The Regulatory Paradox: why it matters to trade finance and what we can do about it

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What our research has told us already

There are limitations of regulation as a means of managing the transition to more sustainable trade and supply chain models, according to the ITFA ESG Committee's May 2023 report.[1] The research suggests that the current regulatory approach to sustainability reporting for financial institutions restricts the capacity of banks and their clients to invest in longer-term projects that prioritise a transition to more sustainable business models. More than this, there is an increased likelihood of "greenhushing", or under-reporting, to avoid accusations of greenwashing.

This is a Regulatory Paradox. In other words, the longer-term interests of global society and the planet are being disincentivised by regulatory structures that are focused on both the past and the financial risks associated with lending now.

Yet the reasons why it is happening is intrinsic to the way capital market regulation works. Almost by definition, regulation is there to avoid financial crises in the future using the lessons of the past. Energy transition and decent work are critical to our future but, without substantial change, the approach will always be backward-looking and risk based. As a result, capital treatment will always be the same for all lending, whether short or long term and, more importantly, whether it is vital to the future of our planet or not.

For trade and supply chain finance the results are profound. Any trade finance is complex, high frequency and multinational; it is very short term and has lower risks of default.[2] However, there is no differential capital treatment for trade finance generally and export, project or supply chain finance directed towards transition projects specifically. This means that practitioners will not experience any collateral benefits any from "transition" funding and the costs of funding these projects are borne by the financial institution itself.

So, the regulatory paradox in action produces a raft of unforeseen consequences, quite apart from "greenhushing" which are existential for trade and supply chains across the world.

An important area where the regulatory paradox causes concern is around the inconsistent reporting requirements around the world. Sustainability reporting on climate is mandatory in the UK and the EU; in the EU, sustainability reporting is not restricted to climate but instead includes a "double materiality" component whereby organisations and their financiers must report not just on environmental, social and governance risk and their mitigation, but also on what they are doing to transition to more sustainable business models in the future.

Unforeseen consequences: why this matters now

The ITFA research has highlighted a number of additional unforeseen consequences, especially affecting emerging markets. For example, the putative "Global North's" regulations are focused on a narrow definition of sustainability that prioritises the "E", or environmental aspects of ESG. However, the requirements of economic development in the "Global South" and particular the African continent, mean that the S, or social, aspects of Environment, Social and Governance reporting are more important. A coal mine may raise flags for an organisation in the global North, but in the Global South, that mine is a source of employment, income and social cohesion.

This means a traditional view of the win-win benefits of trade is potentially challenged, or even compromised, by regulations that are focused too stringently on climate-related financial risk rather than transition. Such a consequence for trade and the advocates of a multilateral approach to trade is unimaginable and presents risks in the form of stronger compliance and data collection requirements that may militate against their own transition.

Similarly, smaller businesses in deep tier supply chains will need to collect data and comply with regulations as well, particularly under the EU's pending Supply Chain Act and Sustainable Finance Disclosure Reporting (SFDR). Companies as small as €150m will be affected by 2024 and if they cannot provide the appropriate data, they may well fall out of supply chains or fail to access appropriate finance. This could lead to the trade finance gap for SMEs widening – especially but not only in emerging markets.

Where the regulatory paradox starts to bite

Regulators in the EU and the UK have said that they will impose fines where regulations are not met.[3] In other parts of the world, the requirements are not as punitive. Our report highlights the risks of regulatory arbitrage where businesses locate to take advantage of less stringent regimes making Europe uncompetitive over a period of time despite the best intentions of everyone.[4]

This is strong stuff but, based as the ITFA ESG committee research was on a representative survey of their members and 40 in-depth semi-structured interviews with regulated entities in the trade and trade finance space, the results are important. Just 18 months ago it was pointed out that only $1 in every $5 of trade finance is contributing positively towards Sustainable Development Goals (SDGs).[5] At the time, a burgeoning international regulatory framework around sustainability offered the opportunity to be forward looking and to use capital and pricing to incentivise transition.

The Regulatory Paradox that the ITFA research has uncovered as a consequence of current regulations means that this opportunity is likely to be missed. The importance of such a miss cannot be understated for emerging economies, for the planet and for financial organisations themselves who want to enable a just transition towards more sustainable business models.

So, what do we need to do to enable a Just Transition?

There are no simple answers as the magnitude of the problem is hard to under-state. But the banks who were interviewed as part of the research were uniformly agreed on the need to start somewhere. Two areas of particular focus were identified in the ITFA research:

First - creation of common audit and data standards

There are only limited attempts to create a coordinated approach to regulatory audit standards and even fewer that apply specifically to trade. While this remains the case, it is more likely that regulations are applied inconsistently. Businesses, trade bodies and associations place varying priorities on ESG measurement and standardisation, on achieving net zero targets, and on developing the digital technology to enable measurement through supply chains. A cross-industry approach so that some of the unproductive formalism, that is, multiple and non-standard reporting, of the Anti-Money Laundering/Know Your Client regimes can be avoided is imperative, including working with the various rating/scoring agencies and businesses - to implement agreed audit standards, similar to what is already in place for financial reporting. This will define the "how" of compliance with regulatory reporting requirements which currently are prescriptive on what but open to interpretation on methodology.

Second - creation of a shared data repository

There will always be some ambiguity around the capital treatment of sustainability for as long as data collection methodologies and data modelling techniques are under-developed. At present, financial disclosure requirements and reporting frameworks are being standardised[6] by the IFRS[7] by integrating the International Sustainability Standards Board, the Sustainability Accounting Standards Board (SASB),[8] and the Global Reporting Initiative.[9] The streamlining of standards like this will be a significant step along the road of making disclosures comparable and consistent and, since they also include the measurement of sustainability over time, they may also add to the understanding the transition towards more sustainable business models, and the financial risks during that process.[10]

However, these frameworks have two main weaknesses in the context of trade finance.

- First, they are survey-based and so not scalable into the trade finance context where data needs to be collected at a higher frequency and on a transaction basis across complex supply chains that have social considerations because of their global reach as well as environmental ones.

- Second, while there are statements about what needs to be collected (data on scope 3 carbon emissions, for example), there are few signals on how to do this. As a result, every organisation will continue to measure their own data in their own way within the evolving frameworks meaning that the benchmarking and consistency may still be less than optimal.

The combination of these two factors will make it difficult to run scenario models on consistent data for some time to come. Further, at present the focus of the IFRS is on climate factors only. While this simplifies the process of data collection and is understandable, there are limitations, both in terms of the applicability to trade and supply chain finance and, more importantly, in terms of the differing requirements of the EU Taxonomy frameworks.[11]

All of this makes a shared data repository imperative. Such a data repository should cater specifically for the needs of trade and supply chain finance at a transactions level and integrate the consistent and comparable reporting standards defined by the audit standards work into frameworks that cover not only ISSB but also the EU Taxonomy and emerging taxonomies in the UK, Australia, Japan and elsewhere. This would allow scenarios to be built and a greater consistency of understanding about the sustainability-related financial risks inherent to the transition towards more sustainable business models to be developed.

The establishment of common audit standards and a data repository are clearly co-dependent but there are a number of critical elements that will underpin the success of any such organisation:

1. It should be independent of any single interest group.

2. It should monitor the transition to more sustainable business models across all environmental, social and governance dimensions as an ultimate goal.

3. It should incorporate the interests of the trade finance ecosystem including smaller banks, and emerging markets.

4. It should develop modelling capabilities that demonstrably address the issues of false incentives in current ESG reporting.

5. It should foster collaborative, pre-competitive data-sharing between trade and supply chain finance organisations.

6. It should produce consensus data analytics based on a clear definition of the dimensions of sustainability, testing of models and data collection techniques and have the capacity to associate causally the climate related reporting data and financial risks.

An institutional framework around audit standards and data collection would potentially remove inefficiencies inherent in the current system and allow the exchange of best practice between larger and smaller organisations across the trade and supply chain finance ecosystem globally.

The next steps

ITFA has taken these messages from the report seriously and is committed to establishing a Sustainable Trade Foundation (STF), which will be independent using the UK Community Interest Company structure. Its uniqueness is in:

1. The combination of defining the "how" behind comparable audit standards and developing the shared data repository to allow trade and supply chain finance professionals to model their own sustainability performance against an industry benchmark and understand the intrinsic financial risks associated with sustainable trade and supply chain finance.

2. The cross-industry scope of the work it will do and the membership of its Advisory Board.

STF Vision

The vision of the STF is to provide a common standard for ESG reporting in the interests of transparency and achieving a measurable and reportable net-zero, avoiding greenwash on one hand, enabling comparability and regulatory ease on the other.

STF Scope and Remit

The STF's remit will eventually be to cover all aspects of E, S and G. However, it is recognised that this is a monumental task thus the STF will limit its scope in the first year to metrics around Net Zero. Additionally, the STF will focus its attention on net zero in the first instance but has a broader ambition to deliver its findings and audit standards across the ESG mix around the world. This broader ambition will be reflected in its international membership.

STF Aims and Objectives

The overall aim of the STF is to create a commonly understood and applied ESG metric or "passport" that works at both an entity and transaction level, for businesses, finance providers and regulators. The foundation would do this by achieving the following aims:

- To provide a shared and collaborative understanding of the difficulties in "auditing" for ESG, by means of Board level collaborative workshops and practitioner-led research.

- To agree core measurement standards and data for ESG such as sustainable development goals (SDGs) and taxonomy compliance.

- To utilise OECD product code metrics and other tools for their practical application at an entity and transactions level.

- To create a shared data repository to support the audit standard based on agreed, existing metrics and standards that will be supported by the industry and presented to the regulator by the Advisory Board which will be cross-industry and associated with the ITFA ESG Committee.

- To work with existing initiatives across the sector to implement these standards, (digitally, where possible).

- To ensure inclusiveness by working with practitioners and representatives from emerging markets to understand their requirements in relation to ESG standardisation.

Indicative Timelines

September 15th 2023: Expressions of interest in supporting year 1 funding from major trade finance organisations

September 30th 2023: Registration of STF with Companies House – founding members agreed

October 11-15th 2023: ITFA annual conference, Abu Dhabi – launch of STF with founding members announced

November 1st 2023: STF begins its work

Endnotes

1 Dr. Rebecca Harding and the ITFA ESG Committee (May 2023): The Regulatory Reporting Reality of Making Trade Sustainable”
https://itfa. org/the-regulatory-reality-of-making-trade-sustainable-may-2023/

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4 Dr. Rebecca Harding and the ITFA ESG Committee (May 2023): The Regulatory Reporting Reality of Making Trade Sustainable”
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https://flow.db.com/trade-finance/trade-s-sustainability-challenge

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