It takes a financial village

David Morrish examines the important role that banks can play in sustainable trade finance as providers of expertise, scale and robust compliance within a transparent supply chain

Risk comes in many forms and, in principle at least, financial markets help to manage it by transferring it, in whole or part, to the counterparties best able to cope. A particular strength of market-based financing is that counterparties can be varied both by sector and geography. But some parts of the world are cut off from the benefits of mainstream finance, with negative consequences – particularly when it comes to fostering sustainability.

Sustainability is no longer just a "nice to have". One of the main global challenges of the next 10 to 15 years will be meeting the UN's Sustainable Development Goals (SDGs). (See FW, December 2018/January 2019, for recent articles on these.) "The SDGs are a moral imperative, with objectives that include nothing less than ending poverty, fighting inequality and injustice and tackling climate change. The SDGs are also an economic imperative…[providing] ultimately stronger growth," said Mark Carney, governor of the Bank of England, in a speech to the UN General Assembly in April 2016.

One of the stumbling blocks in building sustainable supply chains is that financial markets in developing countries may function poorly. "In parts of Malawi, there is no cash distribution system," says Shona Tatchell, chief executive of Halotrade, a start-up that is using blockchain to help build sustainable, transparent supply chains and has a live pilot with tea farmers there. "Farmers have to wait for a truck to come once a week." Small agricultural producers in such regions may not even be able to get a market price against which to bargain or plan. Malawi offers pricing certainty and predictability by setting a cap and a floor on tea prices, but tea is a low-value commodity so incomes are small.

Such conditions make immediate goals around sustainability – such as a secure living wage for the farmers, prevention of deforestation, good water management and the development of renewable energy sources – difficult to achieve. When income-smoothing mechanisms, such as credit or interest-bearing savings, are also not available, investment in any form of development becomes challenging.

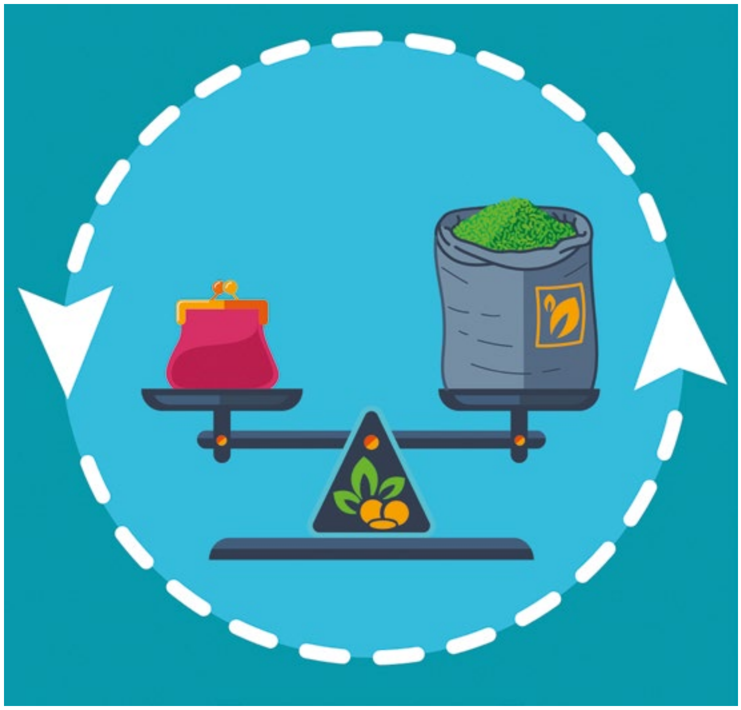
There are many initiatives on the ground in developing countries designed to help with financing needs. M-Pesa, the mobile phone-based money transfer service, for example, was set up by Vodafone to help funnel remittances. But its success depended on a network of banks and agents that could support liquidity locally and Carney argued in his speech that although "niche" approaches such as social impact investing and multilateral development banks are "important catalysts…[they] won't be sufficient" to meet the SDGs. He called for "sustainable investment flows, based on both resilient market-based and robust bank-based finance".

The thinking is that banks should be able to bring scale, expertise, discipline and transparency to funding sustainability. For commodity trading, that generally means bringing in large, international banks. Ghana Cocoa Board (Cocobod), for example, a marketing board that aims to obtain the best price for its small cocoa producers and to maximise Ghana's foreign exchange revenue, raises capital in the international markets each year. Its 2018 syndicated loan was for $1.3bn and priced at 60 basis points over Libor. At that point, local banks charged between 15 per cent and 40 per cent for loans to agricultural businesses. The international banks not only brought much tighter pricing, they also brought size. Ghana has an annual GDP of about $50bn, so $1.3bn is more than local lenders could support.

> *Some money services are cut off from the global banking system, leading to 'financial abandonment'*

But small producers in developing markets do not enjoy the market clout of Cocobod and that weakness has been compounded since the financial crisis by the withdrawal of large banks from some correspondent banking relationships. Tougher regulations on, for example, "know your customer" and money laundering, together with higher capital requirements, have made maintaining correspondent relationships in some markets unprofitable and reputationally risky. The upshot is that some banks and money services are cut off from the global banking systems, leading, Carney says, to "financial abandonment".

The higher costs and lack of transparency that have made many international banks prune back their trade financing activities add up to "abandonment" for several reasons. For example, they mean that affordable funding, and sufficient funding, may not be available, even for profitable projects. Developing countries that cannot access funding beyond their own borders also cannot externalise risks. Everything depends on government treasuries and on local policy, which may not be optimal. There are other problems but enabling commodity-dependent countries to manage their economies sustainably "will play a crucial role" in meeting the SDGs, according to the UN Conference on Trade and Development.



What to do? "There is no magic bullet to having a verifiably sustainable supply chain," says Tatchell at Halotrade. "You have to be part of an active consortium and you can't just parachute in and then leave again. A scalable solution needs banks, regulators, corporates, tech companies and philanthropists to work together." (Tatchell is a former head of trade finance innovation at Barclays.)

The Halotrade project in Malawi is backed by a number of institutions including Unilever, which provides supplier finance and so shoulders the credit risk, as well as Barclays, BNP Paribas, the Cambridge Institute for Sustainability Leadership, IDH, Provenance, Rabobank, J Sainsbury's and Standard Chartered. Its initial aim was to encourage sustainability by putting more money in the pockets of small farmers. "The savings in the supply chain financing are in the order of 8 per cent but, because tea prices are capped in Malawi, they go into a development fund for the farmers that helps them, for example, to make better use of water resources, to get education and to put in solar panels," says Tatchell. A transparent supply chain, however, has benefits that go beyond a higher standard of living on the ground.

"The market does ask for due scrutiny of environmental, sustainable and green (ESG) credentials," says Mike Wilkins, head of sustainable finance at S&P Global Ratings. He adds that investors in ESG "are not hunting for yield, they are looking for assets to populate an ESG fund to sell to retail investors. They also want to show regulators that they are shifting their focus towards sustainability."

Tatchell wants to see regulators back sustainable investment by amending the rules to support it. "The loss given default on verifiably sustainable and transparent projects should be lower, so the cost of capital should also be lower," she says. Regulators are aware of the need for change. "There has been a really big emphasis by investors and regulators on ESG reporting since the Paris agreement on climate change, but the quality of the reporting still varies considerably," says Corinne Bendersky, associate director, sustainable finance, at S&P Global Ratings.

She says that "in terms of level and consistency" the quality of data on the ground is mixed. The rating agency has introduced a diagnostics questionnaire for its ESG evaluation that aims to allow comparison across sectors. The metrics include health and safety records and data on water recycling – just the sort of data that companies such as Halotrade want to provide.

"Does doing good also mean doing well? There are some studies that suggest that good ESG practices are related to good financial performance," says Bendersky. In Wilkins' view: "There will come a time when transparency on the environmental contribution of financing will have to be baked-in. The green labels on specific instruments may disappear as companies are required to show their environmental credentials through mainstream financial disclosures." ■

David Morrish *is relationship director at The London Institute of Banking & Finance, responsible for the development and promotion of its international trade finance qualifications. Prior to his current role, David worked for the Lloyds Banking Group, where he led its main corporate trade branch in the City of London*