to apply these methodologies simultaneously.

When performing sensitivity, scenario analysis and stress testing on climate change and environmental risks, credit institutions shall be expected to at least consider the impact of physical migration risks on the credit institution, how climate change and environmental risks could arise under different scenarios and how climate change and environmental risks could arise in the short, medium and long term.

Financial institutions should determine their assumptions under different scenarios according to their own risk profile. As part of their capital planning, credit institutions should assess their capital adequacy according to credible baseline and institution-specific adverse scenarios. For adverse scenarios, it is recommended that institutions assume extraordinary but realistic developments with sufficient severity in terms of their impact on capital adequacy.

Expectations regarding disclosure

Financial institutions must disclose the basis on which they assess the materiality of climate change and environmental risks, and are required to review these findings at least annually. Where a credit institution considers that climate change and environmental risks are not material in relation to its own operations and activities, it should document this decision with qualitative and quantitative information supporting the assessment.

When a financial institution discloses data, metrics and targets that it considers relevant in relation to climate change and environmental risks, it should also provide market participants with a comprehensive view of its risk profile. To this end, it is important that the institution discloses the underlying methodologies, definitions and significant changes between periods under review, as well as the processes and procedures related to sustainability.

If a credit institution wishes to contribute to climate change and environmental sustainability objectives, it should provide a comprehensive picture of the impact of the organisation and how it contributes to its objectives in order to avoid greenwashing risks.

Expectations on the management of other risks

In relation to operational risks, a new expectation for financial institutions is to include in their loss data collection at least those loss events due to climate change whose impact can be detected in the accounting records. It is also important that institutions assess the operational risks associated with climate change through scenario analyses and develop mitigation procedures for the risks assessed.

As regards the management of market risks, credit institutions should take into account that climate change may lead to shifts in the supply and demand of financial instruments, products and services, which may also affect their value. It is therefore essential for financial institutions with a significant trading portfolio to integrate the impact of climate change-related factors on market risk into their risk identification.

With regard to the credit spread risk component of bank book positions, it is important that credit institutions assess the importance of climate change and environmental credit spreads among all determinants of overall market risk.

The final phase of compliance with the Green Recommendation may therefore present challenges for the credit sector in a number of areas, and it is worthwhile to start meaningful preparations as soon as possible to meet the more complex requirements that will apply from next year. Numerical risk management limits, business planning around sustainability performance indicators, and the integration of climate change risks into banks' ICAAP frameworks and capital calculations could be challenging.

The newsletter was written by: Szabó Marcell, Vajda Péter

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

Péter Vajda
Senior Consultant
M: +36 70 198 1291
E: peter2.vajda@kpmg.hu

KPMG.hu

BLOG