ITFA ESG RESEARCH OVERVIEW: BANKS FAILING TO FIND CONSISTENT APPROACH TO REGULATORY SUSTAINABILITY REPORTING

Written by Rebecca Spong Editorial Consultant, October 2023

The world's largest trade finance banks are being inconsistent in their use of regulatory reporting frameworks for sustainability, according to new research published by ITFA's ESG Committee.

This lack of consistency in reporting could hinder any efforts by the wider trade finance market to seek preferential capital treatment for transactions that are ESG-compliant, argues the report author Dr Rebecca Harding.

This in turn could disincentivise the market from providing the necessary financing needed to support the global transition to a more sustainable low-carbon future, she says.

The research was conducted using AI techniques to compare the full regulatory reports of the 15 largest trade finance banks to see to what degree they match with the latest sustainability standards framework – as set out by The International Sustainability Standards Board (ISSB) in June.

The new framework outlines common language to use when disclosing the impact of climate risks on a company's business outlook. It is an extension of the original framework outlined by the Sustainability Accounting Standards Board (SASB).

The research found that 13 of the 15 banks analysed use their own approach to regulatory reporting rather than focus on a specific regulatory framework. None of them fully complied with SASB regulatory frameworks. There were also no common compliance methodologies used by the banks studied.

This new research builds upon Harding's previous research paper published in May, which investigated what she has coined the "regulatory paradox" – a term describing how current well-intentioned regulations aimed at managing financial risk are inadvertently making ESG-related financing less attractive to banks.

Harding says this latest research is a "wake-up call" for the trade finance industry to really come together to create change.

Sean Edwards, ITFA chair agrees, saying: "What this report has shown is that formative work still needs to be done to achieve the best possible partnership between the two sectors. Crafting reporting standards that work for everyone will focus minds and energy on the most efficient and effective way of delivering sustainable finance."

ITFA has already taken the first steps towards improved reporting standards with its proposed creation of an industry-level entity – provisionally known as the Sustainable Transition Foundation (STF). It will be an independent body that aims to create common and consistent audit standards for sustainability reporting.

Harding sits down with ITFA to further discuss the challenges of the "regulatory paradox" and how this latest research lays the ground for ITFA to take a leading role in supporting banks to create a more sustainable future.

Q: This latest report helps illustrate the challenge of the "regulatory paradox" – a term you coined in your earlier research paper. Can you define what the 'paradox' is?

Harding: The regulatory paradox is this: current regulations are focused on a backward-looking approach and that backward approach – which is all risk-based – is militating against banks taking a proactive view on managing the transition into the future.

It means that if I am a bank, I have to adhere to certain regulations that aim to minimise financial risk from climate exposure. But the role of the regulator is to manage systemic risk, and so they are not really managing climate risk.

The purpose of having regulations is to help banks manage the transition. The paradox is that it is set up with the best of intentions – but it is having a reverse effect. Banks are looking to manage risk retrospectively. They want to work with clients to manage the transition, but that can't happen with regulations as they are at the moment.

Q: Is there a lack of incentive for banks to support the transition to a low-carbon sustainable future?

Harding: It is exactly that. There is no preferential capital treatment. There is no way of looking over a longer period of time. The scenario modelling banks are required to do for climate risk is the same period used when assessing capital risk. They are only looking at one to five years whereas climate risk can be up to 30 years. The problems we are seeing now are not to do with what happened yesterday or last year, but a function of what happened 30 years ago.

The problem we have is climate risk and sustainability risk are huge and very long-term. Obviously, in 30 years it might be a systemic problem for the financial system as well. But at the moment the way of modelling risk is to look backwards – and that tends to show that climate issues haven't been systemic and didn't affect our modelling in the past.

There is also a risk of 'green-hushing' – where banks don't know how to report climate risk and therefore, they are only reporting the bare minimum on ESG targets to avoid liability or loss of reputation through over-reporting and under-delivering.

Q: Can you give an example of a climate risk that could eventually become a systemic financial risk?

Harding: Let's consider that the icecaps are melting more quickly than we thought. Our current climate models say that there is a risk to sea levels in 50 to 100 years' time. Regulators say 'it's not our job to regulate the causes of climate change – we just want to know what the systemic risk of this scenario is'. The conclusion would be that there is zero systemic risk – the melting icecaps are only an immediate problem for those living very close to the Artic Circle. However, the melting icecaps will affect everyone's grandchildren and great-grandchildren, and if, for instance, a huge tidal wave hit Norway, that would be a systemic financial risk. But with our current backward approach, this kind of long-term risk can't be modelled. We are not going to create any change with the regulatory system as it is now.

Q: What do you see as the solution to this 'paradox'?

Harding: The second piece of research that I did tells you exactly what we need to do. The SASB and various other organisations have all come together to say we need to create some kind of interoperable standard. They are beginning to get the idea that all regulations need to say the same thing and have the same goals.

The research I've done matches SASB standards to the 2022 regulatory reports from 15 of the largest trade finance banks. A total of 13 out of 15 banks say explicitly they are developing their own models. Not one of them fully complies with SASB regulations.

Currently, everyone is doing their own thing – no one is complying with common standards and none of those standards are interoperable. We can't talk to regulators for preferential capital treatment for the transition because we are all doing different things.

There is also the problem of a lack of data, meaning we can't model scenarios. If we can't model scenarios we can't talk to regulators. But we have to start somewhere – someone has to jump on the train at some point and say we are doing it this way.

This is a wake-up call to the industry to act. What we need to do is say this is the benchmark, this is what we are going to use, and this is how we are going to pool that data and see where the risk is. This is particularly challenging in trade because of the nature of supply chains and the requirement to track all of this through the entire supply chain.

Q: Following the publication of this research, what are the next steps?

Harding: ITFA's initial sustainability report published in May identified the need to establish a separate and independent entity that focused on creating common, consistent, and comparable audit standards for sustainability reporting.

The plan is that this new entity should be structured as a UK-based Community Interest Company with the working name of the Sustainable Trade Foundation (STF).

This latest research forms the business-case for such an organisation in that it provides a starting point for gap analysis and data collection against the emerging frameworks.

The concept of the STF project is to develop both comparable audit standards and a shared data repository to allow trade and supply chain professionals to model their own sustainability performance against an industry benchmark. It has got to be independent; it has got to be cross-industry and it has to be very academic in what it does on the data side of things.

The remit of the new entity will be to cover environmental issues as well as social and governance issues. However, it will limit its scope in the first year to defining metrics around achieving net zero carbon emissions.

The full report on the 'Regulatory Paradox' is available here.