S P E E C H

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Speaker Erik Thedéen
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Finansinspektionen
Box 7821
SE-103 97 Stockholm
[Brunnsgatan 3]
Tel +46 8 408 980 00
Fax +46 8 24 13 35
finansinspektionen@fi.se
www.fi.se

Climate and sustainability in focus at FI

Sustainability is one of the major issues of our time. And rightly so. When it comes to the environment and the climate, which I will be focusing on today, research clearly shows that the current trajectory is unsustainable and needs to be changed.

From one perspective, sustainability issues are not entirely new for financial firms. Sustainability is linked to many factors that financial firms need to consider in order to be able to assess the risk level of an exposure—regardless of whether the risk is related to loans, insurance policies, investments, etc. Part of this, in practice, is about risks such as credit risks, market risks and insurance risks.

But the issue has become larger than that. In 2015, the Swedish Parliament decided on a new goal for financial sector policy: that the financial system must contribute to sustainable development. This means that financial market actors must take environmental, social and corporate governance issues into account when running their businesses. At the EU level, the European Commission has prepared an action plan for the financing of sustainable growth based on recommendations from a high-level group of experts. The objective of the action plan is to reorient capital flows to achieve sustainable and inclusive growth, integrate sustainability into risk management, and foster transparency and a long-term approach in financial markets and in the economy as a whole. We are in a transition.

To see the financial system's role in this transition, we can look back at what was one of the big issues of the 20th century; namely, what kind of economic system that would best serve us all. In the short term, we might take our institutions for granted, but in the longer term, they are something we choose.

If society can democratically agree on common priorities, why not let a central planner determine the resource allocation? Why let firms and individuals make their own decisions about production and consumption?

History shows that planned economies have often turned into command economies that have deteriorated. The track record when it comes to human rights and the environment is lousy. When the wall came down in 1989, it became clear that countries that had chosen market economy systems had been more successful than countries with centrally planned economies.

The market economy, with its decentralised decision-making structure, has proven itself able to create good conditions for increasing productivity and rising real wages. Why?

At the core, it's about information. How do we know what households want? How do we know that a production method is competitive? How do we choose the investments that people's savings will finance?

If this type of information were easy to observe and compile, the central planner's job would be simple: gather the information and allocate society's resources accordingly.

In reality, though, this information is disseminated, incomplete, and even hidden. But when we allow households and firms to trade with one another, a lot of this information is reflected in the prices. Market prices are thus fundamentally a mechanism for creating, compiling and conveying information, which in turn enables efficient resource allocation.

In the early 1990s, British economist Paul Seabright had a conversation with a Russian government official who was responsible for the bread production in Saint Petersburg. "We want to learn about the market economy," said the official. "But I have to understand the details. Who is responsible for the bread production in London?" The question was not misguided, says Seabright, because it is really the answer—that there is no such person—which is so remarkable.

In a classic market economy, it is the price mechanism that solves the task. But the market economy is not without shortcomings—as many economists have also pointed out. There are plenty of examples of how unregulated or under-regulated markets lead to unacceptable consequences for the environment, people or society at large. To give some examples, it could be firms releasing chemicals into sensitive natural environments, not providing their employees with reasonable working conditions so they become ill or injured in some other way, or making large profits and then concealing the profits in tax havens.

The strength of the market economy, i.e. that it is decentralised, is also its Achilles' heel. In some situations, the interests of society and the actions of individual actors point in different directions, and the result is that resources are allocated improperly from society's perspective.

Let me provide three examples of situations where markets might not generate the right resource allocation:

- It can happen when a firm's production gives rise to costs that are borne by others, what economists call negative externalities. Emissions that pollute local waterways and natural environments is a classic example.
- It can also happen when making a decision that has far-reaching consequences beyond one's own time horizon. For example, if firms and other actors in the economy focus on the short term when making decisions that create large costs borne by future generations. This is what Bank of England Governor Mark Carney calls "the tragedy of the horizon".
- A third example is when one party is making decisions on behalf of another party that does not have access to the same information. Economists call this asymmetric information. If you've ever hired a carpenter to do work on your house you might recognize what I am talking about. You have a rough sense of what you want done, but you rely on the person doing the work to carry out the work in a proper manner. In such situations it can be a challenge to write a contract that works well for both parties.

When it comes to the climate, we see all three of these challenges at the same time. It is easy to see why problems arise. The climate is global. Greenhouse gas emissions create negative externalities for others. The really big costs emerge far in the future, beyond shorter time horizons. And when savings are channelled to the large investments that are required to make the transition, this typically goes through several layers of intermediaries, and the information asymmetries can be large. This makes it difficult for savers to assess how individual firms impact, and are impacted by, climate change, and to discern which investments can actually be expected to generate value.

Handling climate-related matters is a central part of working with sustainability. The way things have evolved shows that the economic system we have is not delivering well enough when it comes to managing essential parts of society's resources. And the future risks are primarily dependent on how we act today. This means that the system needs to transition. And it needs to transition in time.

Economists often advocate using taxes and regulations to better capture the social costs that an activity gives rise to, so that the price signal conveys the right information.

Sustainable finance builds on this. When the price does not capture the relevant information, efforts need to be made to strengthen the signal. The risks, and the opportunities, need to be made visible. And costs that are transferred to others, whether today or in the future, need to be made visible.

There is a saying that the market makes a good servant but a bad master. Working with sustainability is about ensuring that the market is serving us people and doing what it is good at—channelling capital to the right investments and encouraging new, creative solutions to the challenges of both today and tomorrow.

The market economy's ability to generate material welfare has given it its legitimacy, but I believe this legitimacy is contingent on the system's ability to generate value in a broader meaning, i.e. to give people what they actually want, including sustainable development. This is where the financial system can play an important role.

We must not forget that large parts of the financial system are dedicated to managing other people's money. It is therefore natural to start with this question: What do they want and how do we make sure they get it? It is clear that more and more people want to invest in a way that generates a good return—generates value—in a broader meaning. Capital should generate a return, but taking into consideration the effects on society and the environment. We no longer talk only about shareholders and returns, but also about stakeholders and value generation in a broader sense. To do this, firms need to take a broad and long-term approach. Personally, I think that firms which do not factor long-term aspects into their operations or take into account costs they cause others will generate inferior returns. In other words, a sound sustainability approach and value generation are ultimately not contradictory; rather, quite the opposite.

The journey has begun, and we have come quite far, but there is still a lot left to be done. Let me describe where I think we stand today.

First of all, I can say that a lot has happened in the past few years. Five years ago, there was barely any discussion about the link between sustainability on the one hand and financial stability and consumer protection on the other—neither among supervisory authorities nor in wider circles. Now these topics are at the top of the agenda in the public debate.

One important reason for this change is that it is becoming increasingly clear that the problem is not only about how one specific actor impacts society, the environment and the climate. On the opposite, sustainability issues also have a direct impact on firms—on their exposure to risk, their business models, and their value.

What is motivating firms and supervisory authorities to adopt a comprehensive approach to the climate-related issues in particular is that, given the wide impact that climate change is having on our society, risks which were previously related to individual exposures or specific industries are now becoming a challenge at the systemic level.

When a firm does not manage its risks properly, it may experience a decline in profits. However, when there is a failure at the systemic level to identify, measure and price risk, the consequences can be significantly larger. We saw one example of this in the most recent financial crisis. That time, it was linked to negligent lending. Next time it may be climate risks that are in the spotlight.

Work on these matters has intensified on an international level in recent years, particularly following the Paris Agreement in 2015. These questions have been the focus of much work by, among others, the Financial Stability Board (FSB) and also at the EU level, as reflected in the Commission's action plan.

Within the Central Banks and Supervisors Network for Greening the Financial System (NGFS), of which FI was one of the founding members, we have also determined that climate-related risks are a source of financial risk. Therefore it is within the mandates of supervisory authorities' mandate to ensure that the financial system is resilient to these risks. This is an important statement, in part because we are more than 40 authorities, supervising more than two-thirds of the globally systemic banks and insurance companies, standing behind it, but also because it means we have committed to taking action. And also because it means that we expect you to take action.

It is important to remember that a transition, however necessary and desirable it may be, in itself can entail financial risks, for example in the form of stranded assets, as our societies move away from fossil fuels and related technology. If we are to live up to international and national agreements, we need to continue the transition. In order for us—firms, authorities and others—to be able to manage this change, we need to be able to identify, measure and price such transition risks.

The transition will also require major investments. To ensure efficient resource allocation, we in turn need to be able to identify and price the opportunities that emerge from the developments and assess what investments are required to reach climate targets.

It is important for both society and the functioning of the financial system for the transition to occur in an orderly fashion. The longer we postpone the transition, the more serious the consequences could be. A late and abrupt transition increases transition risks at the same time as the physical consequences of climate change continue to become greater. And the greater the climate-related risks, the greater the financial risks. It is therefore in the interest of everyone to transition in time and in a well-structured manner.

What does this mean? That firms already need to ensure their resilience to transition risks. Smart firms do it by being agile and adapting their business models in time. Smart firms do not dig their heels into the ground. The size of future risks is largely determined by how we act today, but it is important to remember that future risks are not the only thing at stake. We are already

experiencing risks materialising among firms whose business models are not in line with the established climate targets.

Investing in firms that work actively with sustainability can also generate good returns. Not only because they are managing this type of matter specifically, but rather because it is a sign that they have good corporate governance, are taking a long-term approach to their work and can survive in, and even benefit from, an ever-changing world. Personally, I think that firms that work actively with long-term risk analyses are more profitable over time. There is also some research supporting this. Financial firms that invest in such firms should therefore be able to give their customers both good returns and sustainable savings.

In order for financial firms to be able to identify and manage risks and opportunities, they need to be able to determine which firms are agile and which have their heels dug into the ground. This is a prerequisite for ensuring the financial system's resilience and safeguarding consumer protection. Banks, insurance companies, investors and others need to identify which firms are having difficulty handling the transition. And supervisory authorities like FI need to ensure that this work is being done. By doing so, we not only safeguard financial stability and consumer protection, but we also promote an orderly transition.

For firms and authorities to be able to take action, they need data, information and relevant tools. Today, there is neither reliable data nor a shared terminology in this area. The FSB has noted this in its work on climate-related risks and therefore established the Task Force on Climate-related Financial Disclosures (TCFD). The TCFD was tasked with creating a framework for how firms can report climate-related financial risks and opportunities. I would like to emphasize that the focus is on financial information, which is a prerequisite for it to be useful as a decision support. Sustainability issues are sometimes referred to as *soft issues*. I would like to counter this by saying that *soft issues* are sometimes really *hard issues*.

The large and growing demand for this type of information is illustrated by the more than 800 firms and organisations, together managing more than USD 100 000 billion in capital, that support the TCFD recommendations. An increasing number of banks, insurance companies and asset managers are also requesting this type of information from firms. This in turn means that firms have begun to respond to the demand. In this way, financial firms can contribute to greater transparency. However, even if we are seeing a positive change, more firms need to start reporting climate-related information, and firms also need to be clearer about the financial impact the development is having on them.

Transparency has several advantages. In order to be able to report relevant information, firms need to work proactively with identifying and measuring risks and opportunities. With this comes a greater understanding of the changes

in governance, strategy and business models that are needed to manage the transition. This allows the firms' reporting to become a strategic tool internally, which helps firms adapt their operations. More firms are on their toes.

In addition to the TCFD, there are a number of standards and frameworks for integrating sustainability information into firms' reporting. This is a sign that these issues are gaining ground. At the same time, diversity can lead to fragmentation and a lack of transparency, which is a problem. This is something that we have seen in our supervision.

Last year, FI surveyed how financial firms are providing information about sustainability. We determined that the large number of standards firms report applying makes it impossible for an external observer to compare information between firms. Often, it was also not possible to interpret how firms integrate sustainability into their operations, and thus neither how these issues in practice are integrated into their risk assessment and risk management. This means that it is also not possible to assess if and how firms are adapting their operations to the risks and opportunities they see.

A lack of transparency also increases the risk for greenwashing, where firms describe their operations as being more sustainable than they are. It is important to reduce the risk of greenwashing through better information in order to not only obtain an accurate overview of the risks and opportunities but also for people to feel confident that they are getting what they want. This was a specific problem we saw in our analysis of the sustainability information provided by fund managers—unclear and hard-to-assess information makes it difficult for individuals to determine how sustainable a fund is. As a result, their expectations could be skewed. Greenwashing is also a problem at the systemic level since it can reduce confidence in sustainable products in general. This also reduces the credibility of the financial market's ability to channel capital in the right direction.

What conclusions can we draw from this? That firms need to do more to ensure that their reporting is relevant and usable. Based on the information from a firm, external stakeholders need be able to obtain a good overview of how the firm handles these matters and how they affect the firm's operations and development. Another conclusion is that comparability must increase, not only across firms but also across regions and industries.

These are central issues in the ongoing debate, both within the EU and globally. Many argue that there is a need to coordinate and align different standards to create uniformity and comparability at an international level. Many also point to supervisory authorities as having an important role in reaching this goal.

In 2018, IOSCO decided to establish the Sustainable Finance Network, a network that FI is chairing. During the spring, the network conducted an

analysis to gain a better overview of how these issues are handled in different countries, the initiatives that are currently under way in the area, and the degree to which different frameworks and standards are applied. We are also analysing what role the supervisory authorities have, or may have, in particular when it comes to reporting. In June, we arranged a conference at which we discussed how sustainability issues can impact firms' business models and risk management, the impact of these issues on investment decisions, and whether it is time for a convergence of different frameworks. The question of the role of the supervisory authorities was a common thread throughout the discussions.

We will present our conclusions in a report to the Board of IOSCO in February next year. I do not want to preempt the ongoing analysis work, but I can say that there is a lot of pressure from the market when it comes to these matters, at the same as the demand for global standards is a complicated issue. On this topic, I would like to encourage the industry, just like it has done in other areas, to work together to achieve increased harmonisation—initially, at least, at a national level. In terms of reporting, for example, we are seeing some signs of voluntary harmonisation of standards.

At the same time as transparency needs to increase, we also need methods and tools that make it possible to obtain a better understanding of the extent of climate-related risks, given different scenarios. Within the NGFS, for example, we are working to develop a number of scenarios that will help us better understand how the risks develop given the strength of response to reduce greenhouse gas emissions and whether measures are implemented in an orderly and predictable manner or not.

This work is complex. First, there is uncertainty about the effects that various temperature increases will have, and also about the link between climate change, the macroeconomy and the financial system. Second, we need to consider and plan for a long time horizon at the same time as historical data probably only will provide limited guidance for the future. Third, this development is highly dependent on future political decisions and technological development, two areas where there also is fundamental uncertainty. But this does not stop us from taking action.

To sum up, where are we today? I would summarise it like this: We are ready. We know what we want to achieve. But we are still developing our understanding of how to achieve it. However, time is of the essence for both developing scenario analyses and for increased transparency.

So, what can you expect from us? That we will continue to work with sustainability in different ways, and that we will integrate these issues into our day-to-day activities. The targeted supervisory activities that we have conducted in this area over the past few years have increased our understanding of how the industry address these matters. We bring this knowledge with us as we increasingly integrate sustainability into our ongoing supervision. We are

currently pursuing dialogues with you on how you are integrating sustainability into your work, what this means in practice for your operations, and how you inform others about this work. You will also see sustainability included in a number of our activities in the future.

We will also continue to stay involved and participate actively in the international work – both at the EU level and globally – to find paths forward. We are bringing our experiences from supervision also into this work. This applies in particular to the work with the European Commission's action plan and the assignments that the European supervisory authorities are working on. The strength of the international work is that it is possible to pull together energy and expertise, and achieve the coordination required for us to work toward the same goals. "If you want to go fast, go alone. If you want to go far, go together."

And what do we expect from you? Many of you are working actively with sustainability, but we see at the same time that there are things left to do—both when it comes to how you address these issues in practise, and how you provide information about it. We therefore expect you to continue to work proactively for sustainability to be an integrated part of your governance, strategies and business models. Financial firms must conduct an overall risk assessment, and in this analysis we expect you to consider relevant sustainability risks. I also think it is important for you to work together so that sustainability-related information becomes more harmonised across firms. Here, I see the industry associations playing an important role. Finally, I would like to encourage you to be involved in the ongoing EU work—take advantage of the possibilities to provide feedback to announced proposals. We must all be humble with regard to the difficulty of the task at hand. A central contribution to this work is for you to share your experiences about which measures are taking us forward and in the right direction and which are not. Also, see to it that you prepare for, and adapt your operations to, pending legislation, standards and guidelines.

The financial system cannot drive sustainable development on its own; the ultimate responsibility lies with the political system. However, the financial system can play an important role in identifying, measuring and pricing risks and in conveying relevant information that makes it possible for the right investments to happen, thus contributing to an orderly and efficient transition. If we succeed, it can make a real difference. For the environment and climate, for peoples' living conditions, and for financial stability.

And, actually, it can be really good business for firms that show they can rise to meet the challenge.

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I would also like to take this opportunity to say a few words about the work to combat money laundering. Money laundering is a criminal activity that greases the wheel for other crimes. Through money laundering, it is possible for criminals to enjoy the benefits of their criminal activities. Money laundering must be combatted.

Money laundering is a cross-border activity. A lesson learned from the European Commission's general review of EU banks is that cross-border anti-money laundering efforts have fallen short in several ways. In many cases, banks have not taken responsibility at the group level for money laundering work in foreign subsidiaries. At the same time, the cooperation between supervisory authorities in different countries has not been strong enough.

The most recent money laundering directive, AML5, the Swedish implementation of which will soon be decided by our national Parliament, provides improved conditions for greater cross-border cooperation between authorities. At FI, we have already started to work this way. We should have done it earlier, but now we and the Baltic supervisory authorities are doing it for the first time. This means that we are working together—both strategically and operationally.

Let me also say a few words about the ongoing money laundering investigations into Swedbank and SEB and the timetable going forward.

Both investigations are extensive and have a broad approach. We need to assess the Swedish banks' management and control of money laundering risks in their subsidiaries in three different countries—Estonia, Latvia, Lithuania—all the way back to 2007. The investigations began in April and are being carried out in cooperation with the supervisory authorities of the three Baltic states, which are also conducting their own investigations or other supervisory activities to assess the subsidiaries' compliance with local regulations.

In the summer, we finalised verification letters, in which we presented our preliminary observations and assessments. Swedbank and SEB will respond to these letters during September. The investigations will then continue with FI evaluating the banks' responses and making an assessment about whether our preliminary observations still stand. FI is planning to present the results of the investigations at the latest at the beginning of next year, which is later than what we previously communicated. It is important to emphasise that we currently do not know what the final assessments of the two banks in question will be. However, if we were to decide that we want to start a sanction case, we would then inform the company in question and also disclose that a sanction case has been started.

The primary reason that our work is taking its time is the large volume of investigation material; this material includes data from not only parent banks and subsidiaries, but also covers a long period of time.

In addition to the investigations, we are making considerable efforts to enhance the supervision in the area of money laundering—by reprioritising our activities, redistributing existing supervision resources, and, in particular, strengthening the international cooperation within this area.

If we were to receive more resources, this would provide scope to further expand and intensify our supervision. This means primarily more frequent investigations of the more than 2,000 firms that are under our supervision. And these investigations will then be both broader and more in-depth so we can follow up continuously on whether the banks are in compliance with all of the steps in the anti-money laundering regulations. We will also need to develop methods of analysis (e.g. risk classification tools) and methods to cooperate and to increase the exchange of information with other authorities, in particular the police.

We are also prioritising further development of the international supervision cooperation. This means coordinating concrete supervisory actions between authorities in different countries. This also applies to qualified exchange of experiences and information-sharing. Because efforts to combat money laundering focus on a bank's organisation and internal control, there are also strong links between anti-money laundering supervision and regular prudential supervision. Therefore, matters related to money laundering should have a permanent place in the agenda of the supervision colleges for the major banks that FI participates in together with other national supervisory authorities.

Forceful efforts to combat money laundering are of great importance for the public's faith in banks and government authorities. Our roles differ, but both FI and the industry have a lot of work in this area for a long time coming.