CLIMATE AND ENVIRONMENTAL RISKS AND OPPORTUNITIES IN MEXICO'S FINANCIAL SYSTEM: From DIAGNOSIS TO ACTION

Results of a comprehensive survey of financial institutions in Mexico, 2019

BANCO DE MÉXICO®

Inquiry: Design of a Sustainable Financial System

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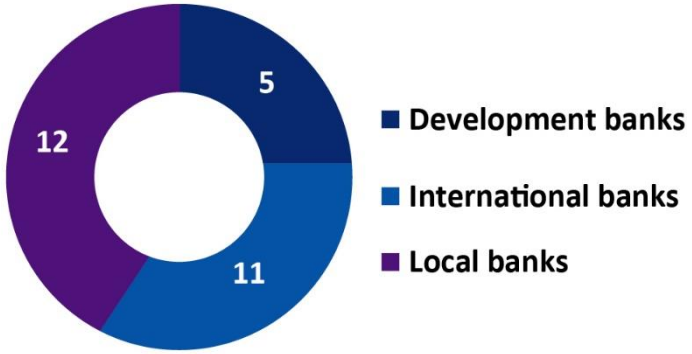
Introduction

- For Banco de México, the **sound development of the financial system**, which is one of our key legal objectives entails:
  - Fostering **financial stability** and **better services** for the benefit of households and corporates and also **eradicating financing and risk management practices that avoid recognition of environmental and social negative externalities and risks.**
- UNEP FI with the close collaboration of Banco de México launched in 2019 an in-depth study to evaluate the **awareness and risk management practices** of Mexican financial institutions regarding climate/environmental and social related risks.
- This report is an important step to promote Mexican financial institutions' involvement in **incorporating environmental and social risks into their mainstream risk management strategies** and capitalizing market opportunities that result from the transition to a low-carbon economy.
- The world is experiencing a **"one in a century pandemic".** This should be a reminder that **extreme events are closer than they appear. We need to address climate, social and environmental risks before it is too late.**

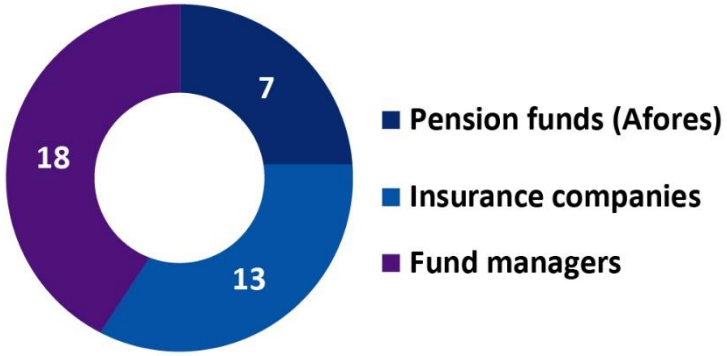
Surveyed institutions & structure

- The study was based on a **detailed survey and in person interviews** with the senior management teams of financial institutions.
- A total of 66 questionnaires were completed (28 credit institutions, 38 asset managers and asset owners), covering a significant share of the financial system.
- The study included **40 in person 2-hour interviews** with senior managers.
- The report is structured in three main chapters covering **governance, strategy and risk management practices** related to climate, environmental, social and corporate governance risks.
- Each chapter includes a set of **drivers, challenges and recommendations** to **better align financial flows to the development of an environmental and socially responsible agenda, and a low-carbon economy.**

28 Credit institutions
Reported credit assets: MXN 5,448,031 million



38 Asset managers and asset owners
MXN 2,623,008 million in reported assets



Governance

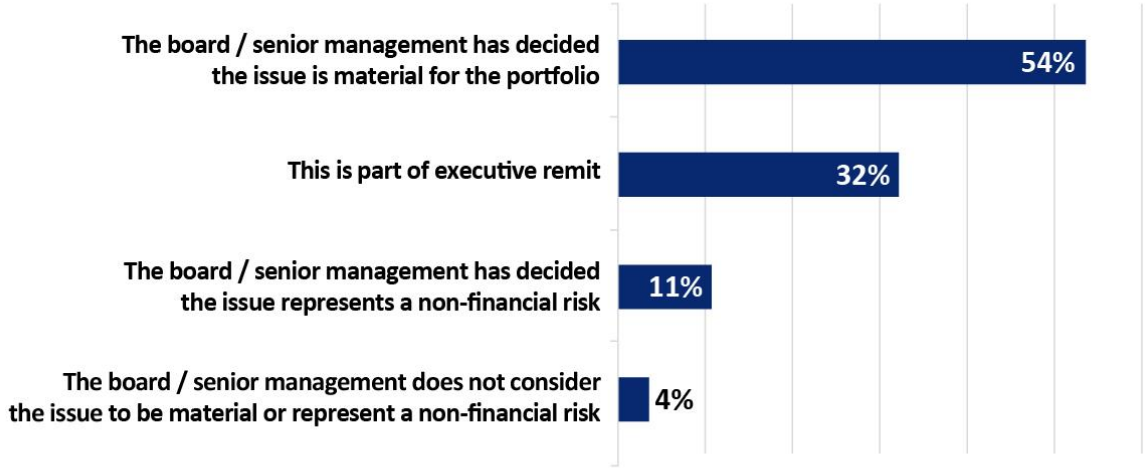
Assessment of levels of board/senior management oversight of climate, environmental and social risks

Governance: board of directors and/or senior management oversight of climate, environmental and social risks

- Most senior managers consider relevant having environmental and social risk management systems in place to support decision making (75% of credit institutions and 45% of asset managers report having set up this policy).
- While senior managers are aware of Mexico's vulnerability to climate/environmental risks, only half of them consider that these risks are financially material.

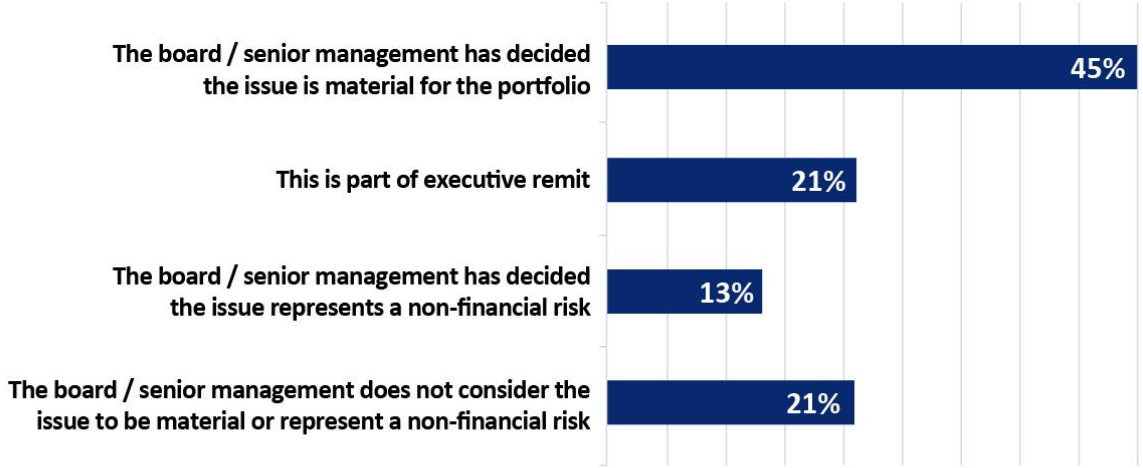
Credit institutions

% respondents



Asset managers

% respondents



Governance: board of directors/senior management oversight of climate, environmental and social risks

- Close to half of financial institutions are **building competencies** at the board level to address climate/environmental risk.
- Close to a third of Financial Institutions (FIs) monitor implementation and oversee progress against goals and targets for addressing environmentally related issues.

Credit institutions

Asset managers

Risk Strategy

How much climate, environmental and social risks are considered in the mainstream risk management/business strategies and disclosure policies of organizations

Embedding climate, environmental and social risk into mainstream risk strategy

The majority of FIs expect to be affected by physical and transition risks in the next six years.

64% of credit institutions and 68% of asset managers foresee to be affected by physical risks within the next six years.

67% of credit institutions and 65% for asset managers foresee to be affected by transition risks within the next six years.

Selected risks mentioned by senior managers interviewed:

Transition risks

1. Carbon taxes
2. New low-carbon technologies
3. Automotive (new technologies)/transport (more restrictive rules)
4. Changes in regulations to control overexploitation of natural resources
5. Changes in the use of PET / plastic use trends
6. Regulatory changes in fertilizer use
7. Environmental regulations in relation to real estate projects

Physical risks

1. Climate-related events (hurricanes, droughts, floods)
2. Impacts caused by over exploitation of natural resources, mainly waste
3. Changes in wind patterns

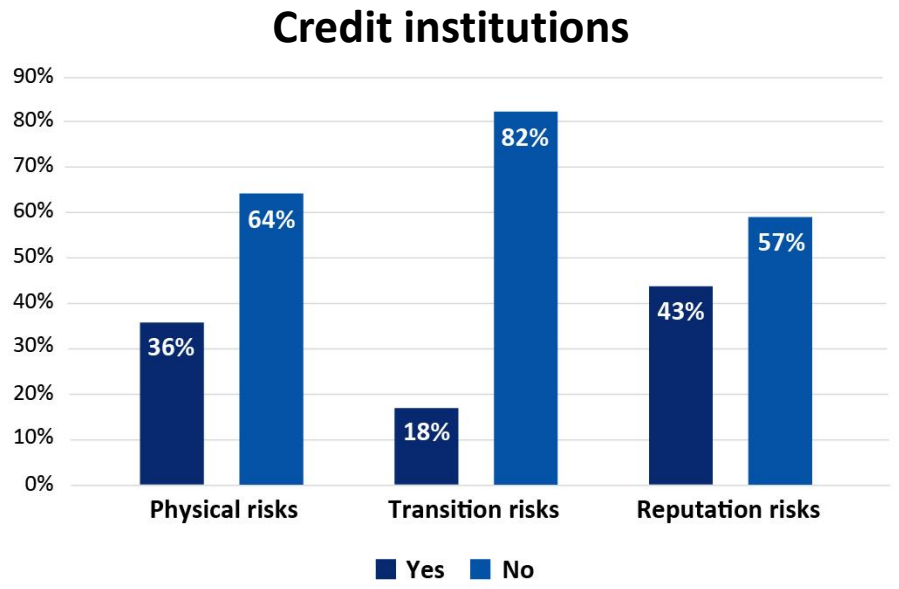
Incorporation of environmentally related risks into mainstream risk analysis

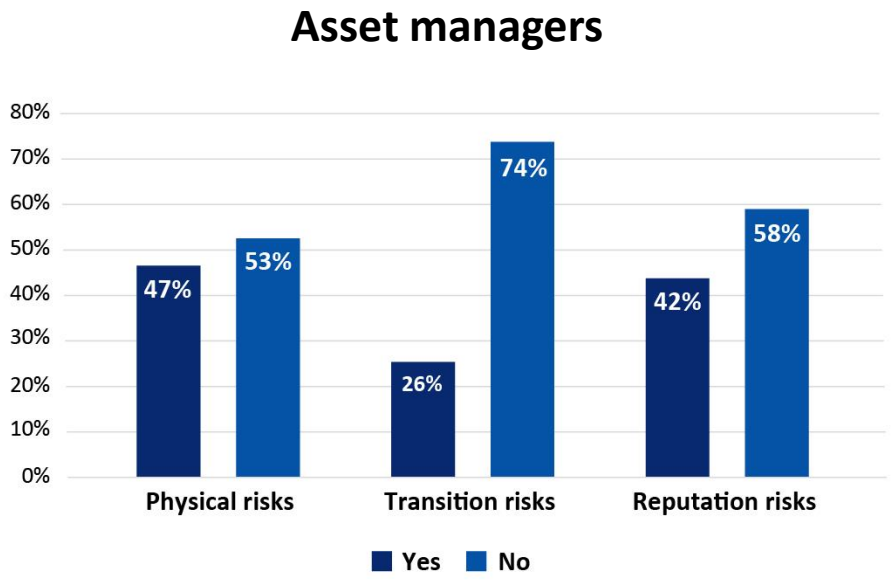
A minority of FIs assess physical, transition and reputation risks. Asset managers are a bit more advanced than credit institutions.

Senior management was made aware that stress testing against different climate pathways is rapidly being adopted internationally (with different physical and transition risks).

Some FIs assess reputation risks by using Big Data.

"Has your organization performed any analysis of exposure to physical, transition and reputational risks?":

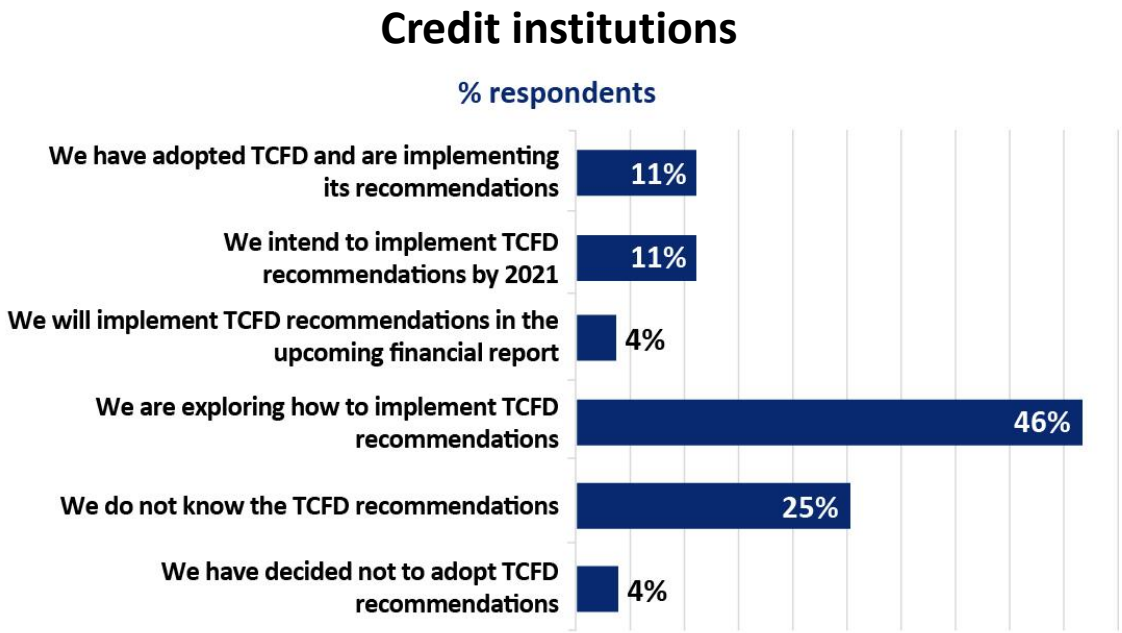


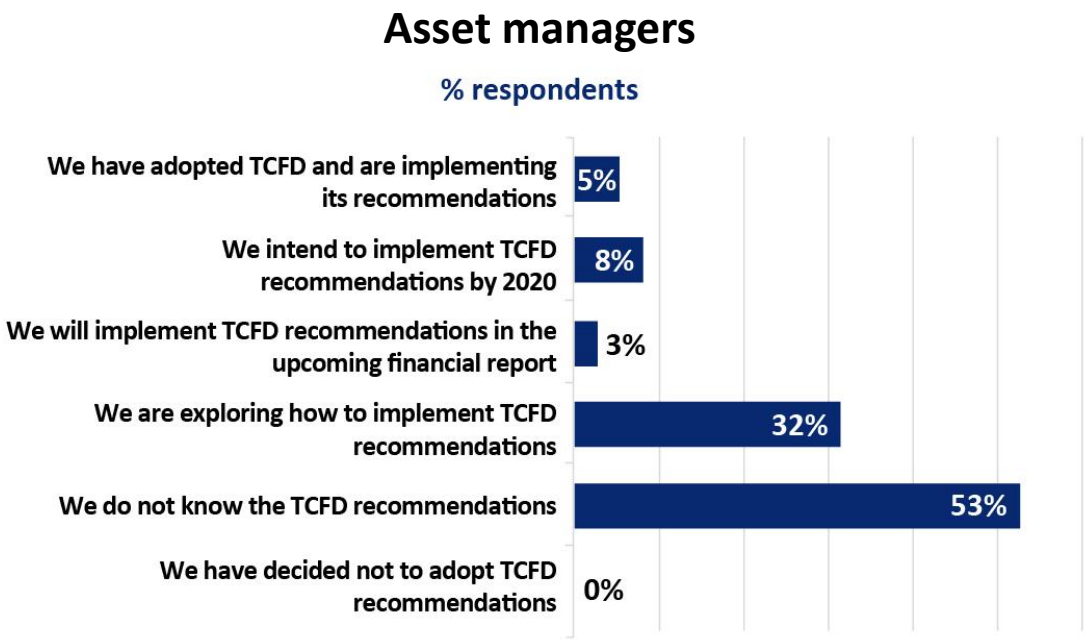


Knowledge and adoption of TCFD recommendations

75% of credit institutions know the TCDF recommendations. Only 47% of asset managers know them.

Half of credit institutions and a third of asset managers are exploring how to implement the TCFD recommendations.





Risk Management

Capabilities to properly identify, process and incorporate relevant data into the mainstream risk analysis processes of organizations

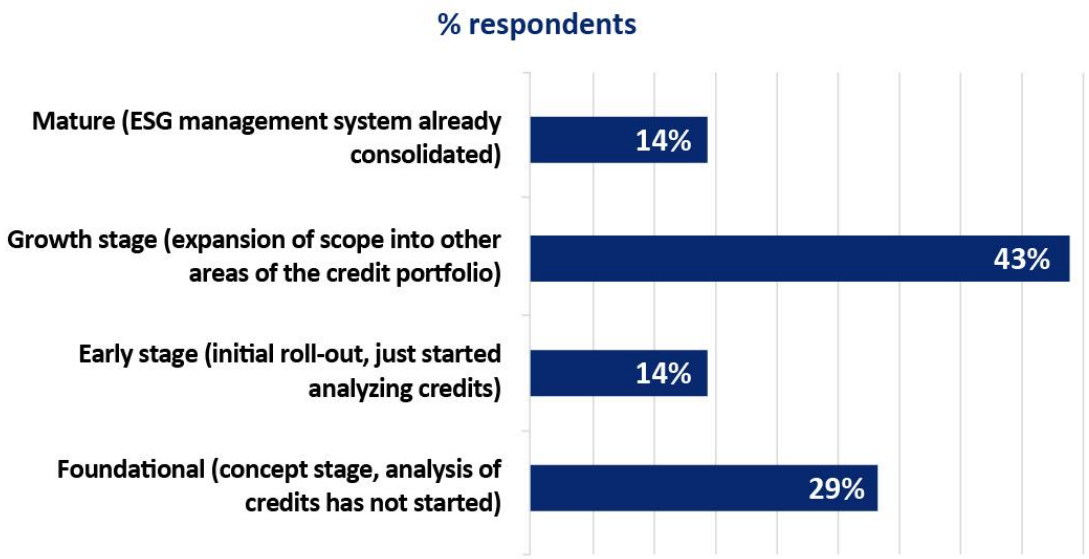
Environmental and Social Risk Management System (ESRMS)

71% of credit institutions are implementing the ESRMS at different stages.

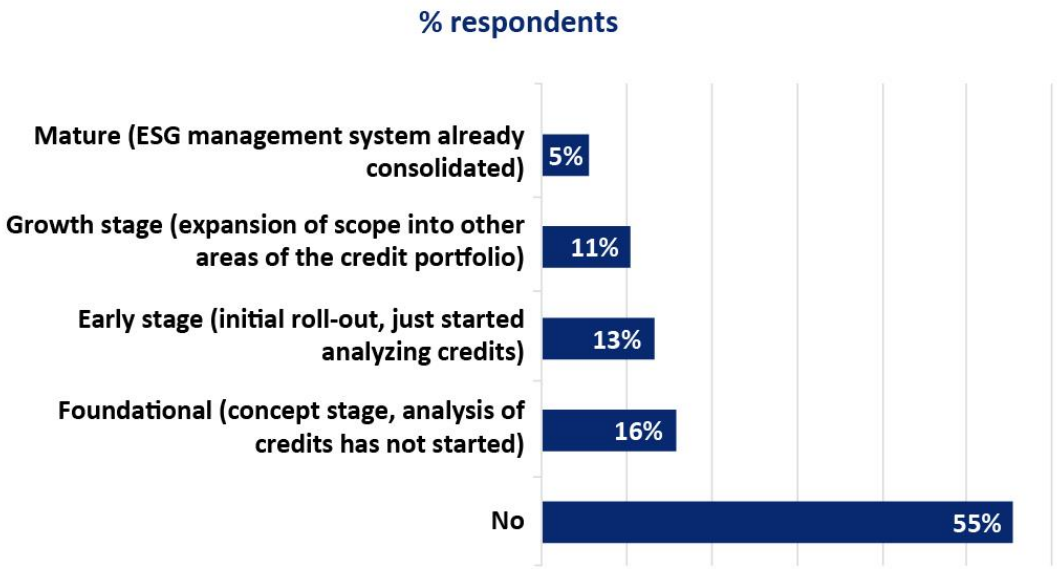
The ESRMS is less prevalent with asset managers; only 29% have it in place.

The ESRMS is applied only to a small percentage of the portfolio of FIs (on average 34% of credit portfolio and 23.5% of asset manager's portfolio).

Credit institutions



Asset managers



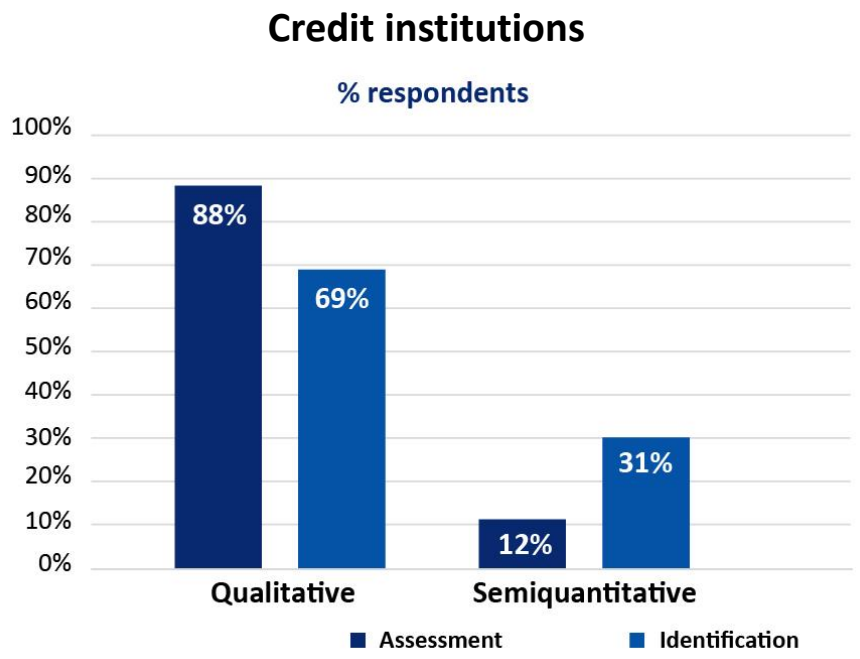
Performance of environmental and social risk analysis

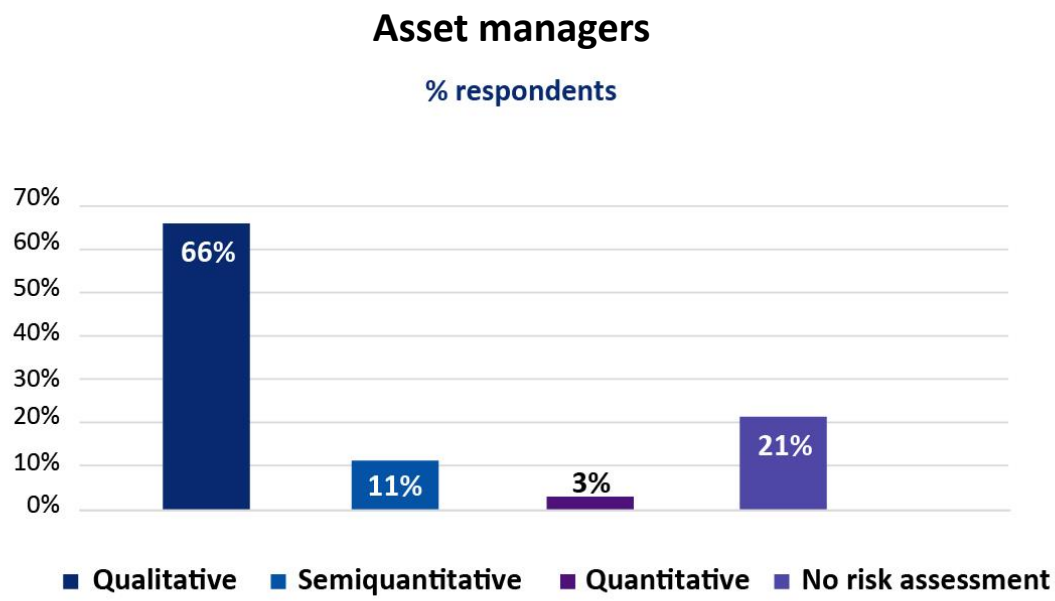
Half of credit institutions and close to a third of asset managers implement and track management and control measures of clients/firms in order to mitigate climate/environmental and social risks.

Public disclosure of environmental and social risk analysis of FIs practices is at an early stage.

The environmental and social risk analysis performed by FIs is mostly qualitative, essentially referring to legal compliance and documentation requirements.

Semi-quantitative analysis refers to the use of ratings and classification systems.





Recommendations

Main Recommendations

1. Adopt the recommendations of the Task Force on Climate-related Financial Disclosures (TFCFD).
2. Establish capacities throughout the entire FIs to analyze environmental and social risks and opportunities. In this regard, redefine board competencies and update board assessment policies (including relevant committees, capabilities and reporting obligations).
3. Set timelines and commitments to incorporate environmental, social and governance (ESG) considerations into major plans of action, credit, asset allocation and risk management policies, annual budgets, and business plans.
4. Include material ESG considerations in the FIs performance objectives and define specific reporting indicators (key performance indicators).
5. Adopt forward looking tools to analyze physical and transition risks and apply stress tests to different climate pathways .

Concluding Remarks

This report is a call to action to all CEOs and Board of Directors of financial institutions to incorporate environmental and social risks and opportunities into their risk assessment and management strategies, to reinforce internal policies, and to develop internal competencies to assess physical and transition risks associated with climate change and environmental degradation.

The costs to our society will be larger, the longer we take to internalize the negative externalities associated with climate/environmental and social risks.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