SSCF - the fastest way to a sustainable global economy

Monica Blanco

SCF Consultant

FCI

Build Back Better, the Japanese concept of investing in disaster risk reduction, adopted by the UN in 2015 in the Sendai Framework for Disaster Risk Reduction, has become a well-known concept during this health crisis.

In the world of trade, where seven out of the ten identified highest impact risks have shocked global supply chains, and where supply chain finance is being undermined by the specialised press and several governments in several countries, the motto Build Back Better takes on an extreme opportunity to improve sustainability in supply chains through SCF.

The time when pollution or poor labour conditions were seen by companies and consumers as the price of doing business no longer exists. Thanks to the internet, consumers are better informed than ever and are increasingly demanding ethical codes from companies. All companies, regardless of where they stand in the supply chain, are no longer exclusively responsible to their shareholders; they are also responsible and accountable to society and will play a greater role in the development of sustainable markets.

Financial providers, as part of the value chain, will support trade, while minimising future negative impacts like the ones we have experienced in previous years, such as pollution, deforestation, desertification, and illegal labour. This has been caused by neglecting resources that can be regenerated to make corporations and supply chains sustainable in time.

Sustainability fell under philanthropy as a chapter in corporate social responsibility and investor relationships. Frequently it was enough to say that a company was as sustainable as it could be. But the financial crisis and the pandemic have both revealed that we were living under inappropriate governance rules, based exclusively on short-term targets and profit.

Exactly 18 years ago, the oil tanker Prestige broke in two and sank off the north-west coast of Spain, spilling 20,000 tons of fuel into the sea, affecting 2,000 kilometres of shore; the devastation spreading to Portugal and France, causing the third biggest and most costly accident in history, after Chernobyl. Not only was it costly in money, but it was also a social and environmental disaster of the greatest magnitude.

Investigation into this catastrophe showed that the oil trade was like Russian dolls, where companies based in tax havens were hidden one inside the other. The owner of the ship was based in Liberia. The flag of the vessel, in the Virgin Islands - a Russian company - Crown Resources - that hired the battered ship, as a branch of a financial company based in Gibraltar, and the Russian consortia Alfa Group, based in Switzerland (that owned and managed said ship), were merely the tip of the iceberg. Within such arrangements were other companies and prestigious banks: all of them held statements of the highest environmental care in their Annual Reports, when in reality they all eluded their responsibilities in the oil spill.

Eighteen years later, a pandemic has broken out, and the reality is that corporate governance and self-regulation has captured the attention of policy makers. As I am writing this, the European Commission has an open public consultation on sustainable corporate governance that will help put forward a proposal in 2021. This consultation complements two studies that focus on sustainable and responsible corporate behaviour, to prevent adverse influences on society and the environment. Its findings might entail new regulation at EU level, requiring companies to report publicly on steps they have taken to identify, address, prevent and mitigate any adverse impact of their operations and on third-party businesses. There were some attempts for the development of such regulations in the UK or in France and, at the European level, under the EU Non-Financial Reporting Standards. However, such reporting requirements related to the adequacy and the frequency of the reporting but did not meet any required standards or provide any remedy to those found affected, which ultimately raised concerns about the effectiveness of these reports.

For the European regulator, companies still have a short-term and financial focus that affects their ability to integrate sustainability into their risk management and business strategy. This is the reason there are plans to develop new regulation where Environmental, Social and Governance (ESG) risk analysis and metrics will be designed and used by investors as an insight into a company's quality of management. Eventually these will convert into financially relevant business indicators, providing good insight for investors.

The regulator has put supply chains as a central core value of sustainable development, and its focal point is the due diligence process. This new due diligence process will not only include the identification and assessment of potential impacts, but will also implement measures to act upon findings. For the Prestige case, this could have made a difference. The guarantee given to the shipping company and the finance given to the owner of the oil would have not passed ESG risk analysis. The environmental dangers of the fuel oil used is twice as dangerous as regular fuel as it is non-water soluble: this would have required better due diligence of the maritime transport; an obsolete and unsecure single-hull tanker with pending application of the EU Directive on maritime safety. By applying ESG analyses to this great environmental and social catastrophe, health and safety issues and vast economic losses could have been avoided.

Global organisations, financial institutions and technological providers, as integral parts of supply chains, should act as proactive promoters and enablers of this change which will bring not only a better, more sustainable future, but also great financial and reputational profit to our organisations. This is the time where society, as our stakeholders, demands not to be reactive.

Recently a development bank declined offering a risk participation guarantee to a financial institution for an SCF programme with an anchor client in the mining sector, due to the environmental risks associated with this industry. However, it would be better to take an active role in the development of environmental management standards as a condition to offer a risk participation agreement, which would greatly benefit the society as a whole, instead of rejecting the programme.

Although there are some efforts to make sustainable supply chain finance programmes, like the ones run by Puma and Levi Strauss, these still generally remain in the sphere of loans or bonds given to certain suppliers, and not in factoring or reverse factoring programmes.

If we think about the fastest and most secure way to a future of sustainable supply chain finance, reverse factoring is the most challenging yet more promising technique to achieve these goals because of its cascading effect.

The challenge for financial institutions is to take the few (but courageous) steps necessary to achieve these goals, which will start by thinking and designing how to develop sustainable SCF deals by collaborating with anchor clients in defining and tailoring more sustainable programmes, as well as helping them understand how they can add value to each process.

By integrating ESG parameters, created together with anchor clients and translating them into KYC and on-boarding efforts, we can achieve a great deal of sustainability in a shorter amount of time. The key challenge here is to have the right metrics against which to measure suppliers and also the right approach to make the benefits of sustainability investment easier to understand. These programmes can create incentive for them to take part by offering preferential discount rates.

Another challenge is how to deal with ESG data, and here is a great opportunity for technology providers to differentiate themselves. Many studies show that blockchain will be an asset for this kind of transaction. However, blockchain demands a unified, multilateral approach to regulation, and how to interpret such regulation in code is still difficult. It would be hard if ESG regulation is not unified over all geographies as it would require a supranational body to coordinate efforts, which would not be easy to develop.

Until then, only cooperative supply chain finance relationships could be the answer to a quicker, sustainable finance approach. For this reason, associations like FCI - that are the link between financial institutions promoting and ensuring best practice in supply chain finance - can play a major role in educating, together with development banks and other international organisations. They can be part of the transformation, promoting real change and ensuring that we Build Back Better.

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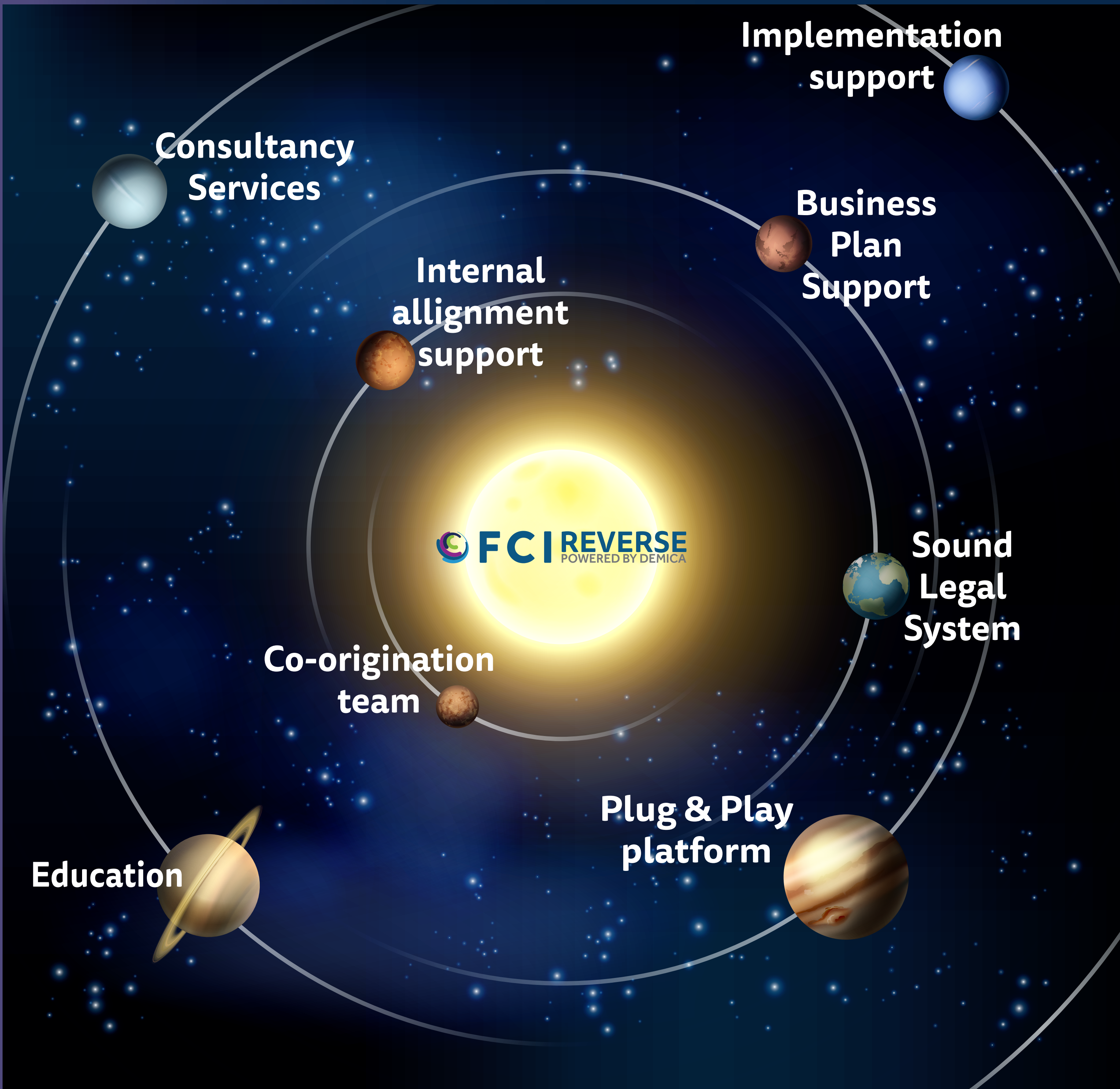

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