# Alejandro Díaz de León: Climate change and its impact on the financial system

Remarks by Mr Alejandro Díaz de León, Governor of Bank of Mexico, at the Conference on Climate Change and its Impact on the Financial System, Mexico City, 5 December 2019.

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Good evening everyone. On behalf of Banco de México, I am pleased to welcome the participants of the Conference on Climate Change and its Impact on the Financial System. It is a great pleasure for Banco de México to collaborate jointly with CEMLA, the Center for Latin American Monetary Studies, the NGFS, Network for Greening the Financial System, and the University of Zurich in organizing this meeting. The sessions that comprise the conference cover some of the main topics in climate change and its economic and financial impact.

Climate change and environmental degradation constitutes a challenge at national and global levels and is a source of financial risk. Climate change is presenting challenges related with extreme weather events, rising sea levels, declining productivity of agriculture and fisheries, trade and supply chain disruptions, the degrading of ecosystems, reduced welfare of communities due to air and water pollution, and even mass migrations in the territories most adversely affected.

In some emerging and low-income economies, poverty, an inadequate institutional framework and a weak rule of law has created a fertile ground for a predatory behavior that has significantly degraded the environment, in some cases irreversibly, deteriorating both the welfare and development opportunities of the population affected.

## Call for global action

The growing recognition of climate change consequences is influencing the core tasks of central banks. For Banco de México, the sound development of the financial system, one of our key objectives, requires from the central bank, not only to foster financial stability and better services for the benefit of households and corporates, but also to eradicate financing and risk management practices that avoid recognition of environmental and social negative externalities and risks.

Globally, the voices behind this call for action are expanding rapidly. Multilateral organizations are focusing increasingly their portfolios on green and sustainable activities and several central banks are in favor of decisive action.

NGFS, the Network for Greening the Financial System, was originally set up by 8 central banks and now has 51 central banks and financial supervisors together with 12 observers. The fact that this technical expert group was just created two years ago, highlights the global commitment to address climate related risks in the financial sector.

The NGFS supports an orderly transition towards a low pollution and low carbon economy by promoting best practices, improving data availability, and by raising awareness on the consequences of climate change.

## The role of central banks

For central banks climate change has been primarily an issue of financial stability and of resilience of financial institutions. The market has not been pricing climate environmental risks appropriately. Thus, capital can be stuck in activities which over time will be subject to a potentially severe loss of value. This means that we, central banks and supervisors, have to make sure that financial risk related to climate change or environmental degradation is adequately accounted for and priced by the financial sector.

What can central banks do? On the risk mitigation side, we can support the design of appropriate tools such as proper disclosure and transparency and also have a forward looking approach, especially given that historical data may not be a good predictor of future risks. Here is where scenario analysis comes in, as it helps us understand how climate risks will impact the financial system over say 10- to 20-year time horizons. This is a complex task because today most central banks and financial supervisors do not have the necessary tools and we need to have more specialized human resources in this field.

Our actions can definitely complement but do not substitute an integral climate/environmental policy. It is thus for policy makers to contribute by supporting the necessary transitions in the real economy and internalize the existing environmental/climate externalities. This has proven to be difficult but not less important.

NGFS members are trying to lead by example. In this regard, UNEP FI with the close collaboration of Banco de México launched an in depth study with individual interviews to evaluate, among other issues, the degree of awareness of Mexican financial institutions regarding climate/environmental and social related risks; and if financial institutions are equipped to assess and manage these risks. This exercise represents an important step in the direction of engaging Mexican financial institutions to incorporate environmental and social risks into mainstream risk strategy, and to capitalize the market opportunities that result from the transition to a low carbon economy.

Also, the recently published NGFS handbook on central bank portfolios management, which has a section on Banco de México, shows that there is a growing commitment among central banks to incorporate Sustainable Responsible Investment (SRI) practices.

SRI objectives are aligned with Banco de México values. These are to promote social interest, transparency, caring of the environment, and ethical commitment. As such, Banco de México has incorporated SRI considerations within the fixed‑income holdings in its own portfolios, including debt issued by supranational organizations, government‑sponsored entities, and corporations.

Implementing SRI does not imply a financial return trade-off, as responsible and ethical firms are less likely to experience unforeseen losses and are more likely to outperform non‑SRI securities in the long run. As such, SRI criteria can assist in identifying risks in a different dimension while offering long‑term value.

## Developing green financial instruments

Let me move to a related topic which is building a framework of common reference for green/sustainable investments, which is closely related to the question of how to foster the market development of green financial instruments. In this respect, establishing a credible system of taxonomy in Mexico is key. To avoid green washing a consistent classification system for sustainable economic activities is necessary. This taxonomy will enhance market transparency and remove uncertainties and therefore support companies, banks and investors in their financial decision making.

By defining through a collective effort what is green or sustainable, for at least the most polluting or carbon emitting industries, we can provide integrity to the market and facilitate the transition to a more sustainable economy in a proper time frame. In the absence of this effort, companies and other market participants will continue to define by themselves what is green with the risk that some will claim that they channel resources to green activities when they are *de facto* brown.

In this case, financial markets may be incapable of supplying credible green or sustainable financial products, thus leaving the growing demand for green/sustainable/ESG assets unmet. The lack of a green taxonomy therefore hampers the financial sector’s capacity to support the flows of capital that the economy needs to remain vibrant in the long term.

Mexico has been advancing in the definition of a credible system of taxonomies, including green bonds, green loans, and green/sustainable projects. In 2018, the Green Finance Advisory Board (Consejo Consultivo de Finanzas Verdes) together with the Climate Bonds Initiative published the Green Bond Principles MX for green bonds issued in Mexico, which are aligned with the green bond principles of the International Capital Markets Association. According to these principles, green assets and projects have to be part of eligible activities which are listed in the standards established by the Climate Bonds Initiative. In the absence of a fully developed national taxonomy, today in Mexico the external opinion is the one interpreting if the activities are or not green and if the indicators and metrics to measure the impacts (carbon emissions reductions, water reductions, etc.) are appropriate.

Regarding the definition of a green loan taxonomy, GIZ from Germany is financing a study that is developing a green loan taxonomy for the banking sector in Mexico, using as a benchmark the taxonomy derived from the European Union Sustainable Finance Action Plan. In order for the banking sector to start reporting on this effort by 2020, an interim less complex proposal than the European will be tested by some members of the Mexican Banks Association during the first quarter of 2020. A green loan taxonomy is expected to be issued by 2021.

We also need to advance in the definition of a taxonomy on green funds, which are strongly in demand by young environmental/climate conscious millennials. Starting in 2020, CONSAR will require Afores to include mandatory Environmental, Social and Governance (ESG) metrics in their risk and investment process.

We must also make sure that reporting and disclosing green information is accurate and verifiable by third parties. In the future, certifiers and second opinion providers will use the green taxonomy to verify against green activities more than to interpret what is green or not.

Also we can incentivize environmental and socially responsible behavior of economic actors by looking at new ways to include climate/environmental information that is materially relevant into the risk analysis of credit institutions. Such information could be collected by credit bureaus and be part of their data bases thus enriching the information these entities provide to the market.

Ladies and gentlemen:

As I have said previously, greening the financial system is a topic highly relevant for Banco de México. The development of more standardized methodologies and criteria for assessing environmental risks, as well as of green and sustainable investment instruments, can contribute to a turnaround in the allocation of economic resources to longer-term activities and projects that are consistent with greater social and inter-generational benefits.

For Banco de México, incorporating a better climate change risk assessment is crucial to promote the stability of the financial system and to foster its efficiency and transparency. This is why Banco de México ratifies its interest in promoting a dialogue with other central banks, supervisors, academia and experts. I am sure that this conference that focuses both on recent research on these topics as well as financial policy is producing valuable ideas and lines of action for our common objective of greening the financial system.

Thank you very much and welcome again to our venue.