UNIVERSITY OF CAMBRIDGE
INSTITUTE FOR
SUSTAINABILITY LEADERSHIP

Incentivising the trade of sustainably produced commodities

A Discussion Paper prepared for the Banking Environment Initiative's Sustainable Trade Finance Council

Contents

About this discussion paper

This discussion paper was written by Andrew Voysey, Tamara Slater, Thomas Verhagen and Simon Tyler (Senior Associate) at the University of Cambridge Institute for Sustainability Leadership (CISL). CISL hosts the Secretariat for the Banking Environment Initiative (BEI) and this paper was informed by a range of industry practitioners active within the BEI's Sustainable Trade Finance Council, for which the authors are deeply grateful. This project has been part supported by the UK Foreign and Commonwealth Office (FCO). The opinions expressed in this report are those of the editorial team and not recommendations or official positions of CISL, the University of Cambridge, members of the Sustainable Trade Finance Council, or the FCO.

Executive summary

The Banking Environment Initiative's (BEI) Sustainable Trade Finance Council of banks, importers, traders and industry bodies was convened by CISL in early 2015. Its aim is to leverage banks' role as facilitators of international trade and thereby accelerate the transition to a world where importing sustainably produced commodities, at scale, is a new market norm. The Council has been building on the work of the BEI, including the Soft Commodities Compact and the Sustainable Shipment Letter of Credit, to help achieve this aim. A key focus of the Council to date has been to understand how to scale-up the role that banks can play in supporting the shift towards sustainable soft commodity supply chains. This question is relatively new to the trade finance industry and, while momentum is visibly growing, many issues remain to be worked through. The Council has therefore developed this discussion paper to set out the group's initial ideas and trigger wider debate throughout the industry.

Why is this work important?

Agricultural expansion is widely acknowledged as one of the greatest causes of tropical deforestation. Shifting to sustainable forms of production is known to offer developmental, economic and environmental benefits and companies, governments and civil society actors around the world are focused on achieving this transition. Trade finance is a primary driver in enabling the production, trade, shipping and processing of most commodities, and typically those linked with deforestation such as soy, palm oil, timber and beef. Responding to client needs, which differ depending on how deep into the transition they are, banks therefore have a unique role in working across commodity supply chains to support this journey. Banks' own motivation should go beyond innovating to align with client needs and enhancing their social value and also recognise the risks they may be exposed to if their business is behind the curve of this transition.

Expanding the product solutions for sustainable trade

The BEI, in conjunction with the Consumer Goods Forum, developed the concept for the Sustainable Shipment Letter of Credit (SSLC) – an approach that, with the support of the International Finance Corporation (IFC), enables banks to reduce the cost of exporting certified sustainable palm oil to other emerging markets. This concept addresses a pivotal issue in the palm oil supply chain which is that major emerging market importers are not favouring sustainable methods of production, often because of the premium prices expected, leaving producers with mixed demand signals. The approach has been verified as practical and commercially attractive.

The Sustainable Trade Finance Council has been exploring how the SSLC approach can be expanded beyond palm oil to other forest sensitive commodities and beyond the Letter of Credit to other trade finance instruments. Expanding the approach to other soft commodities would require a credible internationally recognised sustainability certification that can be evidenced in the trade finance documents already handled by banks. Relevant schemes in the soy and timber supply chains do not appear to offer easy solutions today, so would require persuasion to evolve their systems modestly. Further opportunities for expanding the SSLC to additional documentary trade finance solutions are already within reach, however expanding the approach to trade finance under 'open account' terms may require multi-stakeholder innovation.

Incentivising sustainable trade at scale

Opportunities for individual trade finance banks to identify and incentivise sustainably produced commodities through trade finance processes already exist, but because this is a new area for them, a key question is how banks across the industry can be encouraged to focus on this important

agenda. The Council has therefore also been exploring different drivers for industry-level engagement, including: 1) cost of funding in the market, 2) regulatory cost of capital, 3) compliance/'know your customer', and 4) enhanced risk management. Building sustainability drivers into the determinants of the cost of funding in the market for trade finance banks was identified as the most viable and practical consideration to energise this agenda in the short term. Supporting a more systematic consideration of sustainability in credit risk analysis should also be pursued over the medium term, and there are already signs of individual bank leadership on this front.

Next steps

The Council has made the following recommendations based on the findings of the discussion paper:

- Market testing to ascertain what level of demand there is for the SSLC in its current form, prioritising those banks and clients who are best placed to benefit.
- Co-ordinate and develop efforts with Multilateral Development Banks and Export Credit Agencies to identify ways in which the cost of funding for sustainably produced commodities can be reduced.
- Integrate sustainability into mainstream education of credit risk officers.
- Maintain a 'watching brief' on – and be ready to engage with – further interest shown by regulators.

The Sustainable Trade Finance Council is now seeking feedback from the broader industry on these key findings and recommendations and would welcome hearing from interested parties via CISL.

Purpose

This paper explores opportunities to transition to sustainable agriculture supply chains. In particular, it focuses on the role that banks and the finance industry can play in incentivising the trade of sustainably produced commodities.

Why is this work important?

Agriculture is widely acknowledged as one of the greatest causes of deforestation. Avoiding the conversion of forested land for agriculture is therefore a major focus when adopting plans to shift to sustainable modes of production. Indeed, agricultural production is a major theme across the Sustainable Development Goals developed by the United Nations and adopted by countries in 2015. There are four priority 'forest sensitive' commodities, which are thought to drive the majority of deforestation; these are palm oil, soy, timber and beef.

The level of deforestation linked to agriculture has highlighted a need to transition to more sustainable production of agricultural or 'soft' commodities. There are various approaches that are being taken already to shift towards sustainable production, from working with producers on the ground through to shifting buyer demand. Commitments have been made from major corporates to transition to sustainable sourcing. A key example of this is the commitment made by the Consumer Goods Forum (CGF) to achieve 'zero net deforestation' in their supply chains by 2020. The commitment was made by the CGF Board in 2010, representing their 400 members with combined procurement power of over $3 trillion, and sending a clear demand signal for sustainable soft commodity production.

This paper, and the broader objectives of the Banking Environment Initiative's Sustainable Trade Finance Council, focuses on the role that banks can play within the supply chain to incentivise sustainable soft commodity production and trade, and how banks can build on the positive demand signal already set by corporates such as members of the CGF.

What role can banks play?

Banks have a unique role in working across commodity supply chains and can therefore support sustainable production in various ways (refer to Figure 'How do Banks Finance Commodity Supply Chains?' on page 4).

Trade finance is a primary driver in enabling the production, trade, shipping and processing of most commodities, and typically those linked with deforestation such as soy, palm oil, timber and beef.

The WTO estimates that between 80 and 90% of global trade is reliant on trade finance. Simply calculated this relates to over $15.0 trillion.

The most important core business considerations for an importer of commodities are price, quality and consistency of supply. In any volume business specifically, price is the most important consideration; without being able to compete on price, an importer will lose market share, turnover and therefore profit. Price is still an issue where consumers demand a particular quality or process such as 'Fair Trade' or organic products and even when these markets are small by comparison. An importer or trader will always try to satisfy the demands of customers but they could fail if they cannot compete on price.

The cost of sustainably produced commodities *can* be higher than its unsustainable counterpart, at least while the world is in a period of transition. In times of plentiful production the price differential – the difference between the two types of production – can widen, making the sustainable product appear more expensive. If prices for unsustainable product fall, importers and processors of sustainable product become less competitive and could see their market share diminished. A fall in prices can be the result of over production just as much as falling demand. In times of recession or falling market demand, many producers actually increase production in an attempt to maintain cash profit levels and to cover costs even though it strains margins. Some may argue that this affects high cost producers the most, so the effect on sustainable product can be exacerbated.

If a focus on the cost drivers for importing commodities results in narrowing the actual or perceived price differential between sustainably and unsustainably produced commodities, this should encourage importers to increasingly favour sustainably produced alternatives. In turn, this would send important signals to producers to undertake the switch in production methods towards sustainability and make unsustainable product less acceptable in the market place.

Banks can therefore play the following roles:

- ***Innovation*** in the products and trade finance solutions available, to enable sustainability information to be traced and identified in trade finance processes in the first place;
- ***Incentivising sustainably produced commodities***, by finding ways to reduce the price differential between the trade of sustainable commodities relative to their unsustainable alternatives;
- ***Amplifying the demand signal*** already set by certain importers, by committing to only finance sustainably produced commodities progressively over time.

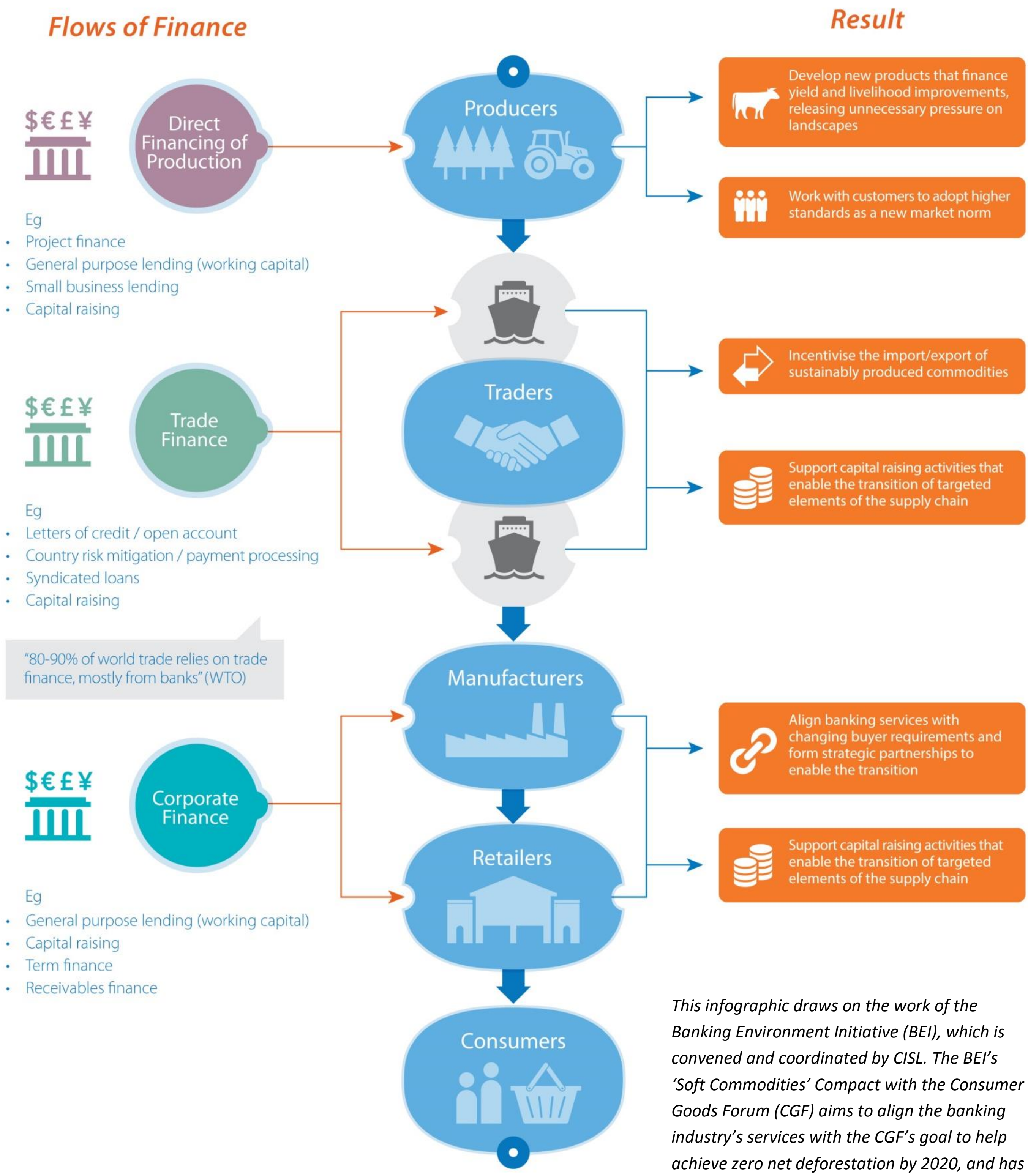
What is the Sustainable Trade Finance Council and what is it hoping to achieve?

The BEI's Sustainable Trade Finance Council aims to leverage banks' role as facilitators of international trade and thereby accelerate the transition to a world where importing sustainably produced commodities, at scale, is a new market norm. The Council was formed in early 2015 and this paper describes some of the initial analysis undertaken by the group, focusing on how banks can finance the trade of sustainably produced commodities, and how that trade can be incentivised.

The Sustainable Trade Finance Council currently includes representatives from: BEI Member banks including Barclays, Deutsche Bank, Santander, Standard Chartered Bank and Westpac; major commodity importers and traders such as Olam, Unilever and Wilmar; trade finance industry bodies BAFT and the ICC Banking Commission; and civil society organisation, WWF. The University of Cambridge Institute for Sustainability Leadership (CISL) provides the group's Secretariat.

How do Banks Finance Commodity Supply Chains?

And how could they support the growth of sustainable production?



This infographic draws on the work of the Banking Environment Initiative (BEI), which is convened and coordinated by CISL. The BEI's 'Soft Commodities' Compact with the Consumer Goods Forum (CGF) aims to align the banking industry's services with the CGF's goal to help achieve zero net deforestation by 2020, and has so far been adopted by a dozen banks representing over 50% of the global trade finance market.

What has already been done by the BEI?

The BEI's Sustainable Trade Finance Council builds on the work already done by the BEI, in particular the Soft Commodities Compact and the development of the concept for the Sustainable Shipment Letter of Credit.

'Soft Commodities' Compact

The Soft Commodities Compact is a unique, client-led initiative that aims to mobilise the banking industry to help transform soft commodity supply chains, thereby helping corporate clients to achieve their goal of zero net deforestation by 2020. This commitment to achieve zero net deforestation was made in 2010 by the Board of the Consumer Goods Forum, representing their 400 members with combined procurement power of over $3 trillion.

In recognition of the role that banks can play in transforming to sustainable supply chains, the Soft Commodities Compact was developed, and endorsed by the CGF Board in 2013. The Compact was developed through collaboration between the BEI and the Consumer Goods Forum (CGF), with input from WWF. It calls for banks to help achieve this goal of zero net deforestation by 2020, through their financing of soft commodity supply chains.

Twelve banks have so far adopted the Compact, including eight BEI member banks and four non-member banks. In total, the adopting banks account for over 50 per cent of global trade finance.

Sustainable Shipment Letter of Credit

As part of the focus on sustainable supply chains and building on the Soft Commodities Compact, the BEI, in conjunction with the CGF and commodity buyers, sought to identify how documentary trade finance solutions could help incentivise the trade of sustainably produced commodities. The overarching aim of this work therefore links closely to the CGF's goal to achieve zero net deforestation in their supply chains by 2020.

The initial focus was on one financial instrument (Letter of Credit) and one commodity (palm oil). This narrow focus was adopted in order to develop practical and commercially viable solutions, with the expectation that, if successful, it could be used as a pilot and pathfinder for other commodities. The result of this work was the concept for the 'Sustainable Shipment Letter of Credit' (SSLC).

The SSLC enables sustainability information, in the form of internationally recognised certification standards, to be captured in Letter of Credit documentation. The SSLC therefore provides greater transparency and enables parties to identify if a particular shipment is certified. In the case of the palm oil pilot, it was agreed that the Roundtable on Sustainable Palm Oil's (RSPO) standard would be used as a starting point. The sustainability information is captured anyway through physically stamping the Bill of Lading document, which is one of the documents processed by banks. In this approach, the banks' role is limited to simply checking whether or not the document is stamped, with the requirement for the sustainability information only being triggered by the buyer's instruction.

While the SSLC does not incentivise the trade of sustainably produced commodities per se, it does provide a platform for banks to do so. An example of this may be preferential terms for sustainable shipments. Shortly after the launch of the SSLC, the International Finance Corporation (IFC) decided to offer preferential terms to banks financing sustainable palm oil shipments via the SSLC mechanism through its Global Trade Finance Program, which banks use to offload risk and benefit from the IFC's AAA-rated credit-rating. This created an immediate economic case for banks, in turn, to be able to offer price reductions to their clients choosing to trade sustainably certified palm oil.

The SSLC has now been tested by banks in practice and has already seen a positive response. For example, one BEI member bank has reported nearly $50 million of new 'sustainable shipment' business in one six month period by working with just one customer. Interestingly, this business was done using a different form of documentary trade finance to the Letter of Credit, 'Documentary Collections'. The SSLC approach has also been recognised as a high-potential, impactful innovation more broadly through the FT/IFC Transformational Business Awards; the BEI was shortlisted for a 'Transformational Finance' award in 2015.

A platform for change

The Soft Commodities Compact and SSLC provide a foundation and a case for how sustainable commodity production can be recognised by trade finance banks and incentivised through trade finance solutions. These approaches show that under certain circumstances, encouraging the trade of sustainably produced commodities can be practical and commercially viable. While this work is an important starting point, it is recognised that it is just one of many possible solutions to incentivise the trade of sustainably produced commodities. Further development on the Soft Commodities Compact therefore continues. Testing the market demand and capacity for concepts such as the SSLC will be important. An opportunity also exists to expand Sustainable Shipment Letter of Credit approach to additional agricultural commodities, to new financial instruments, and to changing the drivers of cost of capital.

It is hoped that this work, and its ongoing development, can continue to transform supply chains to incentivise sustainable soft commodity production.

What is the BEI hoping to achieve?

The BEI formed the 'Sustainable Trade Finance Council' in 2015 with the aim of leveraging banks' role as facilitators of international trade and thereby accelerating the transition to a world where importing sustainably produced commodities, at scale, is a new market norm. The Council has identified four key roles to transition toward this goal, and which build on the work already done by the BEI:

1. ***Technical*** – to explore how to expand the trade finance solutions available to customers beyond the Letter of Credit and to other commodities.
2. ***Market education and awareness*** – to equip the market with the knowledge of how banks can help to operationalise importers' sustainability commitments.
3. ***Advocacy*** – to work with major emerging import markets, starting with China, to see how the Council can support them increasing demand for sustainably produced commodities.
4. ***Leadership*** – to explore what it would take for the banking industry as a whole to set goals to promote the trade of sustainably produced commodities.

This paper focuses predominantly on the initial findings from the 'Technical' analysis, and in particular explores three key strategies for change. The first is exploring how the Sustainable Shipment Letter of Credit approach can be expanded beyond palm oil, to additional commodities. The second is identifying new trade finance solutions beyond the Letter of Credit to incentivise the trade of sustainably produced commodities. And the third is exploring how the banking industry as a whole, over and above individual voluntary action, can be encouraged to incentivise sustainable trade.

Overall, it is hoped that this 'Technical' aspect of the Sustainable Trade Finance Council's work will both enable sustainability information to be included and identified in trade finance processes, and to provide an opportunity to incentivise the trade of sustainably produced soft commodities.

It is presented here as a Discussion Paper because the Sustainable Trade Finance Council does not claim to have all the answers but, rather, wants to drive and shape a wider debate amongst industry leaders to accelerate the pace of learning and innovation.

Identifying sustainable trade: expanding the Sustainable Shipment Letter of Credit approach

The first step in incentivising the trade of sustainably produced soft commodities through trade finance is developing ways in which banks can recognise if a particular shipment is sustainable. The BEI's Sustainable Shipment Letter of Credit (SSLC) approach for palm oil shows that for one commodity and using one trade finance instrument, sustainability information can be tracked through the trade finance process, improving traceability and providing an opportunity for banks to incentivise the trade of sustainably produced commodities.

An opportunity now exists to expand this approach to additional soft commodities, and to other trade finance instruments, to enable sustainability information to be identified more broadly in trade finance processes.

How can the Sustainable Shipment Letter of Credit (SSLC) approach be expanded?

The SSLC approach provides a basic framework for including sustainability information in trade finance documents, enabling banks to recognise if a particular shipment is sustainable. There are two key factors that are critical for this approach, particularly in the context of applying it at an industry level; firstly, that there is a credible, internationally recognised sustainability certification, and secondly, that evidence of the certification can be included in the trade finance documents already handled by banks.

The BEI's Sustainable Trade Finance Council has been investigating how the SSLC approach can be expanded to additional commodities, and other financial instruments, using these two key factors as a basis.

Applying the SSLC approach to additional commodities

There is an opportunity to expand the existing SSLC approach beyond palm oil, to additional soft commodities. To do this, the selected commodities need to have an appropriate sustainability certification, which can be evidenced in the trade finance documents already handled by banks.

The BEI has chosen to focus on the 'zero net deforestation' aspect of sustainability, in alignment with the Consumer Goods Forum goal to achieve zero net deforestation in their supply chains by 2020. For this reason, the BEI's Sustainable Trade Finance Council is focusing initially on soy and timber, as both commodities are known to have a large impact on deforestation, and both already have existing and relatively well established international certification standards to verify zero net deforestation. Examples include the Roundtable on Responsible Soy (RTRS) and ProTerra for soy, and the Forest Stewardship Council (FSC) and Programme for the Endorsement of Forest Certification (PEFC) for timber.

In developing the initial SSLC approach for palm oil, it was identified that evidence of the Roundtable on Sustainable Palm Oil certification was already included in the trade finance documents, by physically stamping the Bill of Lading document. This provided an opportunity for banks to easily identify sustainable shipments within their existing processes. After consultation with relevant experts, an equivalent process to indicate sustainability certification on the documents handled by trade finance banks in the trade of timber and soy was unfortunately not identified at this stage.

However, other evidence of certification could be used. For example, evidence of FSC certification is included in the invoice, which typically forms part of the trade finance documents. The FSC have also recently developed an Online Claims Platform, which could be adapted for use by banks. On balance, it appears that some evolution of how sustainability certification is evidenced on trade documentation will be needed before banks can easily use this mechanism to differentiate sustainable from unsustainable product at the individual shipment, or transaction, level.

Expanding beyond the Letter of Credit to other documentary trade finance instruments

The overall approach used for the SSLC can also be applied more broadly to other documentary trade finance instruments such as Documentary Collection. Documentary Collection is where the exporter instructs its bank to send transaction documents related to its exports to the importer's bank with specific instructions to present the documents to the importer against payment or against acceptance by the importer. Just as with the Letter of Credit, exporters continue to rely on banks to route the documents, so as to control the release of the shipment at the destination of the importer's country.

Much like with the SSLC approach, identifying sustainability information in Documentary Collection relies on an existing sustainability certification that can be easily identified by banks within their existing processes. The role of banks is again limited to checking whether or not the particular sustainability certification is present, and not verifying the quality of the certification or validating the certification standards. In this regard, it appears that the way forward to expanding the SSLC approach to other forms of documentary trade finance is relatively straight forward.

What if the trade documentation isn't handled by banks?

While the SSLC approach provides a good basis to identify sustainable shipments via documentary trade finance, it is acknowledged that a key limitation is the reliance on banks seeing evidence of the sustainability certification on the documents that they handle as part of the trade finance process. This approach will not apply so easily to the portions of commodity trade that is carried out under open account terms (typically used by large, reputable buyers), as banks do not see the documents being exchanged by exporters and importers that might incorporate sustainability information. The Sustainable Trade Finance Council has therefore been exploring opportunities for banks to identify sustainable trade under open account terms.

The work so far has acknowledged that both banks and clients may need incentives to invest in establishing the sort of transparency that would be required for banks to favour sustainable shipments under open account terms, as new information flows would need to be established. A range of possible measures have been explored at a high level, some looking to draw on innovations already underway in financial value chains. One example for further exploration is the use of distributed ledger electronic Bills of Lading to record the presence of sustainability certification in a structured format. This is not currently common market practice, but is receiving wide attention from forward-thinking practitioners. On balance, while promising routes forward exist, it is acknowledged that the incentives for investing in such innovation will need to be clear and compelling.

What if there isn't a relevant sustainability standard or certification?

It is acknowledged that not all soft commodities have a relevant internationally-recognised sustainability certification scheme in existence today. Without such certification schemes, it can be very difficult to identify if commodities have been sustainably produced in the context of the fastmoving short-term trade finance business, and therefore difficult to use an approach such as the SSLC which focuses on individual shipment, or transaction-level, due diligence.

An alternative, or additional, approach may be to include a sustainability risk screening approach in customer due diligence processes that banks already run. The objective would be to create a simple and effective post-transaction monitoring mechanism at the client level, providing an opportunity to engage with clients to understand how they are managing the risks they are exposed to via traded commodities.

There are tools publicly available to help banks in this approach. For example, the International Finance Corporation (IFC) has produced a Global Map of Environmental and Social Risks in Agro-Commodity Production (GMAP), which via an access database contains a comprehensive list of 150 country-commodity combinations. Banks can select country-commodity combinations relevant to their business and run analysis of relevant elements of the trade finance portfolios over a defined period of time. Protocols for client facing teams to then engage with customers appearing to present high risks can then be developed.

Next steps

The SSLC shows that for one commodity (palm oil) and using one trade finance instrument (Letter of Credit), it is possible for banks to identify if a particular shipment is sustainable, and therefore provides an opportunity for banks to incentivise the trade of sustainably produced commodities.

This discussion paper also identifies further opportunities for expanding the SSLC to additional documentary trade finance solutions that are within reach. Expanding the approach to other soft commodities and to trade finance under 'open account' terms will require further process change in the supply chain processes themselves and multi-stakeholder innovation respectively.

While the initial SSLC pilot did prove the concept can work in practice, it is true to say that further effort needs to be invested to test whether this solution alone can gain real market traction. If such market engagement can be demonstrated, it may offer banks, corporates and sustainability standards organisations the motivation needed to invest in further process changes and innovation.

It is therefore recommended that a clear next step should be focused on market testing to ascertain what level of demand there is for the SSLC in its current form, prioritising those banks and clients who are best placed to benefit.

Incentivising sustainable trade at scale: options for ‘changing the rules’

Why explore ‘changing the rules’ for trade finance?

At an institutional level, many international banks have identified strategic drivers to proactively incentivise their customers to become more sustainable or to ‘tilt’ their portfolios to finance more significant proportions of a sustainable economy.

Until now, banks’ approaches have largely been voluntary, underpinned by sustainability policies or strategies and developing departments to investigate and promote such business internally and with their customers.

A simple tour of some of the more recent public statements and reports published by international banks to identify the strategic drivers banks themselves cite for their work on sustainable finance reinforces this point. The following drivers are commonly referenced:

- Managing risk
- Generating or seizing commercial opportunity
- Developing a better understanding of evolving client needs
- Increasing shareholder value
- Deepening the positive contribution to society

It is clear that banks have put significant effort into these strategies and are increasing their presence in the sustainable finance market. However, it is notable that some of the most important strategic drivers of banks’ decision-making in general, such as the factors that influence their cost of capital, are largely absent from this list.

Herein lies a fundamental question: to what extent can the entrepreneurial and innovative instincts of individual banks be relied upon to deliver industry-level change without changes to the underlying ‘rules of the game’? This paper argues that without further appropriate action to co-ordinate efforts at an industry level and correct system-wide market failures, progress may well be hindered by shorter-term profit concerns and competitive pressures.

In the specific context of trade finance, there is arguably unrealised potential for banks to offer unilaterally some preferential pricing and/or integrate environmental and social risks into their reputational and credit risk management policies and influence access to capital today.

However, it is important to understand the limitations on how scalable this approach might be if only undertaken by a few individual banks alone, particularly with respect to preferential pricing. Banks can adjust pricing to develop a certain product or service, to achieve an internal target or to gain a market lead over competitors. Over time, however, it is difficult to maintain such pricing differentials in a highly competitive market and considering the pressures banks face to increase returns to shareholders, if this pricing differential runs contrary to the more fundamental cost drivers that all market participants face, it will likely not last.

By way of background, the Cost of Capital (CoC) or Return on Capital (RoC) is, alongside credit risk, a fundamental consideration in business planning and strategy for banks. Just as transactions will be turned down if they do not meet credit risk requirements even if the RoC is attractive, a transaction involving a first class credit risk can be turned down if it fails the RoC hurdle. Banks use several differing terms to define the Cost of, or Return on Capital, including Return on Equity (RoE) and Return on Invested Capital (ROIC).

RoC is a calculation that determines the amount of capital a bank must set aside – or invest – to book a loan or transaction and the percentage return that transaction earns related to the capital invested. The calculations encompass credit risk, time period of loans, country risk and allow for a perceived risk for each type of transaction and are established under rules issued from a committee at the Bank for International Settlements (BIS) called the Basel Committee on Banking Supervision (BCBS). Currently banks are obliged to work under Basel II rules but many have already adopted the rules of Basel III, which are still under discussion.

Banks can adopt the more stringent 'Standardised' rules published by the BCBS or opt for 'Advanced' standards which are developed in-house or by ratings agencies and approved by national regulators or central banks.

The effects of the 'Standardised' and 'Advanced' rules are similar in that different categories of loan, service and transaction require different levels of capital to be set aside. A simple example: assume BCBS rules state that for every $100 loaned out a bank must set aside $8 to cover losses. Unsecured loans are risk-weighted with a Credit Conversion factor (CCF) at 100% risk for Basel II purposes. This means that $8 of capital must be set aside. With a margin of 1%, cash income for the year is $1 and the RoC is 12.5% ($1/$8).

A short-term Letter of Credit, however, would be risk-weighted at 20% so the capital required is only $1.6 and the RoC rises to 62.5% ($1/$1.6) – a much more attractive proposition for the bank given a straight choice between the two. Simply put, whilst earning the same $1 in cash per annum, the trade transaction appears to earn the bank five times more than the unsecured loan on a returns basis.

So in the context of maximising RoC, it can be seen from the above that a primary strategic driver for banks broadly, and certainly in the trade finance business, is maximising business with a low CCF. This will become more important in the future as Basel III will also introduce more stringent balance sheet limits and liquidity rules upon banks. It is noteworthy that some trade finance products will, almost certainly, lose their lower CCF under Basel III.

Thus, even small adjustments to the cost of capital will likely have a significant effect on strategic decisions taken by banks. The same is true of a bank's cost of funds. As of today, some of the most important drivers of cost of capital or cost of funds in the trade finance business do not distinguish between sustainable and unsustainable trade.

In this context, this paper examines four primary drivers of a bank's behaviour in the market place and explores the impact that could be achieved by adjusting those drivers to take account of sustainability, as well as how realistic such action might be.

1. **Cost of funding in the market**
2. **Regulatory cost of capital**
3. **Compliance / 'Know Your Customer'**

4. Enhanced risk management

As stated previously, this paper concentrates on those drivers that can be addressed more directly by the banking industry itself. This should not be taken to imply that the on-going efforts of governments, companies, consumers and civil society to address the same issues are seen as any less significant.

1. Cost of funding in the market

In certain situations, adjusting the cost of funds available to banks in the market could be a useful tool to promote sustainable trade finance. Adjusting banks' cost of funds has an immediate impact on their underlying cost of capital so reducing the cost of funds for certain types of business should – all things being equal – boost the margins that banks can achieve and therefore incentivise business development in those areas. It may be possible for such benefits to be passed on to, or shared with, the banks' customers so that these incentives are felt in the real economy.

The cost of funds for a bank is a top priority for its competitive success and refers to the 'blended' or average cost the bank pays on all its debt – long and short term inter-bank debt, bonds, customer deposits etc. As a benchmark, a bank will generally lend to its customer at a margin over LIBOR (the London Interbank Offered Rate or another appropriate money market fixing such as SIBOR in Singapore). When lending to a customer a bank may decide that it needs to make a return of (say) 1.5 % over its cost of funds to satisfy the cost of capital requirement. If the proposed loan is for 3 months, LIBOR stands at 0.2% and the bank might pay a 0.5% margin to a lender on the interbank market. The bank therefore has a cost of funds of 0.7% and adding the required margin of 1.5% gives a total interest rate of 2.2%. The three month loan will be offered to the customer at LIBOR + 2.0%. Any reduction in the 'cost' element of the loan is clearly a benefit to the bank and the transaction as a whole.

Alternate sources of funds specifically suited to sustainable trade finance are the Multilateral Development Banks (MDBs) such as the International Finance Corporation (IFC) and European Investment Bank (EIB), Export Credit Agencies (ECAs) and government or intergovernmental controlled funds that provide guarantees and finance for development.

These institutions already provide funding at reduced rates for qualifying transactions and, when writing a guarantee for business, reduce the cost of capital by enhancing the credit risk. Given that many of these institutions already have explicit mandates to promote sustainable development, there are a number of ways that they could act reasonably quickly to reduce the cost of funding for banks' activities that support the production and trade of sustainable commodities. Some examples are now explored in more detail.

<u>Revolving credit facilities</u>

These institutions could consider expanding their offering by granting short and medium term revolving facilities at prices below banks' normal cost of funds specifically for the finance of sustainable trade transactions. The borrowing bank will be incentivised to make use of the cheaper funds, which will go towards reducing its overall cost of funds and therefore encourage the bank to seek sustainable transactions to finance.

Discounted cost of funds facilities could be granted by institutions in much the same way that major international banks currently grant lines to smaller banks for regular trade finance. In these cases a Facility Letter is accepted and signed by the borrowing bank, containing the terms of a short-term line (usually 12 months) for specific trade finance purposes. The borrowing bank then on-lends to its trade finance customers on a revolving basis. Policing of the use of the facility is carried out on a trust basis by the bank with the lender having the right to audit the facility at regular intervals.

Export and trade guarantees

Many ECA facilities primarily set up to promote exports work in the form of guarantees. This means that they guarantee an international bank, which can lend to the foreign importer of the exported goods. From the bank's point of view, using such a guarantee means it has switched the higher risk of the foreign importer for the AAA risk of the ECA. The CCF is therefore 0% instead of 100%. Funding, in this instance is provided by the bank not the ECA but the bank benefits from the preferential capital treatment. These facilities tend to be for project finance currently but the scope could be widened to include short-term trade transactions and could include specific preferential terms for sustainable trade finance transactions.

One of the main participants in this market segment is the IFC. Historically the IFC finances projects and companies by granting long term loans and facilities of between seven and 12 years. In 2009 however the IFC launched the Global Trade Finance Program and followed with the Global Trade Liquidity Program in partnership with nine MDBs and issues funding to participating banks including Citibank, Commerzbank, J.P. Morgan Chase, Rabobank and Standard Chartered Bank.

It was the IFC, through its Global Trade Finance Program, that was the first MDB to collaborate with the BEI to develop the 'Sustainable Shipment Letter of Credit' for palm oil. Simply put, this initiative saw the IFC offer its partner banks preferential terms for Letters of Credit for the financing of palm oil trade that could demonstrate that the palm oil had been produced in a sustainable manner, according to third-party independent standards. Banks benefiting from reduced cost of funding for such transactions are then incentivised to do more of such business and indeed can use some or all of the reduced cost of funding to pass on incentives to their clients to encourage them to trade more sustainable product. The European Bank for Reconstruction and Development (EBRD) reportedly goes a step further in making evidence of sustainable production methods a condition for banks to access its Trade Finance Program.

On-lending programmes

More recently the IFC has begun to address the shorter end of the trade finance market by establishing the 'Global Trade Supplier Finance' program, which provides post-shipment finance to suppliers based on the discounting of receivables from approved importers. It also runs the 'Global Warehouse Finance Program', which has two components:

i. IFC offers a short-term loan to a bank, which will in turn use the funds to lend to farmers, agriculture commodity producers, or traders against warehouse receipts or equivalent as collateral.

ii. IFC guarantees up to 50 percent of short-term loans extended to agriculture commodity producers or traders against warehouse receipts or equivalent as collateral. Banks can transfer credit risk to IFC from their own portfolio or from a new portfolio they originate. The assets typically remain on the banks' balance sheet, and the risk transfer comes from a partial credit guarantee provided by IFC.

The EIB has, among its lending products, 'Intermediated Loans' which are loans to local banks who subsequently on-lend to a final beneficiary. These loans must further at least one of the EIB's four public policy goals, two of which are environmental sustainability and action for climate-resilient growth. Along with other MDBs, the EIB has committed to work towards developing resources to meet the Sustainable Development Goals (SDGs) and will need to focus more on sustainable finance transactions.

What impact could creating pricing differentials have for customers?
At this point it would be right to question the effectiveness of a relatively small reduction in the financing cost of a shipment or transaction that can be passed down to the customer by a bank. It can be argued that a small reduction in the finance charge might not be enough to persuade producers and traders to switch to sustainable products. Larger companies can certainly influence the market and they have the power and ability to demand sustainably produced commodities but many smaller companies do not have the luxury of scale and compete primarily on price. These companies may well need more incentive to make the switch. To expand on this point:

A major agricultural trader/producer will finance large volumes and will pay a competitive margin over LIBOR whilst the smaller trader/producer will pay a much higher margin on smaller shipments.

For example, a large trader finances a $15.0 million shipment for three months at a margin over LIBOR of 0.75% per annum. Current 3-month LIBOR is 0.12% per annum so the trader pays a combined rate of 0.87% per annum. This means his interest charge would be $130,500 per annum but for three months it is $32,625 – a flat rate of 0.22% on the loan amount.

A smaller trader/producer might well pay LIBOR plus 4% per annum for a 3-month loan of $5.0 million. Here the combined rate is 4.12% per annum and the interest charge for three months is $51,500 – a flat rate of 1.03%.

A 0.1% (10 basis point) reduction in margin reduces the large trader's interest charge by $3,750 to $28,875 – an 11.5% reduction in the cost of the loan.

A 0.1% (10 basis point) reduction in margin reduces the smaller trader's interest charge by $1,250 to $50,250 – a reduction of only 2.4% in the cost of the loan.

In a high volume, competitive market there is a great attraction for the larger trader to reduce its finance charges, especially by 11.5%, but the modest reduction to the smaller company's costs might not be enough to persuade it to switch. For the smaller trader banks might consider meaningful reductions in margin of up to (say) 50bp. A 50bp reduction in the cost of the $5.0 million loan mentioned above would reduce the smaller trader's interest charge by $6,250 to $45,250 – a reduction of a more persuasive 12% and more in line with the larger trader.

Banks could consider such reductions in margin on a case-by-case basis during the credit approval process but could also improve their return on capital by sharing the risk, partially or in whole, with MDBs and ECAs as mentioned above. As discussed previously, a guarantee greatly reduces the capital required for each transaction, thereby enhancing the return.

To reflect the growing underlying risks, banks could also consider charging a premium to finance non-sustainably produced commodities, for example creating a 50bp differential above the cost of sustainable product.

In certain markets such as China, the use of Letters of Credit is common and smaller companies are frequently required to place cash deposits with the opening bank of between 10 and 100%. Here the bank could consider reducing the amount of deposit they require to open L/Cs covering sustainable shipments. This would release cash flow for the trader purchasing the commodity and thereby reduce its costs. Another benefit that can be passed on by financing banks is to increase the tenor of L/Cs from (say) three to six months. Partial or full guarantees via facilities granted by MDBs and ECAs could be used to replace cash deposits, which would also release cash for the customer. Note - reductions in cash deposit and/or tenor will remain a credit decision for the bank because the risk on the customer remains the same weather the transaction financed is sustainable or not.

The point of illustrating the work of the various institutions mentioned above is that there is scope for international commercial banks to engage further with these institutions to develop facilities that provide discounted pricing and/or enhanced capital treatment specifically for the finance of sustainably produced commodities. In achieving this, the banks will also assist the MDBs in reaching their goals concerning the SDGs.

Whilst the international banks are capable of developing deeper relationships with the MDBs individually, it would be beneficial to all parties to have some degree of coordination provided by an independent organisation such as the BEI, the International Chamber of Commerce (ICC) or the Bankers Association for Finance and Trade (BAFT). Coordination would provide a central point of reference for banks and the MDBs and would avoid significant duplication of effort, which would also reduce the overall cost. Coordination could also reduce costs through developing more uniform and generic products rather than bespoke products for each bank.

Given that the MDBs are already involved with sustainable development, coupled with the banks' ability and expertise to develop innovative products in response to adjustments to their cost of funding, this process appears to be a practical and effective way forward in the short- and medium-term.

2. Regulatory cost of capital

The regulatory cost of capital to a bank is largely defined by the BCBS of the BIS and the CCFs imposed under Basel III are of vital consideration for a bank's business approval process.

In theory, it would be relatively easy for banks to be incentivised to promote more sustainable trade finance if the BCBS further addressed the question of the capital treatment for short-term trade finance and adjusted the rules of Basel III to add preferential treatment for the finance of certified, sustainably produced commodities.

In practice, however, this seems unlikely either in the short- or medium-term. Basel III's mandate is to strengthen banks' balance sheets and liquidity from a micro-prudential perspective and to maintain financial stability from macro-prudential perspective. It is certainly true that some national regulators – like the Bank of England, China Banking Regulatory Commission and Central Bank of Brazil – and some supranational bodies like the Financial Stability Board are starting to take various actions on the basis of the links they see between unsustainable development and their micro- and macro-prudential objectives. However, it seems that co-ordinated action by the BCBS may be further off and would anyway be unlikely to find justification for specific preferential treatment of sustainable short-term trade finance.

In 2014, the BEI partnered with the United Nations Environment Programme Finance Initiative (UNEP FI) to commission independent analysis by an academic expert into how sustainability risks might be reflected in the Basel Capital Accord. The resultant study concluded that, in the context of the increasing impact of environmental risks on the stability and sustainability of the economy, and therefore as an emerging source of systemic risk for banks and banking stability, bank supervisors should explore the feasibility of incorporating forward-looking scenarios that estimate the potential financial stability impact of supplying credit to environmentally unsustainable or sustainable activities over time into their 'Pillar 2 – Supervisory Review' stress tests. The study also suggested that bank supervisors should examine 'Pillar 3 – Market Discipline' to assess the feasibility of banks disclosing information about their exposure to, and management of, systemic environmental risks in a standardised manner across countries. The study did not find that adjusting minimum capital requirements under Pillar 1 is a viable starting point. Interestingly, investigating tools and approaches for financial institutions to manage emerging environmental risks, particularly those that are scenario-based, is something that has been picked up by the G20, through its Green Finance Study Group.

3. Compliance / 'Know Your Customer'

Since 2008 the compliance processes for banks has been greatly enhanced to improve best practices and combat money laundering and fraud. The process is called 'Customer Due Diligence' and 'Know Your Customer' (CDD/KYC) and includes Anti Money Laundering (AML) requirements.

The KYC process could be expanded to include sustainability criteria in much the same fashion. As part of the due diligence checks banks would also check that their customers – and to a certain extent, their customers' suppliers – are buying or producing sustainable products.

For CDD purposes a customer's corporate registration documents and identification documents such as passports and utility bills of directors and top management are required together with information on major shareholders. Inclusion of approved sustainability certification in the CDD process might be difficult to gather and administer because of the transactional nature of certification but would reduce the banks' ability and appetite to finance non-sustainably produced goods. Indeed, some banks are already taking this approach on a voluntary basis as part of their reputational and even credit risk management processes.

Compliance rules are laid out in National Regulators' guidelines and applied on a semi-discretional basis by individual banks, e.g. where a company is a well-known household name, it could be considered that the level of money laundering and terrorist financing risks are low and CDD measures could be applied in a manner which is proportionate to that risk. In most institutions, KYC documents and evidence are gathered by front office relationship managers and signed off by the compliance team. Individual transactions generated through operations departments often need compliance sign-off but the front office is generally held responsible. Adding sustainability requirements to the process at the transactional level might make more sense because the CDD process is already well established.

The advantage of this approach is that companies ignoring or bypassing sustainable production methods could be quickly identified and, if deemed necessary, excluded from bank finance opportunities. This would be effective because all banks, traders and processors would be obliged to follow rules that would dissuade unsustainable production practices. In effect the decision to source sustainably has been taken for all the market players and the risk of 'leakage' (when a company refused credit by one bank obtains credit from another bank with different requirements) is far reduced. New rules would be applied simultaneously and costs spread across all players in the market – including consumers. Banks and their customers would achieve goals quickly and sustainable trade finance would be raised out of its niche market.

Similar regulations could be placed on international insurance companies who cover political and transactional risk.

However, in reality, both the feasibility and desirability of this option look questionable, to say the least. On the one hand, compliance procedures are primarily aimed at preventing banks from supporting illegal activities. With some notable exceptions relating to illegal acquisition of land or violation of labour standards, unsustainable economic activities associated with the production and trade of commodities are generally not illegal. On the other hand, the compliance process is sometimes seen as slow and unresponsive compared with the short response times demanded of the front office and operations departments of a trade finance bank by its customers. Therefore, moves in this direction may meet a level of resistance from banks individually and overall on the basis that they would adversely affect the speed and efficiency that makes the business successful.

This paper does, however, recommend that further investigation and discussion is undertaken with the relevant authorities to gauge potential levels of interest.

4. Enhanced risk management

Historically, there has been a view that banks are only indirectly affected by sustainability issues and climate change, to the extent that general economic activity is affected. However, there is a growing body of evidence emerging that these issues are becoming more of a direct risk concern in the short term as well the longer term. Bank Credit Committees are becoming more involved with the issue and, as well as declining business on the grounds of market segment or reputational risk (such as cigarette manufacturers), can pass opinions to customers that can act as a warning that the bank is not prepared to finance a particular industry or unsustainable production method in the future.

The changing conditions around the world relating to sustainability and climate change add several risk considerations for trade finance banks, in addition to reputational risk. Indeed several of these drivers below were emphasised by the Governor of the Bank of England in a keynote speech to Lloyd's on 29th September 2015.

<u>Litigation</u>
the possibility of lawsuits being brought against companies and sectors responsible for large amounts of greenhouse gas emissions or against those failing to build resilience to changing climate conditions into assets in such a way that harm is caused to others or the environment. The growing use of litigation can impact the credit ratings of producers and processors. Some recent indicators that this risk is on the rise include:

"In a precedent-setting case, an Indonesian court has found a palm oil company guilty of violating environmental laws and ordered it to pay $30 million in fines and reparations for clearing an area of protected peat forest that is a stronghold for endangered orangutans in Indonesia's Aceh Province." Mongabay, January 2014

"Singapore has sued five Indonesian companies blamed for farm and plantation fires causing serious air pollution over the city-state, which is a global financial centre with a tropical climate and multicultural population. The latest move by the Singapore government could lead to massive fines against the companies that have been served with legal notices, according to a government statement issued Friday." AFP, September 25th 2015

Physical impacts

The effects of more frequent and intense extreme weather events such as droughts and floods, or creeping risks such as rising sea levels, on fixed assets such as buildings, factories and port installations. The effective depreciation rates of assets may therefore also be considerably higher than in the past. Consequently, faster capital depreciation could mean that assets need replacing more frequently, negatively affecting projected cash flows.

For instance, in July 2015, BMI Research, part of Fitch Ratings, advised financial market investors looking at Brazil that they "should be aware of the water shortages in the country, given their knock-on impacts on electricity prices, headline inflation and business confidence". Sao Paulo relies to a large extent on hydroelectricity and South Eastern Brazil has had its driest winter for 84 years. Deforestation has been cited as one of the drivers by many news agencies including the Guardian (31 Oct 2014), The Financial Times, (11 February 2915), CNBC (1 July 2015) and the Brazilian National Institute for Space Research (26 June 2015).

As a result, sudden and disruptive regulatory interventions are on the rise. For instance, in California, the State Governor announced the first ever, mandatory state-wide water restrictions in April 2015 to combat a five year drought that has been blamed as much on the unsustainable use of water by the agricultural industry as on climate change (New York Times, 20 August 2015).

Consequently, regional banks in California have dedicated significant sections of their filings to drought risk in their business and homebuilding companies have come across difficulties in obtaining water connection permits and regulatory approval. The United States Department of Agriculture forecasts that farming sector net cash income will fall 21% in 2015 and net farm income by 36%. In July 2014 the University of California reported that "428,000 acres, or 5%, of irrigated cropland is going out of production in the Central Valley, Central Coast and Southern California due to the drought".

Withdrawal of capital

The possibility of shifts in investor sentiment, either driven by changes in investor beliefs about the significance of sustainability considerations on risk-adjusted returns or resulting from pressure from beneficiaries in the case of investors like pension funds and insurance companies, leading them to withdraw or withhold capital from unsustainable producers. Withdrawal of capital by investors or funds for such reasons is a growing trend and can have significant implications for companies involved in much the same way as withdrawal of bank finance. For example:

"Storebrand, a major Norwegian pension fund and insurance firm, is to divest from 11 palm oil companies following deforestation and sustainability concerns. According to Bloomberg the insurer will continue to invest in palm oil companies that meet its own environmental and social governance standards. The firm has not said which producers it will now exclude. Christine Meisingset, head of sustainable investment at Storebrand, said, "The main driver behind deforestation in tropical regions is often the establishment of new palm oil plantations. Storebrand would rather invest more in companies that are pushing the industry toward a more sustainable approach." Blue & Green, 23rd January 2014

"Norway's largest pension fund Kommunal Landspensjonskasse (KLP) recently announced it had decided to pull out of its investments in companies that derive a large proportion of their revenues from coal. The announcement came hot on the heels of a similar move by the Swedish fund Second

AP, which announced in October that it will pull out of its investments in 12 coal and eight oil and gas production companies – together accounting for a divestment of holdings with a total market value of about SEK840m (£72m)." neweconomy.com, 29th January 2015

Non-compliant shipments

The effect on short-term trade companies, especially small- and mid-sized, of shipments of produce being refused at the port of delivery due to failing to meet the buyer's requirements on sustainability. Analogous experiences in the market relating to disputes between buyer and seller relating to quality have been seen before. For example:

"China rejects more US corn due to GMO - China's quality watchdog has turned away more corn cargoes from the United States due to the discovery of a genetically-modified strain not approved by Beijing and further rejections are likely, traders said." Reuters, 6th January 2014.

Changing regulatory pressures and consumer demand

Recently there has been growing pressure on governments around the world to impose sanctions and fines on companies involved with unsustainable production methods and these actions could have direct consequences on the credit worthiness and profitability of any company involved. For example:

"Indonesia's financial regulator will introduce rules to restrict banks' lending to environmentally-damaging projects by 2018, which may eventually help the nation curb the forest fires that choke parts of Southeast Asia with thick haze for months each year. The Financial Services Authority, known locally as OJK, is aiming to draft regulations by next year to target agriculture, energy, fishery and microfinance companies. The rules would build on guidelines for sustainable financing in the palm oil industry that the nation's eight largest banks will test starting in January." Bloomberg Business, November 23rd 2015

"SINGAPORE - Supermarket chains NTUC FairPrice, Sheng Siong and Prime Supermarket have pulled all Asia Pulp and Paper (APP) items off their shelves, including popular brands such as Paseo. The Dairy Farm group, which operates chains such as Guardian, 7-Eleven, Cold Storage and Giant, has also stopped replenishing APP stock. It will continue to sell existing items till they run out. Their actions came after the Singapore Environment Council (SEC) temporarily suspended the green label of APP's exclusive distributor in Singapore, Universal Sovereign Trading. On Sept 30, the SEC had also asked 17 firms, including FairPrice, to sign a form to declare that they do not carry products from five companies, including APP, which are under probe over their possible link to the haze-causing forest fires." Straits Times, October 8th 2015

Transition risks

The financial stability risks that could result from a disorderly transition to a low-carbon economy, where existing assets are re-valued downwards in response to unforeseen developments, such as regulatory signals or major technological breakthroughs. For example:

"According to a 2014 Rocky Mountain Institute report, 'the point at which solar-plus-battery systems reach grid parity [...] is well within the 30- year planned economic life of central power plants and transmission infrastructure. Such parity and the customer defections it could trigger would strand those costly utility assets.' American Electric Power's fossil fuel assets may already be at risk of stranding. AEP has aggressively sought a customer financed 'bail out' of its aging coal infrastructure in Ohio, even resubmitting the request after it was denied in early 2015." Ceres Investor- network

These indicators point to a growing trend of unsustainable production methods increasing the pressures on the credit-worthiness of trade finance banks' underlying clients. Working together with the BEI, institutions such as the ICC and/or BAFT could co-ordinate targeted education programs for the banking industry as a whole to support enhanced risk management within the industry on such issues. Coupled with playing a coordination role to support greater flexibility in the types of finance currently made available by MDBs and ECAs, which would support innovation of sustainable trade finance products, the outcome could be a steady growth in capital-efficient financing which will encourage sustainable production methods and satisfy customer demand.

Next steps

This paper argues that reducing the cost of funding in the market for banks booking sustainable trade finance transactions or products is currently the most viable and practical consideration, while supporting a more systematic consideration of sustainability in credit risk analysis should also be pursued.

This paper therefore makes the following recommendations in terms of next steps:

a) **Co-ordinate and develop efforts with Multilateral Development Banks and Export Credit Agencies.** On behalf of the BEI member banks and those that have adopted the Soft Commodities Compact, the BEI should act together with an institution such as the ICC and/or BAFT to drive a co-ordinated approach to all of the key MDBs and ECAs on this topic. A near-term aim could be to develop deeper understanding amongst banks about the actions MDBs and ECAs have already taken to adjust the cost of funding to support sustainable trade finance products. A more ambitious aim could be to trigger a new wave of initiatives, co-ordinated globally, to support a step-change in bank activity across the industry.

b) **Integrate sustainability into mainstream education of credit risk officers.** Working with the BEI, the ICC and/or BAFT should promote education programmes to help banks understand how their market context is changing and drivers of risk relating to sustainability issues and climate change are increasing. This would be a valuable process to inform banks' own processes and manuals, especially at the credit/risk analysis level. Where appropriate, this should also include the sharing of expertise held by many banks and regulators to give the industry overall a better understanding of new market best practices.

c) **Maintain a 'watching brief' on – and be ready to engage with – further interest shown by regulators.** At both national and supranational levels, the level of interest being shown by regulators in these issues appears to be increasing. Globally, this is currently a fragmented landscape, though there are notable efforts by some supranational bodies such as the Financial Stability Board to try and drive greater co-ordination, and the focus is currently more on prudential risk management than in compliance, for instance. Leading banks would be well advised to maintain a close watching brief on these developments so that they can engage positively, with well-informed positions, as required.

Abbreviations

AML	Anti Money Laundering
BAFT	Bankers Association for Finance and Trade
BEI	Banking Environment Initiative
BIS	Bank for International Settlements
CBRC	China Banking Regulatory Commission
CCF	Credit Conversion Factor
CDD	Customer Due Diligence
ECA	Export Credit Agency
ECB	European Central Bank
EIB	European Investment Bank
GATT	General Agreement on Tariffs and Trade
ICC	International Chamber of Commerce
IFC	International Finance Corporation
KYC	Know Your Customer
LIBOR	London Interbank Offered Rate
MDB	Multilateral Development Bank
NGO	Non-Governmental Organisation
RoC	Return on Capital
RoE	Return on Equity
RoIC	Return on Invested Capital
SDG	Sustainable Development Goals
SIBOR	Singapore Interbank Offered Rate
UNEP FI	United Nations Environment Programme Finance Initiative
WTO	World Trade Organisation
WWF	World Wide Fund for Nature