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ESG AND BANK REGULATION: MOVING WITH THE TIMES

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ABSTRACT

The evaluation of data based on environmental, social sustainability and responsible corporate governance-related factors (together: ESG), and the assessment of companies and of investments made in them on this basis, has hitherto essentially taken place within a market-based evaluative framework developing in an entirely evolutive manner. However, ESG has gained so much importance on capital markets in recent years that the voices calling for some of its aspects to be regulated anyway have grown increasingly louder.

This is particularly the case in the banking sector, where – contrary to asset management – ESG has seldom been in the spotlight thus far. As a reaction to this, the ESG approach is set to gradually materialise within EU bank regulation in the coming years, primarily in the context of risk management expectations and reporting requirements, as well as in bank supervision. The new rules may present a significant challenge on less developed markets, and thus for Hungarian banks, principally in the area of data collection. Compliance will nevertheless have the positive benefit of enabling credit institutions to gain a more accurate picture of how sustainably their clients operate, and how resistant they are to climate change and other megatrends, as well as to the related sweeping and profound economic, social and regulatory changes.

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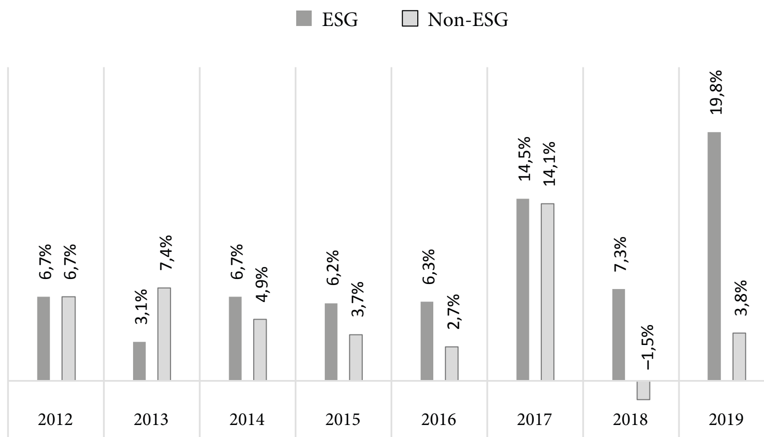
1 INTRODUCTION: ESG THROUGH A REGULATORY LENS

1.1 The increasing importance of ESG

Although consideration of ESG – i.e. Environmental, Social and Governance – factors in investment or financing decisions began to be emphasised in analyses from the beginning of the 2000s, the real market breakthrough has come only in the past few years.[2] Between 2018 and 2020, some USD 100 billion of new capital has flowed into funds managed with an ESG approach. In each of the past five years in Europe, mutual funds managed on an ESG basis have grown more rapidly than other funds; moreover, the difference in growth continues to widen: while last year we saw a net inflow of close to 20% among ESG funds, growth was only less than 4% at other funds. In the second quarter of this year, amid the COVID crisis, every third EUR flowed into ESG funds (Figure 1). Today still only about 15% of the total assets of European mutual funds are managed under an ESG policy, but current trends suggest that by 2025 this proportion will already have grown to around 50% (PWC, 2020).

Figure 1
Annual net inflow of assets into European funds managed on an ESG and a non-ESG basis (as a percentage of managed assets)



Source: PWC (2020)

2 Of course socially responsible investment policies appeared much earlier than this, in the 1960s, when certain branches of industry or countries were excluded from among investments on an ethical basis.

It stands to reason that the ESG approach can be seen to have made headway not only at mutual funds. We can see its value increasing similarly in the case of pension funds (both private and state), foundations, and even venture capital funds. Investors today can already reckon with more than 1,000 ESG indexes, which – in contrast to traditional indexes – also select securities according to ESG factors, so that the ESG approach is also demonstrably expanding among market players pursuing passive investment strategies (US SIF, 2020). According to another telling piece of data, more than 2,400 major international investors have already signed up to the UN's Principles for Responsible Investment, whereby they have undertaken to manage at least half of their assets under some form of responsible investment policy (Barclays, 2020).

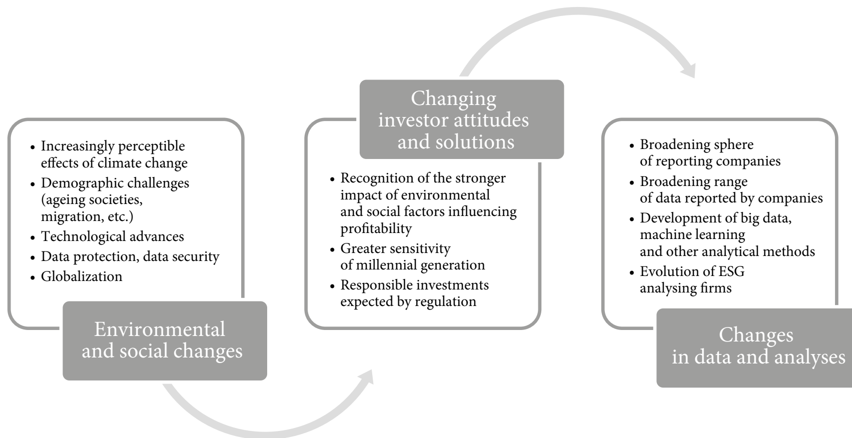
Numerous factors play a part in the growth of ESG. On the one hand, and most importantly, rapid and high-volume environmental and social changes represent very important drivers, as does a deeper, more accurate and increasingly well-grounded scientific understanding of the powerful effects of these factors. Climate change is no longer a hypothesis over which question marks hang, or which necessarily applies only to the distant future, but a megatrend with a by now quantifiable impact on economic performance in the form of droughts or inundations, flash floods, or heat and cold waves. Increasingly strict environmental policies are likewise already a factor shaping given industries, whether it concerns regulations on expected vehicle emissions or restrictions and prohibitions pertaining to plastic products. Compliance – or, as the case may be, non-compliance – with environmental prescriptions is a factor fundamentally impacting profitability, and consequently an increasingly essential part of any analysis.

The other main factor behind the advance of ESG is that, due to the aforementioned recognition of these impacts, attention is also being directed towards ESG factors in the case of investor decisions made on a purely financial (return-maximising) basis. Rather than seeking the positive environmental or social impact of investments, these are merely risk management methods aimed at improving the performance of the given investments. Coupled with this, on the other hand, is the trend – increasingly borne out by surveys of public attitudes – towards more responsible investment preferences on the part of the millennial generation, who are very much looking for their investments to cause as little harm to the environment as possible, or still more, to promote environmental or social sustainability. In certain countries (for example, the United Kingdom), the regulatory framework expects pension funds to adopt this kind of conscious investment policy.

As a kind of third pillar, the rise of ESG is furthermore assisted by advances in the area of corporate data. More and more companies are measuring and reporting a growing amount of data relevant from the point of view of ESG, which professional ESG rating firms have become specialised in evaluating, employing inno-

vative data analysis solutions. In summary, therefore, both megatrends and investor attitudes and approaches, together with the "data side," are simultaneously increasing the value of ESG as mutually reinforcing factors (*Figure 2*).

Figure 2
Overview of factors playing a role in the increasing value of ESG



Source: compiled by the author, based on Barclays (2020) and MSCI (s.a.)

Based on the above, the significance of ESG for public companies is obvious, since – whether an issue of equities or of bonds is at stake – ESG may represent the key to bringing in capital. Though considerably less evident, the relevance for private limited companies is likewise increasing. One of the most important driving factors is the status of relations with suppliers: a consideration that arises ever more frequently in the supply chain is that only impeccable enterprises (or at least those with good ESG performance) may remain suppliers to the big (typically public) companies, since the latter's own ESG ratings cover the entire supply chain.

1.2 The necessity of regulation

As the significance of ESG has grown, so too has the amount of attention paid to it, coupled with the appearance of an increasing number of critical voices. The two principal, related criticisms of ESG have arisen with respect to, on the one hand, the quality and reliability of the underlying data, and on the other hand, the inconsistency of assessments, the variable quality of methodologies used, and most of all the lack of transparency.

A significant portion of the ESG data published by companies (or even banks) is reported on a voluntary basis, and is not – or not necessarily – audited information. However, even if the data themselves are trustworthy, different companies report as many as several dozen completely different – or differently calculated – data points for the same attribute. A typical example is offered by the analysis of *Kotsantonis* and *Serafeim* (2019), who found that 50 big Fortune 500 companies use 24 different measures in the category of *employee health and safety*, while even firms that use the same measures do not necessarily define nominally identical measures in the same way.

Data-based ratings and comparisons represent new sources of problems. For example, some ESG ratings are relative, comparing the performance of companies in a given branch of industry. The choice of peer group, however, in itself already significantly shifts a company's placement in the ranking. Among other things, for this reason it can also happen that a given company might always be able to find a basis for comparison that rates it among the better (or even best) performers among its group, information which in turn will then feature in a prominent place in its ESG disclosures.

Many questions nevertheless arise even without comparisons. The methodologies of ESG rating firms, for example, differ substantially in terms of the indicators or weightings applied. A recently published study by MIT and the University of Zurich revealed that more than 50% of the deviation apparent in corporate ESG ratings is explained by divergence in the measurements themselves (*Berg* et al., 2019). The same analysis found that the correlation coefficient of ratings by the major ESG rating firms is only 0.61, compared to a value of 0.99 at credit rating agencies – meaning that market players and decision-makers obtain somewhat "noisy" information from ESG ratings, thereby calling their usefulness into question. (We might also note, of course, that criticisms were voiced with regard to the credit rating agencies caught in the crossfire during the 2008 crisis that they acted under a kind of herd influence in simultaneously upgrading or downgrading issuers, and that competition and methodological innovation among them was modest; in other words, it is not certain that an almost perfect correlation among ratings is desirable.)

Without attempting to summarise the criticisms expressed by researchers and analysts with respect to ESG, it is sufficient to note that the emergence of these criticisms is in fact a natural concomitant of the evolution of a field that is rapidly gaining cachet. The critical assault to which ESG is subjected at once demonstrates the importance and benefits of its approach. That the significance of ESG will continue to grow is beyond question, but so, too, is the need to strengthen its reliability. The latter, however, is hardly conceivable without further standardisation, to which one – though not the only – route is regulation.

The international organisation of securities market regulators, IOSCO, has occupied itself with the problems of ESG with increasing intensity in recent years. Although for the time being the organisation has not proposed the unification of national regulations it regards as heterogeneous, nor of international but voluntary standards (for example, the Carbon Disclosure Project, Global Reporting Initiative, Integrated Reporting, etc.), it has indicated in its communiqués that progress is needed in the area of sustainability disclosures (IOSCO, 2019 and 2020). Several figures have spoken for the regulation of ESG rating firms. For example, *Steven Maijoor*, chair of the European Securities and Markets Authority (ESMA), has explicitly pushed for ESG rating firms to be placed under the supervision of public authorities (Reuters, 2020).

The latter move would represent an absolutely radical change compared to the essentially laissez-faire situation that prevails today. Although we don't yet know if it will go that far, the first wave of regulation is already upon us. A decision on improved reporting of ESG-relevant data has already been made in the European Union in the context of a review of the Non-Financial Reporting Directive. In its communication on the European Green Deal, the European Commission determined that both companies and financial institutions will have to disclose more detailed data with respect to climate and the environment so that investors may obtain more comprehensive information about the sustainability of their investments (European Commission, 2019b).

Likewise connected to ESG, a number of sustainable finance regulations have been adopted with respect to investment funds and other investment products (pension-targeted products, insurance products combined with investments, etc.). The Taxonomy Regulation[3] provides a framework for the definition of economic activities promoting sustainability, while the regulation on sustainability-related disclosures[4] significantly expands the range of information to be disclosed with respect to the aforementioned investment products. With the amendment of the Benchmarks Regulation,[5] legislators have placed climate change-related indexes within a regulated framework, while amendment of the MiFID regulation is also in progress,[6] which – among other things – will make assessment of investors' sustainability preferences obligatory when providing advice.

3 Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment

4 Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector

5 Regulation (EU) 2019/2089 as regards EU Climate Transition Benchmarks

6 Commission Delegated Regulation (EU) …/... of XXX amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms

ESG rules related to the operation of banks, however, will only take shape in the period to come.

2 ESG AND CREDIT INSTITUTIONS

2.1 The relevance of ESG for banks

As the above overview indicates, ESG factors primarily emerge in the public consciousness in connection with companies issuing public securities, as well as in the context of asset management or investment policies. In the case of banks, the concept has thus far essentially not even appeared – at least not explicitly – in otherwise extremely far-reaching and detailed prudential regulation.

Irrespective of this, the ESG performance of banks has hitherto existed as a "concept," and the major international banking groups have their own ESG ratings. The data required for these is of course published by banks because a significant number of them are themselves issuers of public securities, or – independently of this – because of the CSR or marketing value in relation to their retail customers.

From an investor's perspective, the importance of bank ESG analysis lies in the operation of credit institutions built on trust. In essence, no other industry relies as much on the trust of its customers (primarily depositors) as banking. For precisely this reason, it is not hard to understand the importance of banks' good reputation, and hence their good ESG performance.

As an example, one of the world's biggest asset managers, PIMCO, rates banks as investment targets based on 11 ESG factors, applying various weightings to their scores in terms of importance. Environmental factors are assigned a weighting of 15%, social factors 25%, and corporate governance factors 60%. Three indicators feature among the environmental factors: the category of *sustainable lending* captures the extent to which the given bank lends to sectors with a fundamentally negative environmental impact (crude oil and natural gas extraction, fossil-based energy production, mining, etc.), or whether it is cutting back on such financing or increasing lending to the production of renewable energy. The *environmental impact and sustainability plan* encapsulates the credit risk arising from climate change, focusing on whether the given bank has sustainability goals, or undertakes to reduce emissions of greenhouse gases in its portfolio, or perhaps whether its sources of revenue have been made compliant, at least partly, with the UN's Sustainable Development Goals (SDGs). The third environmental indicator in PIMCO's ESG ratings is based on green bonds: whether the bank is an issuer or if

it fulfils an organisation role, activity on the green bond market increases its ESG score (PIMCO, 2019).

During bank evaluations, credit rating agencies are also taking ESG factors into account in an increasingly intensive fashion, with credit ratings themselves more and more often driven by ESG factors. S&P, for example, recently published an analysis which found that 93% of rating actions on banks guided by ESG factors were negative. The S&P analysis in question found that the "G" factor, relating to corporate governance (e.g. with respect to accounting irregularities, management fluctuation), was the most important in ratings of banks. In the case of social ("S") factors, misselling was the main factor typically leading to negative rating actions, while in the case of environmental ("E") factors typical examples were the exposure of agriculture to increasingly unfavourable weather conditions, or the concentration of oil industry exposures. At the same time, the S&P analysis stresses that ESG can not only damage banks' credit ratings, but can also present opportunities for improvement if a bank is able to demonstrate a long-term risk-aware approach with respect to these factors (S&P Global Ratings, 2018).

The above examples also indicate that while the "G" (corporate governance) factor is essentially the most important in banks' own ESG evaluations, the environmental "E" factor is the most relevant to their lending activity, increasingly more often in connection with climate change.

The ESG performance of banks does not concern their own operations as much as in the case of a normal company. In the case of the "E" factor, the environmental impact of financed transactions is substantially greater than the ecological footprint of banks' own operations (greenhouse gas emissions, waste generation, water consumption, etc.). Accordingly, banks are now more often asserting ESG factors in analyses or lending strategies that pertain to their own clients.

2.2 ESG risk management in the bank sector

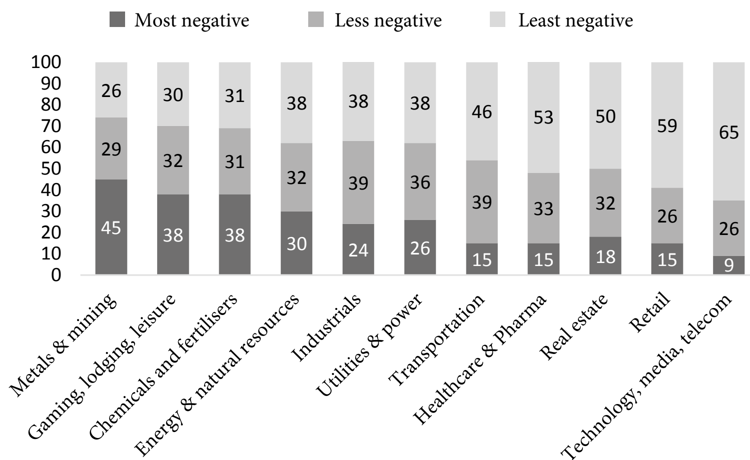
Shareholders, in common with society in general, have a growing expectation – indeed, sometimes even require – that ESG factors are validated more strongly. A famous example is the case of the Commonwealth Bank of Australia, which was sued by its own shareholders some years ago with respect to its failure, in its annual report, to adequately account for the climate risk arising in connection with its financing of a coal mine. Ultimately the bank gave a far more detailed account of its climate risks in its next annual report, while simultaneously withdrawing from the financing of the mine in question (*Stevens*, 2017).

Another well-known and instructive case was when environmentalist groups attacked ING in 2017 based on OECD guidelines for multinational enterprises,

citing the failure of the Dutch bank to adequately disclose the potential environmental harm in connection with its financing of fossil fuel companies, or to report on indirect product emissions, as well as its lack of a plan to reduce greenhouse gas emissions related to its lending activities. The OECD's National Contact Point accepted the complaint, and partly upheld it. The procedure eventually ended in an agreement in 2019 whereby ING undertook to bring its lending gradually into line with the Paris Climate Agreement (Lexology, 2019).

Due to this and similar exposures, based on a recent survey by Fitch, half of banks now apply an ESG approach. It is in this spirit that exclusion policies are adopted (for example, the shutdown of new project financing for coalmines or coal-fired power plants); that ESG screening also becomes apparent in the far more thorough analysis now applied to mining, metallurgy, the chemical industry and particularly fertiliser manufacture (an environmental factor), as well as to the gam(bl)ing industry (a social factor); and – looking ahead – that companies with poor ESG ratings will find it increasingly difficult and expensive to access credit (Fitch 2019, *Figure 3*).

Figure 3
Negative screening applied to corporate clients in banking practice (in percentages)



Source: Fitch (2019)

In general it can be said that in recent years the major international banks have improved their processes and methods with respect to ESG risks; however, in many cases this gets bogged down in simple approaches such as the exclusion or tightening mentioned in the above-cited Fitch report.

Based on a survey by the Central Banks and Supervisors Network for Greening the Financial System (NGFS), an organisation grouping "green" central banks and supervisory bodies, it is apparent that while a growing number of financial institutions are recognising the importance of managing financial risks of an environmental nature, the application of concrete, comprehensive risk management solutions remains limited to this day. Based on (not necessarily representative) interviews conducted by the NGFS, only a fraction of major OECD and Chinese banks employ ERA (environmental risk assessment) tools, and even where applied they tend to be in the experimental phase. Banks operating in developing countries, or smaller banks in general, are lagging even further behind (Network for Greening the Financial System, 2020).

The NGFS report, among other things, highlights the following obstacles to the development and spread of sophisticated environmental risk management solutions:

a) *Insufficient recognition of the importance of environmental risks:* primarily in less developed markets, many market players still operate who are yet to realise the importance of the issue, or who continue to sense it as being distant in time.
b) *A lack of unequivocal regulatory direction*: although in the European Union and even China regulation is already taking shape in the form of recommendations and laws, regulatory requirements are still unknown in many other countries (among them on developed markets such as the United States).
c) *Data deficiencies*: very few credit institutions hold data on the environmental attributes of financed companies, and have an even shorter supply of data on historical losses of an environmental origin.
d) *Limited resources*: numerous credit institutions lack the necessary specialised expertise, or do not have at their disposal the environmental and environmental regulatory scenarios that can be employed in modelling or analyses. Both the hiring of requisite experts (or commissioning of advisers) and internal or external advances in methodology may appear too expensive, in the sense that the benefits of such "investments" are hard to estimate.

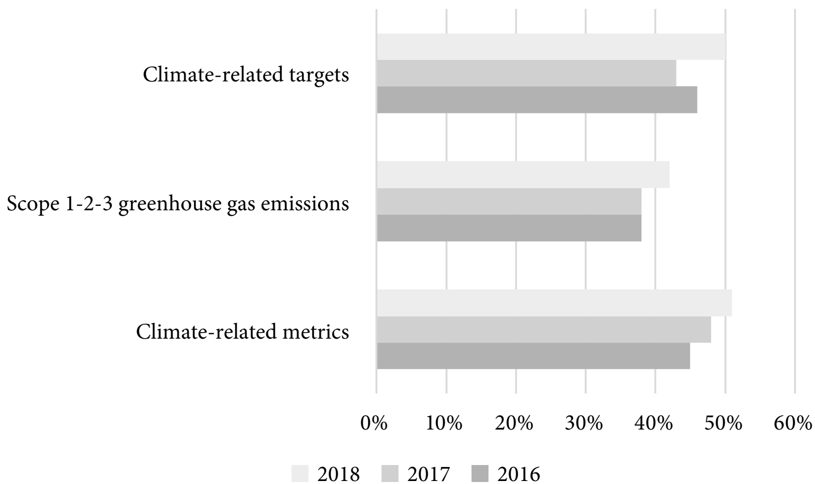
2.3 Bank ESG disclosures

Similarly to non-financial companies, credit institutions are also able to apply a number of voluntary international standards for their ESG disclosures, beyond certain ESG-relevant disclosures prescribed for them in the European Union by the regulation on non-financial reporting already mentioned in the previous chapter (implemented in accounting law in Hungary).

Among the voluntary standards, the framework most closely tailored to credit institutions comprises the primarily climate change-focused TCFD recommendations set down in 2016, bearing the name of the Task Force on Climate-Related Financial Disclosures, a committee established by the Financial Stability Board. The TCFD expects disclosures on (mainly qualitative) matters of corporate governance, strategy and risk management related to climate risks, as well as metrics and target numbers.

Application of the TCFD framework is spreading quickly, with a report issued in 2019 – prepared using an international sample of 104 elements – revealing that the proportion of banks undertaking disclosures according to this standard is growing (albeit not too rapidly) year by year (*Figure 4*).

Figure 4
Proportion of institutions applying TCFD disclosures among major international bank groups



Source: TCFD (2019)

3 THE INCLUSION OF ESG IN BANK REGULATION

Within the expected new elements of bank regulation, ESG will be included with a fundamental focus on the management of borrowing customers. Based on an amendment adopted in 2019,[7] ESG factors will be attached by several threads to the Capital Requirements Directive (CRD) for banks. To this end, the European Banking Authority (EBA) is currently working on professional proposals drawn up for legislators, which will assume material form in a report being prepared for June 2021. What, then, are the aspects likely to be included in the EU legislation and, through this, in Hungarian regulation and practice alike?

3.1 Risk management expectations

As we mentioned in the introduction, ESG today is a concept, or group of concepts, which is very widely used but essentially remains undefined by law. Based on the work of the EBA, a standard definition is emerging at the EU level that may significantly ease the job of analysts and supervisory bodies with respect to banks. However, standardising ESG, though it is a concept apparently well known by many, is by no means a simple task.

The complications begin with the naming in the CRD of "ESG risks," which implies the creation of a new category similar to credit, operational, market and other risk categories. On the contrary, the common view is that in the case of ESG it is more a question of factors that drive or alter the aforementioned traditional financial risks (credit or operating risk, etc.). If, for example, a company devotes insufficient attention to its emissions of greenhouse gases, then the impact of this on the environment – that is, the "E" factor – will increase the operational risk (regulatory or reputational risks) of the company in question, which – among other things – may increase the credit risk from the perspective of the financing bank.

Beyond clarifying the relationship between ESG and traditional risks, any future definition will certainly include an emphasis on so-called physical and transition risks, which embody the two most important categories of financial risk deriving from climate change.

7 Directive (EU) 2019/878 of the European Parliament and of the Council amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers, and capital conservation measures

Transition risks are those risks impacting an enterprise which derive from the transition to a low-carbon economy able to withstand the effects of climate change.

Table 1
Potential forms of transition risk

Subtype of transition risk	Example
Political risks	Energy efficiency requirements, carbon dioxide pricing mechanisms raising fossil fuel prices (e.g. carbon tax).
Legal risks	Compensation obligations arising from legal disputes that occur due to the failure to avoid or minimise harmful impacts on the climate, or failure to adapt to climate change.
Technological risks	The replacement of a technology with harmful effects on the climate with one less harmful, drastically damaging the profitability of users of the "old" technology.
Market-type risks	The shift in the available choices of consumers and corporate clients towards products and services less harmful to the climate.
Reputational risks	Clients, employees, business partners and investors turning away from enterprises that pollute the environment.

Source: compiled by the author, based on European Commission (2019a)

Physical risks, on the other hand, are those impacting an enterprise which derive from the physical impacts of climate change.

Table 2
Potential forms of physical risk

Subtype of physical risk	Example
Acute	Arising from specific events, particularly extreme weather-related occurrences such as storms, floods, fires or heatwaves, which may damage production facilities and interrupt value chains.
Chronic	Arising from longer-term changes in climate, such as temperature changes, rising sea levels, dwindling water supplies, declining biological diversity, and changes in the productive capacity of earth and soil.

Source: compiled by the author, based on European Commission (2019)

An important difference compared to transition risks is that a company's exposure to physical risks is not directly dependent on whether this has a negative effect on climate.

The above-mentioned EBA report will touch upon the systems, procedures, mechanisms and strategies to be applied for the purpose of identifying, evaluat-

ing and managing ESG risks. On this basis, minimal requirements and underlying principles related to ESG risks are expected to appear in EU regulation as well. At time of writing of the present study, the EBA has not yet published its concepts in this regard.

3.2 ESG disclosures

Based on a provision of the Capital Requirements Regulation (CRR) for banks adopted in 2019, from 2021 major banks issuing public securities will have to publish disclosures pertaining to ESG risks, and within this physical and transition risks.

Detailed rules in this area will also be elaborated by the EBA,[8] to which end it initiated a survey in September 2020 as a first step in familiarising itself with current and planned bank disclosure practices (EBA 2020). Among other things, the survey inquires into the following factors to establish whether the relevant data is collected by banks, or if not, how expensive reporting would be:

a) environmental risks based on the EU Taxonomy,
b) transition climate risks,
c) physical climate risks,
d) proportion of green assets,
e) proportion of brown assets (financing environmentally harmful activities),
f) social sustainability risks,
g) corporate governance risks (including money-laundering and conduct risks).

As can be seen from the above list, future disclosures will draw upon a number of "sources." It would be logical if climate risks had to be reported based partly on the aforementioned 2019 recommendation of the European Commission, and partly on the TCFD recommendations of the Financial Stability Board, but there is also a need for reports to be informative about the practical application of the EU's new sustainability taxonomy. The latter, however, rather than focusing on the risks, instead focuses on contributions to sustainability goals – thereby sending a positive "signal." Indicators expressing the proportions of green or brown assets would likewise represent a possible new direction. Besides these, expectations for social sustainability disclosures might also present a significant challenge even for banks at the forefront of environmental sustainability.

8 Article 434a of Regulation (EU) No. 575/2013 – the Capital Requirements Regulation (CRR)

3.3 ESG in bank supervision

Pursuant to the aforementioned new provision of the CRD, the EBA will have to examine the possibility of formally incorporating environmental, social and governance risks (ESG risks) into bank supervision.

As one constituent element of this, the EBA will prepare an analysis of how ESG risks impact the financial stability of institutions in the short, medium and long term, while also elaborating appropriate qualitative and quantitative criteria for the evaluation of such impacts. These criteria will need to include stress testing procedures and scenario analyses serving to assess the impact of ESG risks under different scenarios of varying degrees of severity. Typically such solutions will entail increased supervision and climate stress tests applied by banks.

Beyond the above, the EBA will also need to work out analytical methods and tools to evaluate the impact of ESG risks on institutions' lending and financial intermediary activities.

3.4 The possibility of preferential treatment

Article 501c of the EU Capital Requirements Regulation (CRR)[9] adopted in the summer of 2019, under the subheading "*Prudential treatment of exposures related to environmental and/or social objectives*," opens up – or at least envisions – an important, potentially revolutionary opportunity. Under the new provision, the EBA – following consultations with the European Systemic Risk Board (ESRB), and on the basis of available data and earlier findings of the European Commission – will assess "*whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified.*"

This somewhat laboriously worded new provision indicates, in other words, that lending that supports environmental or social sustainability (or bond exposures of this nature, for example) might be subject to a special, preferential regulatory assessment. This could primarily materialise in the form of lower capital requirements. A proposed amendment to the CRR was previously put forward in the European Parliament for the introduction of a so-called "green supporting factor" envisioning preferential capital requirements for bank lending, with certain

9 Regulation (EU) No. 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012

representatives of the European Commission describing the initiative as a promising opportunity.

At the same time, there is by no means a consensus regarding the justification or legitimacy of a green (or social sustainability) supporting factor. This is to say that some in bank supervisory and regulatory circles are of the opinion that the Basel regulations, which are fundamentally based purely on the financial riskiness of assets, should not be "watered down" on an ideological basis, even if perhaps no one disputes the importance of sustainability as a goal. One key argument put forward by sceptics is that a green capital supporting factor might not only damage the trustworthiness of capital regulation, but might also not necessarily prove very effective in stimulating green investments: tax or other fiscal stimuli, they argue, would perhaps be far more appropriate for "greening" purposes. Still others take the view that it would be far more logical to punish the financing of environmentally harmful activities by raising capital requirements.

Amid the arguments and counter-arguments, the EBA will need to arrive at some kind of conclusive proposal. To this end, the CRR specifies what the EBA's analysis must take into consideration, and what it must contain, namely:

a) methodologies serving to evaluate the actual risk of exposures related to assets or activities fundamentally associated with environmental and/or social objectives, compared with the riskiness of other exposures;
b) elaboration of suitable criteria serving to evaluate physical risks and transition risks – including risks related to the depreciation of assets arising from regulatory changes;
c) potential impacts on financial stability and bank lending within the EU as a consequence of the dedicated prudential treatment of exposures related to assets or activities fundamentally associated with environmental and/or social objectives.

The EBA must submit a report on its findings to the European Parliament, the Council and the Commission by the end of June 2025. In given cases, the Commission will use this report as the basis for legislative proposals to be submitted to the European Parliament and the Council.

The 2025 deadline in itself provoked much debate, the problem of environmental sustainability being simply too urgent to allow many years for the completion of the EBA report, which after all would still not constitute an actual law, and with the concomitant adoption procedure likewise measurable in years. On the other hand, there is a legitimate professional expectation that if the attribute of sustainability (for example, the green or – as the case may be – environmentally burdensome nature of an investment financed through a loan or company taking out a loan) is able to sidetrack prudential regulation, then this should preferably occur

in an empirical manner supported by data. However, no data is available – either in EU bank regulatory circles or at credit institutions themselves – regarding the performance of either green or brown assets, let alone in a time series of adequate length. That being said, the EBA itself has stressed in its public communication the importance of taking steps as early as possible in the area of sustainable finance (EBA, 2019).

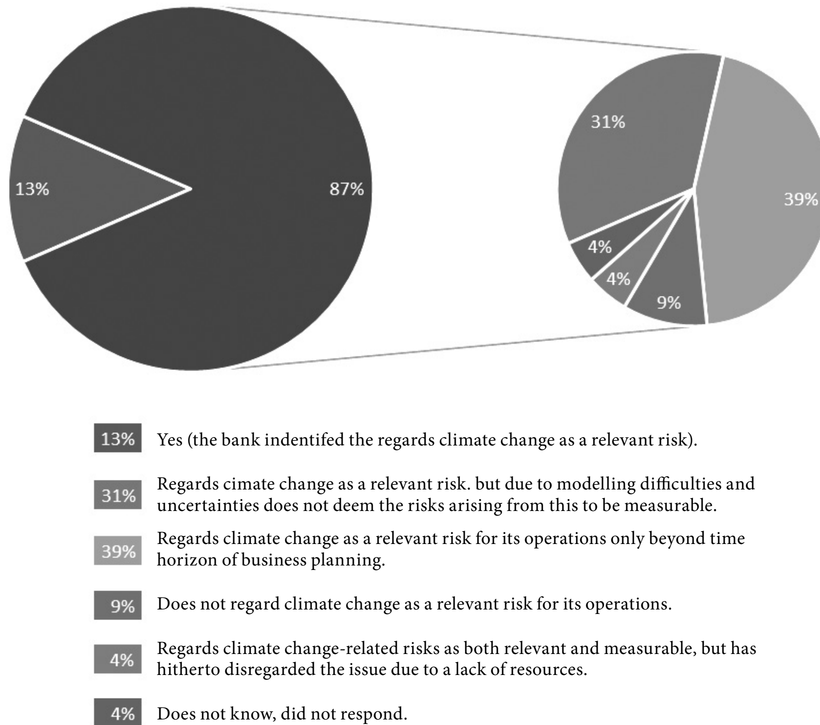
4 THE HUNGARIAN OUTLOOK

The Hungarian National Bank (MNB), in its Green Program adopted in February 2019 (MNB, 2019a), targeted improved management of financial risks of an environmental origin and amelioration of the financing conditions for investments promoting environmental sustainability.

The MNB continuously tracks its own steps to determine how well prepared Hungarian credit institutions are with respect to climate and other environmental risks. To this end, a survey of banks carried out in 2019, which covered more than 80% of the bank sector proportional to balance-sheet footing, aimed to gain a picture of how much attention Hungarian banks devote to the evaluation of climate change-related risks in the course of their business planning. One key question in the survey examined whether institutions have identified risks that can be linked to climate change within the time horizon of their business planning, and if not, then what might be the cause.

A mere 13% of respondent banks answered in the affirmative to the former question (of whether they had identified climate risks), although it is also important to stress that only 9% of banks took the view that climate change is entirely irrelevant from the perspective of their operations. A considerable proportion of institutions (39%) declared that climate change signifies a risk only beyond the time horizon of their bank's business planning. The findings of the global NGFS survey cited in the second chapter of this article were reflected in the MNB survey, in which Hungarian banks likewise indicated that the assessment of climate change risks often runs up against methodological barriers, while the relevant practices remain insufficiently widespread in Hungary.

Figure 5
Approaches of Hungarian banks to climate risks



Source: MNB survey

Based on the responses given to further questions in the survey, banks in Hungary primarily regard physical risks (extreme weather events, uninsured damage, depreciation of assets used as collateral, etc.) as relevant with respect to climate change. Sectors banks regard as the most risky are those which have the greatest exposure to the aforementioned conditions (agriculture), or which are in a state of transformation due to the climate struggle (energy sector, automotive industry). A number of institutions also mentioned the reputational risk as intensifying among an increasing number of clients as a consequence of foreign partners or even domestic social expectations.

Awareness in relation to ESG risks, and the significance attributed to them, is also reflected in whether senior management discusses the topic. Answering another survey by the MNB in October 2020, only a third of Hungarian credit institutions declared that their management body discusses risks related to sustainability or

climate change (MNB, 2020). In an international comparison this is a very low share. One global organization of risk managers, GARP, surveyed 71 financial institutions globally in 2020, and found that 75% of the responding institutions' management bodies discuss these risks (GARP, 2020).

As a "member" of the EBA, the MNB itself participates in the shaping of EU bank regulation with respect to ESG factors. In addition, taking into account these developments, the Hungarian central bank also endeavours through a number of measures at the national level to ensure that the "E" factor of environmental sustainability features more robustly in the country's banking system. In this spirit, as part of the second pillar of the Supervisory Review and Evaluation Process (SREP), it has introduced the preferential capital requirement for green (energy-efficient) housing loans, is working on a comprehensive climate stress test, and plans to set down its expectations regarding the management of environmental risks in a separate recommendation (MNB, 2019b).

Hungarian banks – similarly to most European credit institutions – will thus have a fair amount to do with respect to the integration of ESG factors. At the same time, these developments should not necessarily be looked upon as subject to the constraints of regulation. The bank regulation that crystallises in the coming years will itself tend to merely "shadow" the recognition, occurring somewhat sooner in the asset management sphere, that climate change and other sustainability challenges will transform the economy and society to an extent that requires credit institutions to employ a data-driven, deliberate and comprehensive strategy to ensure their operations proceed in a prudent manner that enjoys the confidence of society.

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