The regulatory reality of making trade sustainable

Executive Summary

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Key findings

This report is a wake-up call to everyone who is engaged in trade or trade finance. Trade and trade finance have the potential to enable the world to transition to more sustainable ways of operating environmentally and socially by incentivising the right source of targeted and tailored lending in line with the UN's Sustainable Development Goals (SDGs) according to members of ITFA. Enabling trade finance to achieve these goals needs to be approached pragmatically – it is often associated with hard commodities that do not play well with a specifically "green" agenda and trade itself creates externalities such as pollution that differs between sectors and geographies.

According to interviewees, if trade finance is to catalyse a fair transition to more sustainable models, there needs to be common standards of regulatory reporting, a commitment to work on consistent and generalisable data standards from within banks, and a more inclusive approach to dialogue with regulators that ensures that the social aspects of sustainability are treated equally to the environmental ones.

However, the current regulatory structures that govern sustainability reporting are creating a raft of unforeseen consequences that will ultimately militate against the long-term objective of meeting sustainability targets globally in the long run. These unforeseen consequences are the result of a market distortion that is providing perverse incentives to banks and has the potential to:

1. Disincentivise lending the transition to more sustainable business models because there is no favourable regulatory capital for Environmental, Social and Governance (ESG) or "green" deals compared to non-transition or "brown" financing.

2. Rely on a backward-looking risk-based approach to sustainability that does not model transition risk on reasonable time frames for climate change.

3. Widen the trade finance gap in emerging markets and for smaller businesses in supply chains.

4. Replace "green-washing" with "green-hushing" where minimum regulatory reporting becomes the norm where achievable, modest, targets are set to avoid accusations of green-washing.

5. Where the "S" in ESG, is under-incentivised because it is an intangible and hard to measure compared to the "E" part.

6. Where the focus on "E" creates a barrier to the development of appropriate frameworks based on "S" in emerging markets and Africa in particular.

This "regulatory paradox" is the basis of the report which is based on 40 semi-structured interviews with ITFA members and a survey representing one quarter of the organisations across the ITFA membership. To summarise:

- Nearly 60% of banks, credit insurance businesses and fintechs surveyed had ESG as one of the top Key Performance Indicators (KPI) or the top KPI for their organisation. 71% said they had become more focused on ESG matters in the last year and 51% said that more budget had been allocated to ESG. However, interviews suggested that no organisation has perfected this and that everyone is dealing with a "work in progress" in relation to regulatory reporting.

- Client facing objectives lay behind much of the work to develop internal and external ESG strategies. Nearly 90% of respondents said they saw provision of appropriate finance as a means of helping the planet to become more sustainable. 88% said it would create business opportunities and nearly 83% said it was a means of engaging with clients in a different way. 55% said an ESG focus was a new way of looking at their internal processes. Nearly 40% of respondents had a dedicated ESG cross-organisation function and for 30% responsibility for ESG was C-Suite.

- The majority of respondents were Europe-based and 65% said that the EU taxonomy was the most important regulatory reporting framework for their organisations, 59% said the EU's Sustainable Finance Disclosures Regulation was the most important, and 58% the global International Sustainability Standards Board.

- There is very little clarity on measurement standards. 78% said that the biggest challenge facing their organisation in relation to ESG was confusion over what to measure; 71% said that the biggest challenge facing their organisation was how to measure ESG. Interestingly, on 37% said that pressing regulatory pressures were a challenge.

- In terms of ESG strategy focus, 20% of respondents said that their ESG strategy would be focused on dialogue with clients, while a further 19% said that they would be focused on regulatory compliance. These were the two strongest areas of focus and points to the two roles of ESG strategy – a product based, client facing one, and a regulatory one. This was also reflected in the interviews which pointed to an organisation pivot towards more values-driven strategies internally and externally. The biggest revenue driver from ESG policies was 72% saying they saw an uplift in revenues from pricing products for transition of up to 25%.

- Trade finance was regarded as a special case within the regulatory frameworks for ESG that are emerging with 25% saying this was because of the need to have transactions-level measurements, and an additional 22% saying that the scale of the reporting requirements made it distinctive. Interviewees pointed to the fact that trade finance is not well understood by the regulatory community or the ESG community and that a united voice to regulators to explain how trade could be made more sustainable through targeted lending to deep tiers in supply chains was essential.

- Credit insurance is a mechanism for supporting trade finance through creation of appropriate risk assessment tools (33%), creation of common measurements (28%) and creation of common sustainability definitions (28%).

- Technology can help support trade finance provide transition support to their clients by automating ESG risk assessments (84%) and providing systematic and consistent data (84%). ESG measurement in deep tier supply chains was seen as a key area for Fintechs by 80% of respondents, as was data aggregation and automation of standards benchmarking. However, many saw the role of Fintechs as being restricted by the lack of common audit standards.

This was action research – to investigate and to try and address the problem of regulatory reporting and capital requirements in trade finance. The report concludes with three clear recommendations based on the ITFA membership's feedback:

1. To establish an Audit Council that takes leadership with other representative organisations for being the "single voice" to regulators that the ITFA members regarded as essential.

2. To establish a common data pool to share experience of scenario modelling and climate-related financial risk that creates common ground in defining the dimensions, data and testing requirements for environmental, social and governance parameters as they relate to financial risk.

3. To include credit insurance, African and emerging market and smaller trade finance providers in the Audit Council and approach to data modelling in the interests of preserving the trade finance ecosystem which is currently endangered by "one size fits all" regulatory incentives. This will allow appropriate weightings and measurements to be developed.

The risks of not acting quickly far outweigh the risks of doing something. There was a general sentiment amongst members that starting somewhere and adjusting methodologies was the way forward to allowing an appropriate structure to evolve that met regulatory requirements and that provided appropriate incentives for transition. Trade finance has strict governance rules that apply globally. This framework is adaptable to achieve a consensus around audit standards and regulatory reporting that can be adjusted for different socio-economic and sectoral conditions.

If this challenge is not addressed quickly by the industry there is a real risk of reputational damage and failure of trade to deliver a long-term goal of supporting sustainable global trade through the financial products it provides. This is a monumental task and will not be easy. But it is also a once in a generation opportunity that future generations need us to seize.

Methodology

The purpose of conducting both an overview of the regulatory requirements and taking such a strong sounding of trade finance providers was to enable an action-research process in the future. Action research is a specific methodology that attempts to investigate and solve an issue simultaneously and is aimed at changing practice and behaviours to resolve problems.[i]

In the context of this report, complexity in the emerging regulatory structures is undermining attempts to address the market failures of climate change and inequality. Since these are endemic externalities from the operation of markets post industrialisation, there is clearly a need to change the behaviours of all economic actors, regulators, finance and corporates alike. In the words of one interviewee, "The regulators complain that the banks don't have a unified voice to promote one method of measuring sustainability; the banks complain that they get no steer from regulators on what they need to report in relation to sustainability."

The action-research approach here identifies a communications challenge between the two parties and uses the authority of a large sample of trade finance providers to provide the first overview of the challenge from their perspective. So this report becomes such a summary for communication purposes while also laying down the foundations for delivering action through, for example, aggregating the various reporting standards and developing education programmes. For an action research approach to work, this report should be the beginning of a process and not the final word.

The action-research approach was conducted in three stages (the second two in parallel):

1. A review of the regulatory literature to identify the principles and the weaknesses of emerging ESG reporting and capital requirements.

2. A survey of members to test the responses from semi-structured interviews and establish ITFA members' attitudes to regulations and ESG.

3. A series of semi-structured interviews with 68 individuals from 40 organisations to identify key challenges, current practice in response to regulatory requirements and suggestions for action in the future.

Figures A1 – A3 show the key sample statistics. Note ITFA consists of some 300 member organisations, so the survey is of 24% of ITFA membership.

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i https://www.sagepub.com/sites/default/files/upm-binaries/36584_01_Koshy_et_al_Ch_01.pdf

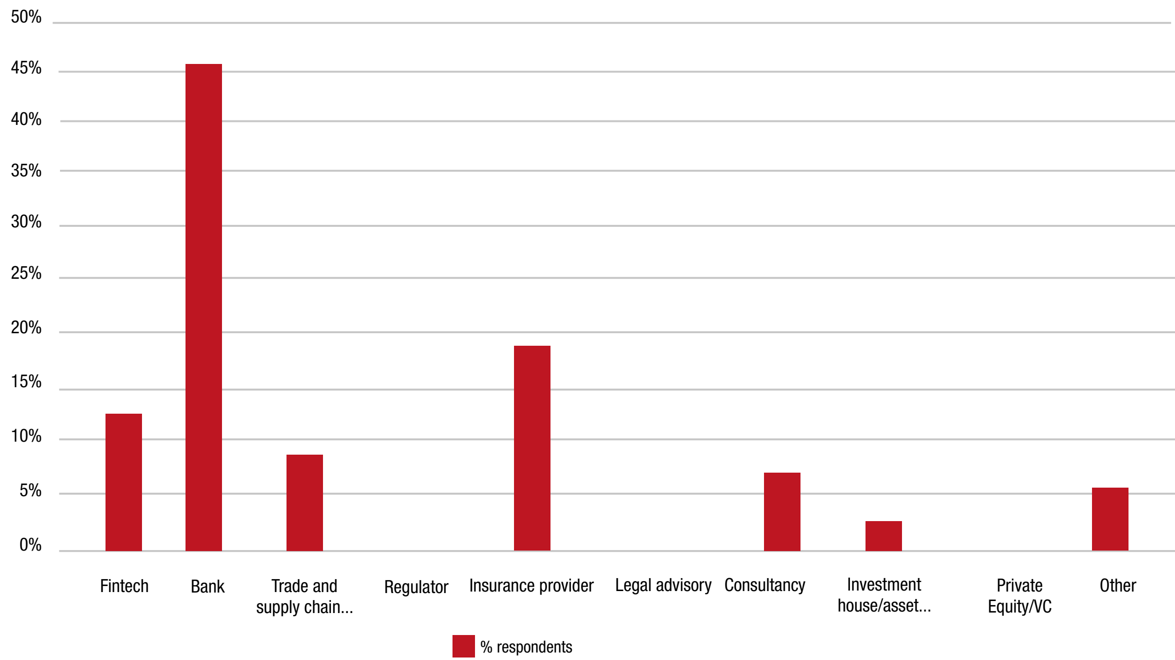

Figure A1: Types of respondent
N = 72

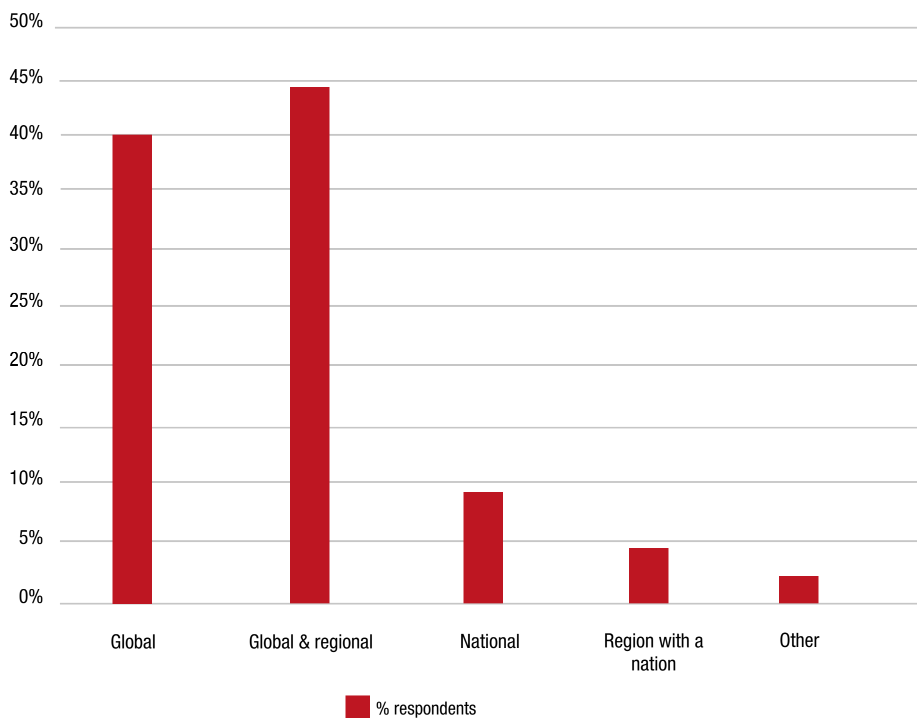

Figure A2 Location of respondents
N = 72

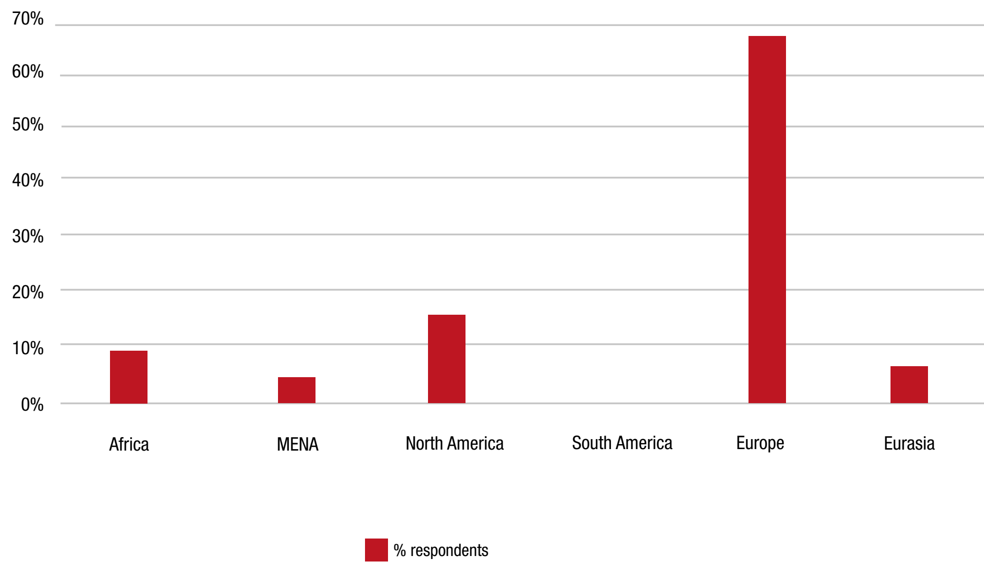

Figure A3 Geographic reach of respondents
N = 72