

Mexico City, January 22nd 2019

Remarks by Alejandro Díaz de León, Governor of Banco de México, at the Seminar on Greening the Financial System

The environmental challenge

Good evening, everyone. On behalf of Banco de México, I am pleased to welcome the Network for Greening the Financial System Steering Committee members and this important group of experts and authorities who have met to discuss key issues and challenges on green finance.

Global warming and environmental degradation constitute critical risks and challenges at national and international levels.

At the national level, they are associated with the loss of natural capital, the degrading of ecosystems, the pronounced deterioration of development opportunities, the declining productivity of agriculture and fisheries, and the reduced welfare of communities due to air and water pollution and poor environment management.

At the international level, global warming and environmental degradation are associated with extreme weather events, the rise of the sea level, potential trade and supply chain disruptions and even mass migrations out of the jurisdictions most adversely affected.

Climate change and environmental degradation challenges are difficult to manage. There is a classic “free rider problem” and then there is the “tragedy of the horizon”, by which financial and economic decisions are taken with an insufficiently long horizon neglecting the full intertemporal impact of today’s actions.

At both levels, a large part of the solution requires:

- i) Correcting incentives for foster efficient economic decision making; and
- ii) Inducing change on economic agents –households, firms, and public bodies- in order for them to change habits and decide to behave in an environmentally friendly way.

This has proven to be difficult. While societies in general are willing to make small gestures for the environment, it is harder to obtain broad support for the important change in relative prices, of carbon emissions that is required to significantly reduce global warming.

The lack of both coordination and supranational authorities has proven to be a critical obstacle at the international level.

Short-sighted narratives, national interests and lack of trust have deterred progress on global warming and climate change, and recent developments are quite worrisome.

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.

This situation has an even harsher effect on the most vulnerable sectors of society.

Thus, a broader revision and improvement in environmental and social policies together with a stronger rule of law is definitely needed and can have a very positive impact.

What is the role of the central bank in this agenda?

For Banco de México, the agenda on greening the financial system is part of our regulatory functions. 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.

This is critical, as they can have major consequences on credit risk, financial stability and social development in an intertemporal context.

Therefore, it is essential that all financial system participants fully identify and measure their direct ecological and social footprint, as well as their direct and indirect environmental and social risk exposures.

Sound credit and project financing cannot neglect the associated climate risks it entails or the ones it is exposed to (those caused by it and those that can affect it).

In fact, global warming and environmental degradation are one of the main challenges of today's economy and financial systems.

Considering both climate risks and opportunities will certainly help to prevent and mitigate losses in the financial sector related to both micro and macro environment degradation and to climate change.

To illustrate the relevance of this agenda, just consider that Pacific Gas and Electric (PG&E), the California utility company, is expected to enter bankruptcy to manage 30 billion dollar of liabilities that accumulated from the devastating wildfires in northern California in 2017 and 2018. This example entails several lessons:

- i) A company's liabilities can increase dramatically due to environment and climate-related factors;
- ii) PG&E had a plan to source 100% of its electricity from low-carbon technologies by 2045, which will be harder to finance;
- iii) Under bankruptcy, the future of long-term contracts of some projects to supply PG&E with electricity at prices much higher than today's rates could be questioned, putting several low-carbon projects at risk.

This example illustrates also the challenges that both environment- and climate-related legal risks pose for the financial system and who will bear the loss.

A transparent framework and an adequate assessment of environmental and social risks can indeed modify considerably the allocation of resources, towards more economic efficient activities and sustainable assets. In contrast, opacity regarding environmental and social risks can lead to bad economic decisions and to devastation and loss of natural heritage.

In this regard, it is essential that both savers and investors be provided with better information on the assets, projects and economic activities they are financing, including their carbon, water and social footprint. Disclosure of information and transparency enhances incentives from both an investor and sponsor dimension.

It becomes therefore imperative to improve the methods for measuring environment- and climate-related risks. Considering these risks properly should be an essential part of credit assessment and adequate lending practices, which is clearly consistent with the strategy of fighting climate change and promoting a sustainable development.

We should leverage on the growing interest that institutional investors show in long term climate-friendly investments that have a positive social impact or pursue best practices in corporate governance.

In addition to physical risks, asset managers are increasingly incorporating transition and legal risks as part of their fiduciary responsibilities and are mindful of the importance to have consistent and cohesive investment narratives that avoid reputational tail risks on a broad set of dimensions, where the environment, social responsibility, and adequate corporate governance are clearly gaining relevance.

The role of central banks and supervisors and the creation of the NGFS in December 12, 2017

One of the Network's purpose is to enhance the role of the financial system to manage risks and to mobilize capital for green and low-carbon investments in the broader context of environmentally sustainable development. And also to define and promote best practices and to conduct or commission analytical work on green finance.

The NGFS has incorporated new participants and currently has 24 members and 5 observers, representing 5 continents. Banco de México is a founding member of the NGFS.

In October 2018, the NGFS held a plenary meeting and published a preliminary report with a simple and powerful message. I quote, "NGFS Members acknowledge that climate-related risks are a source of financial risk. It is therefore within the mandates of Central Banks and Supervisors to ensure the financial system is resilient to these risks."

The report also stressed that appropriate and specific analytical approaches are required, as well as adequate supervision, methodologies, prospective scenarios and stress tests.

Today's seminar takes place within the setting of the meeting of the NGFS' Steering Committee comprised by the central banks and supervisors of nine countries in four continents.

Today in the afternoon, and with the presence of the members of the steering committee, the NGFS' objectives and work streams were discussed. This group will publish its first comprehensive report on April 2019.

Also, note that the Basel Committee has announced that it will monitor and take note of the work of the NGFS and will discuss the progress report on the technical work-streams.

By organizing this seminar, Banco de México underscores its interest and commitment to making significant progress towards greening the financial system and promoting a dialogue with other central banks and supervisors.

Mexico's agenda

In Mexico, we are aware that it is imperative to:

- i. Promote within the entire financial sector the assessment of risks and opportunities related with the environment;
- ii. Encourage an adequate definition and identification of green and sustainable loans, bonds, and infrastructures based on the actual carbon and water footprints; and,
- iii. Create instruments to incentivize environmentally friendly practices among a broad range of economic agents.

Banco de México, along with other authorities, have been analyzing measures to:

- i) Make environmental information publicly available to the financial sector;
- ii) Produce a diagnosis of environmental risk identification and assessment in the financial system and prepare methodology guidelines to facilitate its adoption;
- iii) Develop standards for green bonds and infrastructures;
- iv) Foster the development of the domestic market of external review for bonds and infrastructure projects; and,
- v) Include data on individuals and businesses sanctioned by the Federal Environmental Protection Agency (*Procuraduría Federal de Protección al Medio Ambiente*, PROFEPA) in credit analysis.

Both the private sector and development banks have been making progress in green finance. In 2018, the Advisory Board on Green Finances created the “Principles of Green Bonds MX” which provide investors more certainty on the environmental benefit that the funded projects are expected to deliver.

Ladies and gentlemen:

The incorporation of environmental and climate-related risk assessment processes is crucial to promote the stability of the financial system, and to foster its efficiency and transparency.

The agenda on these issues is thus naturally bound to the role of central banks and regulatory authorities.

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 turnaround in the allocation of economic resources to longer-term activities and projects that are consistent with greater social and inter-generational benefits.

It is a great pleasure for Banco de México to be the venue for this meeting and to collaborate with the NGSF. Already valuable ideas and concrete lines of action for greening the financial system have arisen from this important collaborative effort which is just 13 months old.

Thank you very much and welcome again.