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ESG REGULATORY TRENDS
IN MEXICO



Mexico has a privileged geographical location and an impressive biodiversity system, which is necessary for our economy and even for neighboring countries. Convinced of the importance of caring for this biodiversity, Mexico has adopted international commitments, since the projections and scenarios of droughts, floods and natural disasters in the next decade will probably affect and cause disruption in the supply chains due to climate change, which denotes the urgent need to adapt and implement mitigation measures in the short and medium term.

This requires a solid regulation framework and qualified authorities on the matter. Although Europe and the United States are more than a decade ahead of us in this regard, Mexico has been designing, for some years now, a comprehensive Environmental, Social and Corporate Governance (ESG) strategy, which we will review below.

HOW IS MEXICO DOING IN TERMS OF ESG?

In 2020, a dedicated Sustainable Finance Committee with expertise and dedication in ESG matters was created, whose main objective is to analyze and issue recommendations on sustainable finance that contribute to the stability of the financial system and the mobilization of capital towards projects with positive environmental and social impacts for Mexico.

This Committee is chaired by the Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*) ("SHCP") and is comprised of the Bank of Mexico (*Banco de México*) ("Banxico"), the National Banking and Securities Commission (*Comisión Nacional Bancaria y Valores*) ("CNBV"), the National Insurance and Bonding Commission (*Comisión Nacional de Seguros y Fianzas*) ("CNSF"), the National Commission of the Retirement Savings System (*Comisión Nacional del Sistema de Ahorro para el Retiro*) ("CONSAR") and the Institute for the Protection of Bank Savings (*Instituto para la Protección al Ahorro Bancario*) ("IPAB"), together with 6 independent observers from the private sector, such as the Mexican Banking Association (*Asociación de Bancos México*) ("ABM"), the Mexican Association of Insurance Institutions (*Asociación Mexicana de Instituciones de Seguros*) ("AMIS"), the Mexican Association of Retirement Fund Administrators (*Asociación Mexicana de Administradoras de Fondos para el Retiro*) ("AMAFORE"), the Mexican Association of Stock Market Institutions (*Asociación Mexicana de Instituciones Bursátiles*) ("AMIB"), the Mexican Association of Market Research Agencies (*Asociación Mexicana de Agencias de Investigación de Mercado*) ("AMAI") and the Mexican Council for Sustainable Finance (*Consejo Mexicano de Finanzas Sostenibles*) ("CMFS"). We have a solid scaffolding for the implementation of the necessary regulation. Where are we and where are we going?.

The Committee consists of four working groups: (i) Sustainable Taxonomy, (ii) Measurement and incorporation of ESG risks, (iii) Capital mobilization, and (iv) Outreach and implementation of ESG standards. Each of these working groups has carried out a series of measures and actions aimed at shielding the financial system from climate risks and turning it into a promoter of a sustainable finance approach that permeates the rest of the economy.

WHAT REGULATORY FRAMEWORK DO WE HAVE IN MEXICO?

The regulatory framework in Mexico is broad and very rich, particularly with respect to its Environmental and Social pillars; in the Corporate Governance pillar it is limited and unfortunately some companies and boards of directors are still managed in Mexico in a controlled and even closed manner, due to the family nature of some cases; it is only through the implementation of best practices that businesses are finding the advantages of adopting sustainability measures to increase productivity and reduce contingencies. The Social pillar covers extremely important issues that few are aware of,

from the impact in situ where a project is carried out, consultations with indigenous communities, the defense of human rights and non-discrimination, diversity and inclusion aligned with the business and on boards of directors, and especially after the reforms of the current administration in labor matters, the importance of health and safety at work, the protocol to eliminate workplace violence, to cybersecurity, the protection of personal data and business continuity plans in the event of disasters. All of the above is already duly regulated, and it is expected to continue reforming social issues such as the reduction of the salary gap and the increase in paternity leave.

To promote sustainability in our country, the Mexican government has implemented a regulatory, programmatic and evolutionary framework that considers the country's socio-environmental circumstances and seeks to address the main national priorities, such as:

- The National Development Plan 2019-2024.
- The National Strategy for the Implementation of the 2030 Agenda.
- The National Program for Financing Development 2020-2024.
- The Special Program for Climate Change 2021-2024.

We have a General Law on Climate Change (*Ley General de Cambio Climático*), which was published on June 6, 2012 and amended in 2023, which is a law of public order, of general interest and enforceable throughout the national territory, which establishes provisions to address the adverse effects of climate change in our country.

It regulates the provisions of our Federal Constitution regarding environmental protection, sustainable development, preservation and restoration of the ecological balance. It guarantees the right to a healthy environment by promoting that the federal entities and municipalities develop and apply public policies for the adjustment to climate change and the mitigation of greenhouse gas emissions.

Gracias a que México cuenta con un Atlas de Riesgo y con un Atlas Nacional de Vulnerabilidad al Cambio Climático, documentos dinámicos que orientan la realización de estrategias dentro del proceso de planeación y adaptación al cambio climático, es que contamos con herramientas indispensables para la toma de decisiones identificando los municipios y las vulnerabilidades a las que se encuentran expuestos. Más de la mitad del territorio en nuestro país, es decir el 59% de los municipios en México, es decir, 1448 municipios presentan "muy alta" y "alta" vulnerabilidad en por lo menos 1 de las 6 vulnerabilidades específicas: ambiental y ecológica, física, económica, social, educativa, cultural e ideológica, política e institucional, y, científica y tecnológica.¹

Due to the fact that Mexico has a Risk Atlas (*Atlas de Riesgo*) and a National Atlas of Vulnerability to Climate Change (*Atlas Nacional de Vulnerabilidad al Cambio Climático*), dynamic documents that guide the implementation of strategies within the process of planning and adaptation to climate change, is that we have indispensable tools for decision making by identifying the municipalities at risk and the vulnerabilities to which they are exposed. More than half of the territory in our country, which means, 59% of the municipalities in Mexico, meaning 1448 municipalities present "very high" and "high" vulnerability in at least 1 of the 6 specific vulnerabilities: environmental and ecological, physical, economic, social, educational, cultural and ideological, political and institutional, and scientific and technological.

The General Law on Climate Change regulates emissions of greenhouse gases and compounds, creates and strengthens national capacities to respond to climate change, promotes education, research, development and transfer of technology and innovation and outreach on adaptation and mitigation to this phenomenon, promotes the transition to a competitive, sustainable, low-carbon and resilient economy to extreme hydrometeorological phenomena associated with climate change, in such a way and based on all of the above, it establishes the basis for Mexico to contribute to the fulfillment of the Paris Agreement. Likewise, in environmental matters we have a broad and very complete regulatory framework which is indispensable to know in order to reduce contingencies.

WHAT TRIGGERED THE CAPITAL MOBILIZATION TOWARDS ESG PROJECTS?

What triggered the capital mobilization in a more serious and compelling way to projects and activities with ESG focus, was when CONSAR issued in 2019 a mandatory regulation, so that the *Afores* as of January 1, 2022, would disclose information on the consideration of ESG factors in terms of investments, risks, transparency and use of corporate rights. This was the first mandatory regulation for pension fund managers to include ESG criteria in their investment decisions in a real and efficient manner, creating a virtuous circle through which the projects and companies in which they invested began to request the same ESG information they were required to provide to their stakeholders: suppliers, value chain, among others.

In 2022, the CNBV launched a self-diagnosis tool for ESG factors and climate-related risks for issuers and financial institutions in order to sensitize these actors for the integration and disclosure of ESG information, with a view to future regulation on the matter. Certainly, the authorities have been paving the way for the regulation that we expect the SHCP to issue by the end of this year.

HOW DOES SUSTAINABLE TAXONOMY WORK IN MEXICO?

On March 23, 2023, the first Sustainable Taxonomy for Mexico was issued, although it is voluntary, it is a benchmark for capital mobilization. At the end of 2023 alone, Mexico had the record in sustainable financing with 131 issuances of thematic bonds with \$119 million pesos distributed through 40 issuances, surpassing the amount of the previous year by 48%.

A taxonomy is a reliable, legitimate, and unified classification system that identifies assets or investment projects with positive environmental and social impacts, based on established goals and criteria. The objective is to provide certainty and transparency to financial markets, encourage investment in sustainable activities and better track financing flows for sustainability, providing greater clarity, certainty, and security to the markets with precise and consistent definitions. It is difficult to see with the trends mentioned above, that future financing or bonds do not already contemplate a sustainability label.

Mexico's Sustainable Taxonomy includes 124 eligible activities in 6 clearly identified economic sectors, as well as their respective metrics, thresholds and no significant harm (*no daño significativo*) ("NDS") criteria, and presents the technical evaluation criteria (*criterios de evaluación técnica*) ("CET") for activities related to climate change adaptation and mitigation objectives. All this with the aim of laying the foundations for the promotion of capital mobilization towards projects with positive environmental and social impact, providing certainty and transparency to the Mexican financial system, contributing to the closing of social gaps, reducing and mitigating vulnerabilities to climate change. It is a pioneer, since unlike Colombia's Green Taxonomy, which focuses on the environment, Mexico's recognizes the great need to reduce social inequalities and includes a Gender Equality Index (*Índice de Igualdad de Género*).

In September 2023, the SChP presented the Sustainable Financing Mobilization Strategy (“EMFS”), which seeks to promote the transformation of the Mexican financial system towards a more sustainable, equitable and inclusive development, through a massive increase in public and private sustainable financing. The EMFS is based on three pillars: (i) Sustainable public financial management, (ii) Mobilization of sustainable financing, and (iii) Cross-cutting actions.

At the international level, on January 1, 2024, the International Sustainability Standards (“IFRS S1”) and (“IFRS S2”) came into force, which require an entity to disclose financial information about its risks and opportunities related to sustainability, which are reasonably expected to affect its cash flows, its access to financing and its cost of capital in the short, medium and long term. Such information will be indispensable for primary users of financial information in their decision making related to the provision of resources.

In Mexico, work has been ongoing on the “General Standards for Sustainability Disclosures” or NIS 1 and NIS 2, which will come into force on January 1, 2025. CINIF, an independent body created in 2004, is the Mexican Council for Research and Development of Financial Reporting Standards, which, in line with the global trend, assumes the role and responsibility of issuing accounting standards in Mexico. The NIS must be observed by both public and private entities and must disclose, starting next year, 30 environmental, social and corporate governance indicators, sustainability information whose primary users will be investors and creditors, as well as entities involved in their value chain. In order to generate impact and be able to make use of such information, it must be comparable, verifiable, timely and understandable. The information that every company must disclose will vary from waste management and the use of renewable energy, to how it manages equal opportunities for decent work and reduction of the salary gap, as well as diversity in independent board members and solid integrity and ethics codes, to indispensable topics given the advance of technology, such as information security and protection and privacy of third-party data.

An additional step forward is the publication on August 11, 2023, of the “*Modificaciones a las Disposiciones de carácter general que establecen el Régimen de Inversión al que deberán sujetarse las Sociedades de Inversión Especializadas de Fondos para el Retiro*”, which allows the Afores to provide evidence of compliance with the criteria established by the Risk Analysis Committee. Recognizing that the Afores require tools to face possible events that put at risk (i) their operations in the investment processes, (ii) the financial risk management processes, (iii) their securities monitoring system, the guidelines with respect to the mitigation of operational risk were specified, so that thanks to these amendments, they must have (i) a Business Continuity Plan (Business Continuity Plan or BCP, (i) a Business Continuity Plan (BCP), which must allow the continuity in the provision of services and the performance of critical processes of the respective Afore and its investment companies, as well as the timely reestablishment and mitigation of the effects of a disaster, and (ii) a Disaster Recovery Plan (DRP), which is a set of processes and procedures to protect and have the capacity to recover the information technologies of the respective Afore and its investment companies in the event of a disaster. It also establishes the criteria and alignment with Mexico’s Sustainable Taxonomy, linking both regulations and strengthening the framework for the disclosure of sustainable information. With these modifications we have achieved better protection of workers’ resources and reduced the impact of contingencies.

WHAT IS EXPECTED IN THE FUTURE IN TERMS OF REGULATION?

The Securities Market Law (LMV) and the Investment Funds Law (LFI) were amended on December 28, 2023, being of special interest Article 9 of the LMV by means of which the SHCP, prior opinion of the CNBV, *“shall establish general provisions in the areas of sustainable and sustainable development, as well as to strengthen gender equity, aimed at promoting, inform and evaluate the adoption of best practices in such matters by stock exchange corporations, stock exchange investment promotion corporations, issuers, simplified issuers, brokerage firms, stock exchanges, securities depository institutions, central securities counterparties, price providers, companies that manage systems to facilitate securities transactions and securities rating institutions”*. It is important to highlight the fact that the SHCP is the authority empowered to issue the secondary provisions, which must be done before December 29, 2024.

During 2024 we will certainly see ESG regulatory activity in Mexico and it will be a year to prepare companies, businesses, workplaces and boards of directors in ESG matters. Although in some countries such as the United States the ESG issue is politicized depending on the election season, it is a fact that the global business case is proven and the benefits are proven, both by the most advanced countries in these issues, as well as by the companies that have implemented ESG policies: benefits such as higher productivity, reduction of contingencies, attraction of talent, greater innovation and creativity. The effects for climate change will cause disruptions in the production and distribution chains, and will increase the incidence of natural disasters in the next decade, so having ESG policies in place will be essential to overcome such disruptions as a country and as a business.