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Industry Perspectives: Trade finance and the ESG revolution

The trade finance market is undergoing a radical transformation in terms of environmental, social and corporate governance (ESG). In this *Industry Perspective*, two lawyers at Allen & Overy – Niels de Ru, partner in Amsterdam, and London-based partner Matt Townsend – discuss the regulatory reforms and market pressures driving change among banks and borrowers.

De Ru is head of the firm's trade and commodity finance group, while Townsend is co-head of the firm's international environmental, climate and regulatory law groups, as well as co-head of its international trade group. The two lawyers outline the shift towards sustainability-linked financing, tackle issues around standardisation and greenwashing, and explain the role of law firms in helping firms achieve their ESG ambitions.

GTR: How is the ESG landscape changing in trade and trade finance?

Townsend: We're at a fascinating moment for ESG. First, we're in a period of rapid evolution of the regulatory landscape. It's difficult to remember another time where we've seen anything like the rate of regulatory change that we're seeing now, particularly reforms such as the EU's Green Deal programme and its Fit for 55 climate package.

At the same time, the EU taxonomy for sustainable activities is highly significant in the commodity trading space, because lenders will increasingly seek to align the underlying activities they are financing with that framework. There is also a different dynamic now around reputational concern. Any instrument or form of financing that is tagged as sustainable will be looked at much more closely than it used to be, and that means lenders also have a much greater sensitivity when it comes to accusations of greenwashing.

Underpinning all of this is that from a policy perspective, governments and central banks have made it clear they wish to drive private capital and public funds towards green or sustainable purposes. Taking all of these factors together, this diversion of funds can probably be seen as the biggest redeployment of capital since the Second World War.

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GTR: How is the market responding to those various external pressures?

De Ru: First, when you look at the increase in sustainability-linked financing over the past few years, it's impressive. Numbers published by *Bloomberg* showed that last year, the increase in sustainability-linked transactions was around 50%, compared to 2020, and I expect this year the increase will be even greater.

But more specifically, we're seeing the dynamics around pricing changing rapidly. We have seen borrowers incentivised to meet sustainability targets through pricing on the financing they have, typically by the threat of reductions in their margin. We're now seeing margin adjustments both up and down, meaning there can be a premium that a borrower will get if it meets all of the elements in its ESG KPIs.

A major trend, however, is that both borrowers and lenders are asking whether they should be seen to profit from their ESG performance. Is it right that a lender receives a better margin if its borrower fails to meet its ESG criteria, or that a borrower is rewarded for doing something it should be doing in the first place? In a number of deals we've seen recently, those price differentials are not paid to either the borrower or the lender, but to an external organisation, such as a charitable foundation set up by the borrower, whose goal is to further ESG compliance.

GTR: How can banks and borrowers avoid accusations of greenwashing?

De Ru: There is a common understanding developing in the market that ESG means measuring performance against specific definitions and criteria. A couple of examples are the sustainability-linked loan principles published by the Loan Market Association in May last year, and the sector-specific due diligence criteria produced by the European Leveraged Finance Association. Also, in November last year, the International Chamber of Commerce issued a policy paper announcing it would work to articulate a definition of sustainable trade and trade finance, drawing in market opinion, that everyone can adhere to.

A few years ago, a borrower's performance in terms of ESG would typically be measured by an external rating agency producing a generic report on certain criteria. A trend we've seen recently is borrowers trying to define their own unique sustainability performance targets, for instance on greenhouse gas reduction targets or the use of green energy in powering the business.

We're also seeing targets set by borrowers in conjunction with their banks, which often play a sustainability coordinator role. The result of this trend is that there is less risk of greenwashing your financing by using generic targets that may have already been met, or are easy to meet.

GTR: What other challenges are still being addressed?

Townsend: In commodity finance, there's a lot of regulatory reform targeted at the underlying commodities themselves. If you look at the EU's proposals for forestry regulation, for example, they're not just about timber; they target any commodity that is generated from land use. We are also starting to see greater regulatory focus on commodities beyond the traditional extractives. We expect this will result in more stringent sustainability criteria being applied to commodities placed on operators in the European and the UK market.

Ensuring sustainability across the whole supply chain is challenging. We're only at the beginning of that journey, but we're already seeing borrowers and lenders take a much closer look at sourcing, and I think it's fair to say they are much more sensitive to transparent, thorough due diligence. This is another area where we're now seeing new legal requirements emerge, for instance from the EU around mandatory supply chain due diligence. We can also expect greater scrutiny from NGOs and lenders when it comes to direct and indirect supply chains. That may have an impact on the availability of capital and the level of work needed on getting lenders comfortable on deals.

GTR: What is the role of law firms?

Townsend: In addition to helping paper the transactions, law firms can help borrowers understand and adapt to evolving market and regulatory requirements. Another layer is helping clients appreciate what the horizon looks like, and what will be the likely direction of travel. ESG is not just a once-in-a-moment development. To properly advise clients in this space, whether on the borrower or the lender side, you need a blend of expertise between financial products and sustainability. That blend means we can also help shape market practice and policy developments, by working with clients and trade associations to shape views on emerging regulation. As the market moves quicker than the regulation, lawyers with deep expertise can help clients shape their deals to ensure they're legally and reputationally robust.