”Sustainability and financial stability”

Keynote speech by Alexander Karrer
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Ladies and Gentlemen, dear colleagues,

On behalf of the Federal Department of Finance, is a great pleasure for me to speak to you today, at the occasion of the 2016 Swiss Sustainable Finance (SSF) Members’ Assembly. Please accept my apologies that I was not able to join your proceedings earlier.

I would especially like to thank your President, Jean-Daniel Gerber, for inviting me. Jean-Daniel and I have worked together on many occasions in the past. When he talked to me about his engagement in SSF for the first time, I felt his great enthusiasm for this new job. The mere fact that SSF exists, shows not only the need within the financial sector to work together more closely on issues, but also the need for an association that can act as interlocutor with the authorities. We certainly welcome this development and look forward to working closely with you in the years ahead.

Finally, and before delivering my remarks, I would also like to congratulate the Swiss Team and the Federal Office of the Environment (FOEN) for their comprehensive Report (“Proposals for a Roadmap towards a Sustainable Financial System in Switzerland”). The Federal Department of Finance was involved in this process, which has its roots in the first input-report to the UNEP Inquiry last year. The Swiss Team’s new report identifies a series of concrete proposals for creating a (more) sustainable financial system in Switzerland.

The Proposals are an excellent basis for further discussions. They now need to be challenged and debated, complemented, further specified and then – for those measures retained – put into action. These proposals are also very useful because they cover all activities/products of the financial sector. They will thus help to mainstream financial sustainability instead of confining it to a niche.

Let me now turn to the core of my remarks. Sustainability issues are becoming increasingly relevant in the financial sector and in financial market policies, both at the national level (for example financial market policy and requests by parliament) and internationally (for example G20, FSB, IMF). To address this, I would like to divide my remarks into two parts:

- In a first part, I would like to describe the way we have engaged in work on sustainable finance so far, and the rationale for this approach. Let me just be clear that I will not speak about the public financing of environmental policies. This is a different topic and one where the Finance Ministries' responsibilities are limited to financing – to the extent possible – public environmental policies as decided by the government and legislator.
- In the second part, I would like to touch on the ongoing discussions on sustainable finance at the international level and on how Switzerland engages in these discussions.
- I will then conclude with some thoughts on Switzerland's comparative advantages in sustainable finance.

Why Sustainability Matters for Ministries of Finance

Turning to the first part: Finance Ministries have, of course, a vast experience in addressing sustainability from the point of view of fiscal policy, debt management and financial market policy. From the fiscal point of view, our objective is to ensure – with more or less success depending on the country – sustainability of the budget over the economic cycle, while at the same time keeping debt to GDP at a level that does not burden future generations. Our financial market policies have the objective to ensure the stability and integrity of the financial market place through appropriate regulation. They also have the objective of creating the right underlying conditions to allow the financial sector to prosper in a sustainable manner and to be competitive internationally. When it comes to approaching the *environmental* sustainability of financial activities, our expertise tends to still be limited. We must even ask ourselves: Why should we get involved in environmental issues in the first place?

The answer is actually quite simple: Climate and other environment-related events, as well as changes in according policies, increasingly influence the financial sector. The same also holds the other way around: Developments in the banking and insurance sectors can affect how ventures that relate to the environment are financed and insured. The way to understand and assess such changes is, of course, via the notion of risks. We must, for example, be able to understand the particular physical and transition risks from climate-related events and/or changes in environmental policies for banks, for insurances and for other financial intermediaries. Or, from a more general perspective, we must ask: What are the risks to the stability of the financial system nationally or even globally? How can these risks be mitigated? Going forward, these are some of the core questions we, as Ministries of Finance, will have to deal with, though this process will need to rely on a collective approach of both the public as well as the private sector. And because environmental issues are not confined to political borders, we also need to act at a global level.

Now you may ask yourself how environmental stability can be enhanced by focusing on risk. Again, the answer is quite simple: adequately pricing environmental risks – or in other words internalizing external costs – will bring about a gradual shift towards more sustainable investments. Wrong price signals lead to an over-allocation to investments in high-risk activities and thus an inefficient allocation of capital.

Getting the pricing for environmental risks right will continue to be a challenge, both conceptually and maybe even more so politically. To be able to price environmental risks, the specific risks need to first be made transparent and then analyzed in financial terms. This requires adequate metrics, methods and models. The expertise for measuring and assessing different environmental risks as financial risks is still at a relatively early stage. I would also argue that the lack of reliable and consistent data, tools and methods that link environmental – or even more broadly ESG – to financial factors is one of the reasons for insufficient awareness in the private and public sectors about the systemic importance of sustainability issues.

Because climate change could have profound implications for economic and social developments as well as for global and local financial stability, we need to build a better and deeper understanding of the risks for the financial sector arising from environmental and climate change (notably). Otherwise, it will be very difficult to act effectively to minimize these risks.

Acting upon potential environmental risks also entails significant opportunities for strong and high quality growth and development. In my view, the Swiss financial sector is very well placed to contribute significantly to this economic transformation. Some of the large banks and insurance companies have developed a considerable expertise in approaching environmental issues, and in particular risk assessments. This outstanding pool of knowledge has a big potential: firstly, it can inform the international discussion, and secondly, it can help to mainstream considerations of environmental risks, also in our own country.

In Switzerland, the Federal Department of Finance and the Federal Office of the Environment (FOEN) are engaged in a very fruitful discussion and cooperation on the core questions of sustainability and finance. Based on this work, the Federal Council has endorsed the approach just described. In February 2016, the Federal Council adopted basic principles for integrating sustainability in our financial market policy. Let me list them briefly:

- Sustainable economic growth and financial stability are necessary conditions for sustainable development and vice versa.
- Today's investments and policy choices must account fully for their effects on future generations (long-term perspective).
- External costs must thus be transparent so they can be adequately internalized. Internalization, in turn, is important for effective pricing.
- Private sector initiative should drive sustainable investment and growth.
- The official sector should be a facilitator for sustainable growth by providing a conducive framework including:
    - financial market policy built on stability, quality, integrity and long-term orientation

- sound economic fundamentals and public finances
- strong and effective environmental policies
- strong institutions and rule of law
- an inter-generational horizon that is also reflected in society and institutions

To conclude this part of my speech, let me just point to one challenge that we have to overcome as we discuss sustainable finance: that of the time horizon. While environmental policies and measures taken are geared towards the very long term, Finance ministries often need to look at a much shorter time horizons, including the business cycle and what one could call the financial stability cycle, which is the period between two financial crises. Measures need to be tailored to take account of the different time horizons and to make them consistent.

Sustainability and Financial Stability: International Developments

Let me now turn to the second part of my remarks regarding international developments. As mentioned, there is increasing awareness at the international level of the importance of sustainability in the financial sector context. The UNEP Inquiry was an initial driving force that helped bring sustainable finance onto the agenda of important international bodies such as the Financial Stability Board and the G20. At the request of the G20 Finance Ministers and Governors, the Financial Stability Board created an Industry-led Task Force on Climate-related Financial Disclosures (TCFD) in December 2015. The TCFD is chaired by the finance professional and former Mayor of New York, Michael Bloomberg. The FSB has tasked the TCFD to undertake a coordinated assessment of what constitutes efficient and effective disclosure and to design a set of recommendations for voluntary company financial disclosures of climate-related risks that are responsive to the needs of lenders, insurers, investors, and other users of disclosures. The task force issued its first report in April and plans to deliver its final report by end 2016.

As an active and permanent member in the FSB, we strongly supported the creation of the industry task force and successfully nominated two Swiss representatives to be part of its work. This confirms, inter alia, that Swiss experience and expertise in sustainability issues is highly valued and that this can be leveraged at the international level.

As you may also know, under the Chinese Presidency, Switzerland is an invited participant in the 2016 G20 Finance Track. This allows us to participate in all discussions at all levels an in all working and study groups of the G20 Finance Track. Switzerland is thus an active member in the Green Finance Study Group (GFSG) that was established this year by the Chinese G20 Presidency and that is co-chaired by the People's Bank of China and the Bank of England. The GFSG is currently in the process of identifying institutional and market barriers to green finance and, based on country and market experiences and best practices, and of analyzing options on how to enhance the ability of the financial system to mobilize private green investment, thereby facilitating the green transformation of the global economy.

As part of our engagement in the GFSG (within the work stream on "Risk Analysis"), Switzerland hosted for the G20 an international workshop on environmental risk analysis in the financial sector in Berne last month. Participants in the workshop were members of the G20 Green Finance Study Group, as well as high-level global financial intermediaries from banks, insurance companies, reinsurers and institutional investors. The aim of the workshop was to share experiences and to take stock of existing industry practices in environmental risk modelling and risk assessment. In addition, core challenges for environmental risk analysis were identified, especially those relating to data availability, tools and methodologies.

The workshop made excellent progress in the assessment of risk analysis practices and was particularly successful in fostering an open, engaged and constructive dialog among the different participants from major global banks, re-/insurers, institutional investors and asset managers, as well as from ministries of finance and central banks.

The discussions clearly showed that major global financial intermediaries are engaged in technical environmental risk analysis and that many innovative practices are evolving. This is particularly true for the re-/insurance sector, where work on some core physical risks is well advanced. In other sectors, and with regard to other sources of risks (i.e. transition risks), the work is still at an earlier stage in terms of data availability and quality, tools and methodologies as well as capacities devoted to environmental issues impacting the financial sector. The discussions – incidentally, here in this same building – also confirmed that the development of environmental risk awareness is at an early stage among senior management, clients and politicians. In particular, many smaller firms are not as advanced as the pioneers or some of the global players in this field.

The discussion identified the following main common challenges: Adequate data or metrics are not readily available, there is a lack of basic and commonly accepted methods or models, and awareness of environmental risks has yet to take hold in the mainstream of the global financial sector. There is therefore a need for 1) better access to more granular data and data disclosures 2) better information and knowledge sharing within the industry and between the private and the official sector 3) effective tools and methodologies to support more forward-looking analysis of physical, transition and other balance sheet risks 4) better awareness and knowledge of environmental risks.

In the workshop there was a strong sense that the different types of financial intermediaries – i.e. banks, insurances, reinsurances, institutional investors and asset managers have much to learn from one another and that according international platforms – much like SSF on a national scale – would be helpful. This is a point that we expect to be expanded upon as the work of the GFSG continues.

Conclusions

In conclusion, I would like to reiterate the growing importance of sustainable finance and the commitment of the Federal Department of Finance to contribute to this development. We are at the beginning of the work both nationally and at the international level. A better understanding of the risks involved is key if we want to enhance more sustainable investments. In doing so, we will pursue a market based approach and one which will not create market distortions due to unwarranted government interventions. To the contrary, we should seek to mainstream sustainability across all actors, business segments and products instead of continuing to treat sustainability as a niche. The SSF can help this process by participating actively in the dialogue and in the way policies are developed here and abroad.

I would like to emphasize that Switzerland is very well positioned to promote sustainability in the financial sector and system. Thanks to 1) its experience and expertise in sustainability issues, 2) favorable framework conditions and 3) strong financial sector and 4) the already considerable know-how and expertise in environmental risk analyses among some actors. Switzerland has a unique combination of strengths that can create a long-term competitive advantage in the field of sustainable finance.

The Federal Department of Finance will continue to actively participate in the work of the international financial bodies and deepen the dialog with the private sector at the national and international level.

We need to realize and keep in mind that the path to a truly sustainable financial system is bound to be long and uneven. We must also be ready to better understand the sources for risks and opportunities coming from environmental and other effects. This is why we need to start now with the work that will help shape a financial system that can finance smoothly and effectively the development of an inclusive, prospering and sustainable economy.

I thank you for your attention.