

The Banking Environment Initiative's Sustainable Shipment Letter of Credit

A financing solution to incentivise sustainable commodity trade



Executive Summary

The Chief Executives of the world's biggest buyers of agricultural commodities have, through the Consumer Goods Forum, made public commitments to transforming supply chain practices such that by 2020, their palm oil, soy, pulp and paper and beef supply chains will be helping to achieve zero net deforestation. To deliver this goal, these companies have set deadlines by which they will be procuring only commodities that were produced in line with certain sustainability standards. The banking industry, through the Banking Environment Initiative (BEI), has been working with these companies to establish what aligning banking services with this major client-led transformation would look like in practice.

This paper describes a documentary trade finance solution that has been developed by a group of leading commodity buyers, trading houses, international trade finance banks, development banks, trade finance industry bodies and international NGOs. The University of Cambridge Programme for Sustainability Leadership (CPSL), as the Secretariat for the BEI, convened the relevant industry and supply chain expertise and designed and delivered the collaborative process that led to its agreement.

Specifically, this paper details the simple means by which internationally-recognised sustainability standards associated with individual commodities can be integrated into Letters of Credit (LCs) that support the international trade of commodities. This paper refers to such LCs as the **BEI's Sustainable Shipment LCs** and uses the palm oil supply chain as a demonstration case.

This financing solution does not see trade finance banks acting as the setters or enforcers of sustainability standards; the demand for a Sustainable Shipment will still need to come from the buyer (or importer) and the standards discussed in this paper are agreed independently by a multi-stakeholder, non-profit organisation, the RSPO, which also runs its own audit and verification process. However, the BEI's Sustainable Shipment LC does allow trade finance banks to differentiate between Sustainable Shipments and conventional ones and subsequently consider how they might incentivise the growth in trade of sustainably produced commodities.

Amongst a number of options, one particular incentive mechanism has been explored in some depth and relates to the Global Trade Finance Program (GTFP) of the International Finance Corporation (IFC). The GTFP offers trade finance banks partial or full guarantees covering payment risk on trade in emerging markets, thereby not only improving the risk characteristics of the individual transaction, but also the cost of capital for banks engaging in that line of business. Within the GTFP, the IFC has already been offering banks preferential terms for shipments classified as contributing to climate change solutions and has decided that the BEI's Sustainable Shipment LCs will also be eligible for such treatment. Participating banks could therefore choose to share some or all of these economic benefits with their clients.

The BEI and its Sustainable Shipment Working Group believe that the BEI's Sustainable Shipment LC is practical to implement, is commercially attractive and offers a platform for banks to deliver material support in transforming commodity supply chains to deliver more socially equitable and environmentally sustainable outcomes on the ground.

By publishing this paper, the group aims to bring the mechanics and benefits of the BEI's Sustainable Shipment LC to the attention of all commodity buyers, trading houses, trade finance banks, development banks and others to encourage them to engage with the concept, to commit to supporting it and to translating it into a new market norm. To this end, the BEI looks forward to working with representatives of all of these stakeholder groups.

This paper is constructed as follows:

1. Executive Summary	2
2. Publication details	4
3. Abbreviations and figures	5
4. The context for this paper	6
5. The BEI's Sustainable Shipment LC: An overview	8
6. The palm oil supply chain and sustainability standards	10
7. How does the BEI's Sustainable Shipment LC work in practice?	17
8. Incentive mechanisms enabled by the BEI's Sustainable Shipment LC	20
9. What impact could the BEI's Sustainable Shipment LC have?	23
10. Next steps	24



Deforestation to make way for palm oil plantations in Malaysia

Image courtesy of Mongabay

2. Publication details

Reference

Please refer to this paper as *The BEI's Sustainable Shipment LC: A financing innovation to incentivise sustainable commodity trade (CPSL, 2014)*.

Author

Andrew Voysey, Development Director, Finance System, CPSL

Contributors

With thanks to the BEI's Sustainable Shipment Working Group:

Kai Fehr (Chairman)	Managing Director, Head of Trade and Working Capital, Asia, Barclays
Alain Verschueren	Head of Sales, Correspondent Banking, BNP Paribas
Andy Wright	Managing Director, Funds Services, RBS and Member of the Board of Directors, BAFT-IFSA
Daniel Schmand	Head of Corporate Trade Finance and Cash Management, EMEA, Deutsche Bank and Vice Chair, ICC Banking Commission
Jeremy Goon	Group Head of CSR, Wilmar International
Josh Levin	Senior Program Officer, Finance and Commodities, WWF
Patricia van Haaren	Procurement Director, Commodities – Europe and the Americas, Unilever
Sabrina Borlini	Global Manager for Business Development, Global Trade and Supply Chain, IFC
Sharon Chong	CSR Manager, Wilmar International
Thierry Senechal	Executive Secretary, ICC Banking Commission
Thomas Lim	General Manager – Trading (Tropical Oils), Wilmar International

Copyright © 2014 University of Cambridge Programme for Sustainability Leadership (CPSL). All rights reserved.

Reproduction and use: The Intellectual Property Rights associated with these outputs will be vested in the University of Cambridge. Permission is given for non-commercial uses including, but not limited to, dissemination, posting on intranet or extranet websites and distribution to third parties at no cost, provided that it is attributed to CPSL. Reproduction for sale and other commercial purposes is not authorised without written permission of the CPSL and other rights owners as identified in the publication. For reproduction of illustrations such as maps, photographs, figures, diagrams, charts, tables or other data, see original source information as stated in the publication. Enquiries concerning reproduction outside the scope of the above permitted uses should be sent to CPSL at the address below.

This document is available for download from the CPSL website: www.cpsl.cam.ac.uk

This publication has been developed by and is released by CPSL, 1 Trumpington Street, Cambridge CB2 1QA, UK.
Email: info@cpsl.cam.ac.uk

3. Abbreviations and Figures

The following abbreviations appear in this paper:

BAFT-IFSA	Formed by the merger of the Bankers' Association for Finance and Trade (BAFT) and the International Financial Services Association (IFSA)
BEI	The Banking Environment Initiative
CGF	The Consumer Goods Forum
CPSL	The University of Cambridge Programme for Sustainability Leadership
CSPO	Certified Sustainable Palm Oil
ECA	Export Credit Agency
FFB	Fresh Fruit Bunches (term used by the RSPO to denote palm fruit bunches)
GTFP	The Global Trade Finance Program
ICC	The International Chamber of Commerce
IFC	The International Finance Corporation
LC	Letter of Credit
MB	Mass Balance, one of the RSPO's supply chain systems
NGO	Non-governmental organisation
RSPO	Roundtable on Sustainable Palm Oil
SG	Segregated supply chain, one of the RSPO's supply chain systems
WWF	The World Wide Fund for Nature

The following figures appear in this paper:

Figure 1: The documentary trade finance process	8
Figure 2: A simplified schematic showing the structure of the palm oil supply chain	10
Figure 3: The RSPO's 'Book and Claim' supply chain system, courtesy of RSPO	12
Figure 4: The RSPO's 'Mass Balance' supply chain system, courtesy of RSPO	12
Figure 5: The RSPO's 'Segregated' supply chain system, courtesy of RSPO	13
Figure 6: Supply chain documentation, with additions for certified palm oil in green	14
Figure 7: The sequence of events underpinning trade supported by an LC	18
Figure 8: An example of a Bill of Lading bearing the CSPO stamp	19
Figure 9: The geographic distribution of banks participating in the IFC's GTFP	21
Figure 10: A schematic description of how the GTFP works	22

4. The context for this paper

This paper sits in a wider context of collaboration between the banking industry, led by the BEI, and commodity buyers, led by the Consumer Goods Forum (CGF), to identify changes in bank practice that could better support the client-led transformation of commodity supply chains to help achieve zero net deforestation by 2020.

The Banking Environment Initiative

The Chief Executives of some of the world's largest banks convened the BEI in 2010 to lead the banking industry in collectively directing capital towards environmentally and socially sustainable economic development. The group comprises 10 banks from Asia to Europe and the Americas: Barclays, Bank of New York Mellon, China Construction Bank, Deutsche Bank, Lloyds Banking Group, Nomura, Northern Trust, Santander, Sumitomo Mitsui and Westpac.

Antony Jenkins, Group Chief Executive of Barclays, chairs the BEI's Chief Executive Panel. Jeremy Wilson, Vice Chairman, Corporate Banking at Barclays, chairs the BEI's Working Group. The Secretariat is provided by the University of Cambridge (CPSL).

The BEI achieves its mission by working in direct partnership with its customer base and through the active leadership of its Chief Executives. The initiative focuses on topics where industry-wide action is needed, bringing independent thinking to bear on the issues. At the heart of the BEI's work programme are unique work streams bringing together groups of corporates to identify how banks can better support their needs on key sustainability topics.

The BEI's alliance with commodity buyers

In 2010, the 50 Chief Executives sitting on the Board of the Consumer Goods Forum (CGF) made a public resolution to mobilise resources within their respective business to help to achieve zero net deforestation by 2020.

These companies felt moved to set this bold target in recognition of the fact that their license to operate and the security of their supply chains depends on reconciling the economic, social and environmental issues associated with the conversion of tropical forests to agricultural land, producing commodities core to their business.

CGF member companies, with their combined procurement power of approximately \$3 trillion, are now transforming soft commodity supply chains by integrating sustainability standards into their procurement policies, setting targets and working with suppliers to support their transition to these standards. With the help of international NGOs, they have prioritised the **palm oil, soya, beef and pulp and paper** supply chains, as these are associated with a significant portion of tropical deforestation.

In 2011, the BEI leadership formed an alliance with the CGF to determine how the banking industry could help core member companies to achieve this goal. This collaboration has found new opportunities for targeted commodity supply chain finance to support the transformation of supply chains, aided by working with many key off-takers, and has determined how to introduce the sustainability standards prioritised by CGF member companies into policies governing the provision of finance to key actors in commodity supply chains.

The CGF-BEI Soft Commodities Compact

A major early output of this work is a Compact between the CGF and the BEI (and other major commodity finance) banks. This Compact sets out the commitment of adopting banks to act on the above areas by proactively financing the transformation of supply chains and raising industry-wide banking standards. The Compact was formally endorsed by the Chief Executives of the CGF Board at a meeting in New York in December 2013.

The link between the Soft Commodities Compact and the BEI's Sustainable Shipment LC

The main focus of the Compact at this stage is finance for producers, which, although it represents a small proportion of overall trade and supply chain finance, has a significant impact on farming practice. When banks are financing international trade shipments, the due diligence processes ensuring appropriate standards are in place governing the production of whatever is being shipped have already happened.

At the inaugural BEI Forum in London in 2012, senior trade finance practitioners recognised that if the BEI's focus on sustainability standards in producer finance could be translated in a practical and commercially attractive way into the world of trade finance, the BEI could help these standards to be embedded by all parties throughout global supply chains and multiply its impact in a targeted manner, especially if banks could further incentivise Sustainable Shipments over non-sustainable ones.

In parallel to the development of the Compact, therefore, a proposal was developed outlining how documentary trade finance services could increase the visibility of these standards in international trade flows and generate incentives for buyers, suppliers and the banks prioritising them.

Throughout the first half of 2013, this concept was shared with commodity buyers, trading houses, trade finance banks and development banks through forums such as the International Chamber of Commerce (ICC) Banking Commission biannual member meeting, BAFT-IFSA's Asia, Europe, Americas and global member meetings and Global Trade Review (GTR)'s Asia Trade Finance Week in Singapore. The concept has been consistently welcomed by buyers, trading houses and banks alike, and all have urged the BEI to convert the concept into a specific proposal in a pilot commodity supply chain.

The University of Cambridge's Programme for Sustainability Leadership (CPSL), as the Secretariat for the BEI, therefore convened relevant industry and supply chain expertise and designed and drove a collaborative process to explore this in detail. The results are contained in this paper.

5. The BEI's Sustainable Shipment LC: An overview

Generally speaking, international trade is either financed on an 'open account' basis or, when greater scrutiny is required on each shipment, via documentary trade finance. In emerging markets, including many of the countries most at risk of tropical deforestation, a significant proportion of international trade is financed through documentary trade services.

At the request of the buyer (or importer), a bank issues an LC to assure the supplier (or exporter) of payment for their shipment, provided certain listed documents have been presented to the bank. By removing the risk faced by suppliers, i.e. that buyers will not pay for their goods, trade finance banks play a critical role in facilitating world trade.

Documentary trade finance is provided for each individual shipment under a standardised Letter of Credit (LC).

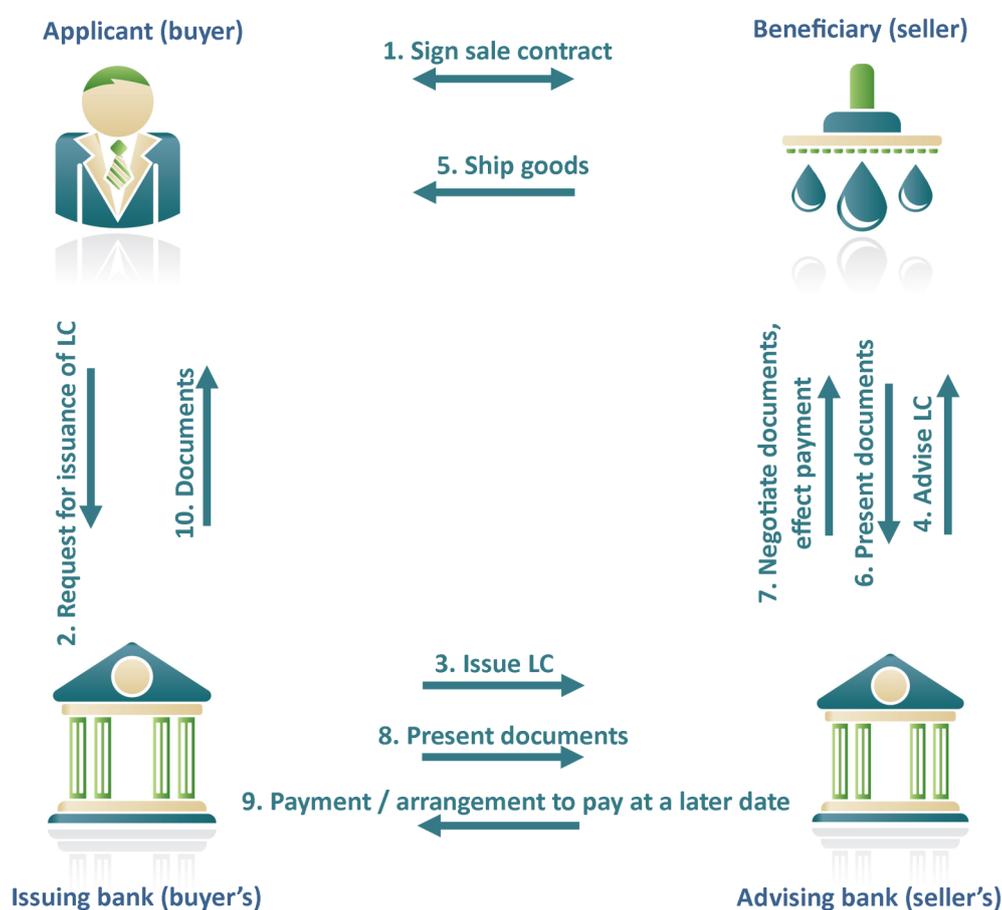


Figure 1: The documentary trade finance process

The documents making up an LC prove that the supplier has carried out the terms of the underlying contract between the buyer and seller and that the goods have been provided as agreed.

The LC can therefore also be used to ensure that all the standards required by the buyer are met by the supplier, provided that these requirements are reflected in the documents described in the LC; indeed, this practice is already common.

The BEI's Sustainable Shipment LC is therefore, in its essence, very simple. If the buyer requires of its supplier commodities produced to a particular, pre-existing and internationally-recognised sustainability standard, it can instruct its bank (the issuing bank) to issue an LC in favour of the supplier including this condition. If such a request does not add materially to the complexity of the documentary trade process and if buyers, suppliers and banks can be incentivised to prioritise these Sustainable Shipments, then the trade finance industry can play a material role in increasing the visibility of sustainability standards in supply chains and rewarding their greater use, thereby helping to drive new market norms.

The BEI has developed this concept by focusing on documentary trade services; the group decided to limit the scope to begin with, prove the concept and build from that basis in due course. The fact that documentary trade plays a significant role in emerging markets, which carry the highest risk of tropical deforestation, made for further strategic justification. That said, the principles underpinning the BEI's Sustainable Shipment LC concept are applicable to open account trade as well; this could be detailed by a similar Working Group.

Of the four commodities that the CGF is focused on (palm oil, soya, beef, and pulp and paper), the BEI Sustainable Shipment Working Group elected to use the palm oil supply chain as a pilot to turn this concept into practice and to lay the foundations for its future expansion.

Palm oil was chosen because, of the four commodity supply chains, it has one of the more mature, internationally-recognised sustainability standards, which already accounts for 15% of volumes produced globally*. However, the Sustainable Shipment concept is equally applicable to all commodity supply chains. All that is required is agreement on which internationally-recognised sustainability standards should be prioritised in scope.

*Source: RSPO, 2013: 'RSPO in Numbers' PowerPoint presentation. Available (08.01.14) from www.rspo.org.

6. The palm oil supply chain and sustainability standards

The palm oil supply chain

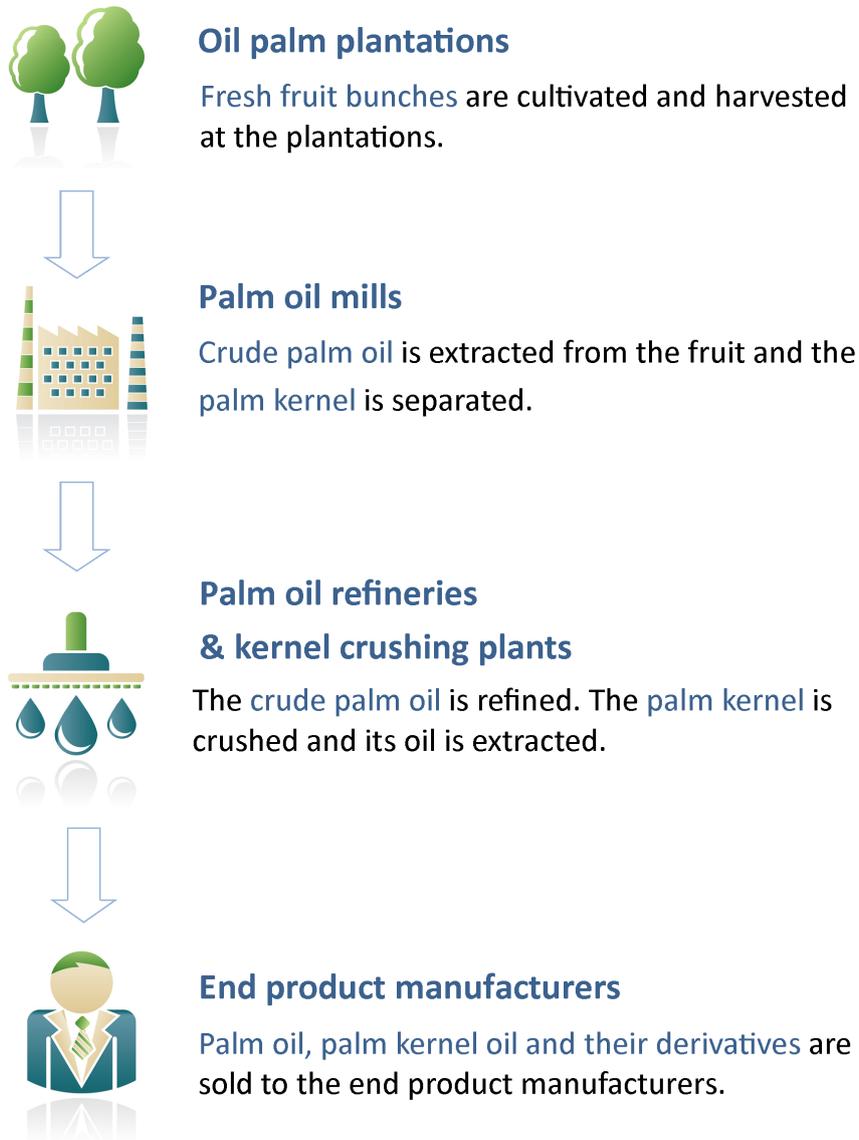


Figure 2: A simplified schematic showing the structure of the palm oil supply chain

The Roundtable on Sustainable Palm Oil (RSPO)

There are a few sustainability standards at different stages of evolution within the palm oil supply chain. The BEI's Sustainable Shipment Working Group decided to focus on one in particular to begin with, namely that produced by the Roundtable on Sustainable Palm Oil (RSPO).

Once again, this decision was taken with the aim of starting with a tight focus in order to make practical progress. The concept can be readily adapted to accommodate other palm oil sustainability standards as needed.

The RSPO was established in 2004 to promote the production and use of sustainable palm oil 'for People, Planet, and Prosperity'*. As an industry roundtable, it brings together oil palm growers, processors, traders, consumer goods manufacturers, retailers, environmental and social NGOs and financial institutions. These parties have agreed a set of principles and criteria to define what they mean by sustainability, and an international certification scheme has been developed to identify oil palm producers operating in accordance with these. Today, 15% of the world's palm oil is certified by the RSPO. Palm oil buyers—many of them CGF members—representing around 35% of global demand have made public commitments to source 100% RSPO-certified palm oil by 2015.

Palm oil certified by the RSPO is referred to as Certified Sustainable Palm Oil (CSPO). For some NGOs, the RSPO standard is not as stringent regarding social and environmental standards as it could be. However, the BEI Sustainable Shipment Working Group's decision to start with a focus on the RSPO was taken on the basis that it is still the international standard of choice for buyers seeking sustainable palm oil in the food and consumer goods industry. It is worth noting that sustainability standards for the production of palm oil for use as a biofuel also exist, but the working group did not consider these relevant for the BEI's Sustainable Shipment LC as these are mandatory standards; the BEI's focus is on how to incentivise greater uptake of voluntary standards.

RSPO supply chain systems

The RSPO operates three different supply chain systems in recognition that the transformation of the palm oil supply chain to achieve sustainability standards throughout is a complex process involving different stages of evolution, and that palm oil buyers will need to meet their own needs and ambitions during the evolution of this process.

1. The first system is called 'Book and Claim'. As represented in Figure 3, this system does not require physical volumes of palm oil to be tracked through the supply chain. Rather, it allows end users to claim support for specific volumes of sustainably-produced palm oil based on RSPO-guaranteed certificates they have purchased online. Buyers tend to see this supply chain system as a representing a necessary transition phase to incentivise more producers to act in accordance with RSPO's Principles and Criteria. In the long term, however, they want to see evidence of sustainable production embedded in supply chains to give them the increased traceability that they require.

*Source: RSPO, 2013: 'Who is RSPO?' web page. Available (08.01.14) at http://www.rspo.org/en/who_is_rspo.

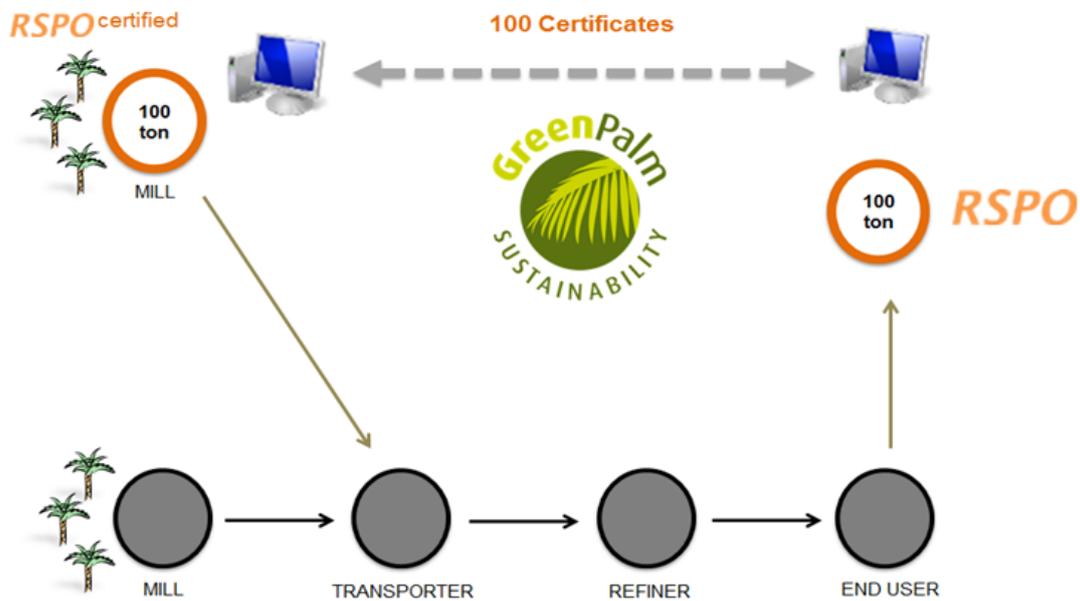


Figure 3: The RSPO's Book and Claim supply chain system, courtesy of the RSPO

2. The second system is called the 'Mass Balance' (MB) system. As represented in Figure 4, palm oil from certified mills is mixed with conventional palm oil during transport and storage. Up until the final refinery, movements of mixed oil are monitored through the supply chain.

Companies cannot sell more sustainable palm oil than they have purchased. This system achieves important progress in tracking physical flows of sustainable palm oil in the supply chain, although it is still seen as a transition phase since sustainable palm oil is mixed with conventional palm oil.

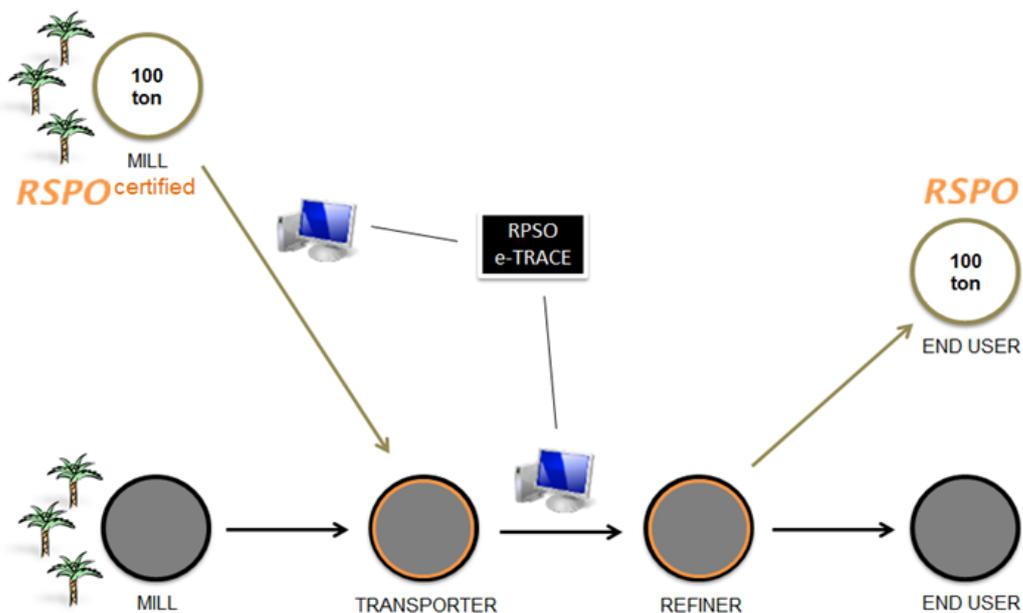


Figure 4: The RSPO's Mass Balance supply chain system, courtesy of the RSPO

3. The third and final system is called the 'Segregated' (SG) system. As shown in Figure 5, in the SG system, palm oil from certified mills is kept apart from conventional palm oil.

Up until the final refinery, all movements of certified oil in the supply chain are reported to a third party and oil can be traced back to certified plantations.

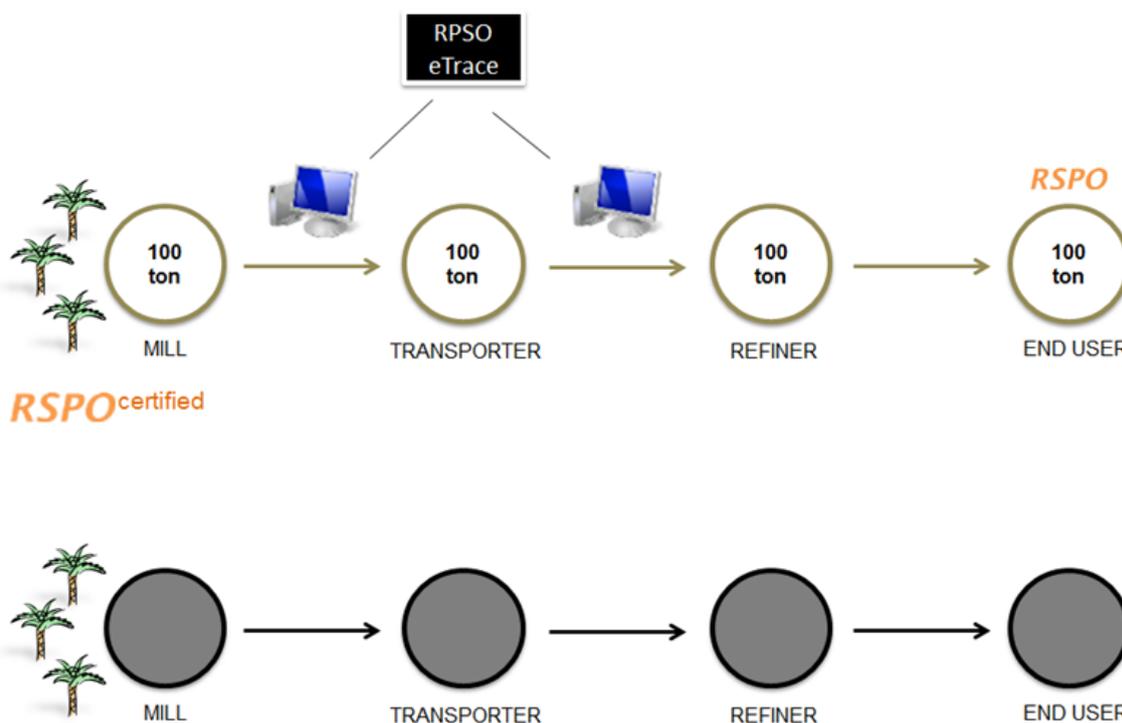


Figure 5: The RSPO's Segregated supply chain system, courtesy of the RSPO

Since it is specifically the flow of sustainability standards through the physical supply chain that the BEI Sustainable Shipment Working Group hoped to promote, it was decided that only the MB and SG supply chain systems should be considered 'in scope' for this work.

A Sustainable Shipment LC in the context of the palm oil supply chain is therefore taken to mean, at this stage, a shipment of CSPO operating under the RSPO's MB or SG supply chain system. Between 30 and 40% of CSPO is traded in this way.*

*RSPO Growth Interpretation Narrative. Available (12/01/13) from: http://www.rspo.org/files/pdf/2011%20RSPO%20CSPO%20GIN_web.pdf

The role of the seller in differentiating certified and non-certified palm oil in the supply chain

As set out in Figure 6, the difference in documentation between the certified sustainable supply chain systems (additions marked in green) and non-certified supply chain systems is simple, and the same process applies to both MB and SG RSPO supply chain systems.

Simply put, at each stage in the supply chain, the supplier confirms to the buyer that the shipment is CSPO.

To differentiate it, the supplier adds a stamp to the relevant documentation, be it the dispatch note, the weighbridge ticket, the delivery order or the Bill of Lading, to mark it as CSPO. No separate RSPO certificate travels with the shipment of CSPO. Instead, the normal documentation is stamped by the seller to indicate that the palm oil has been produced, and is being traded, under either the MB or SG supply chain system.

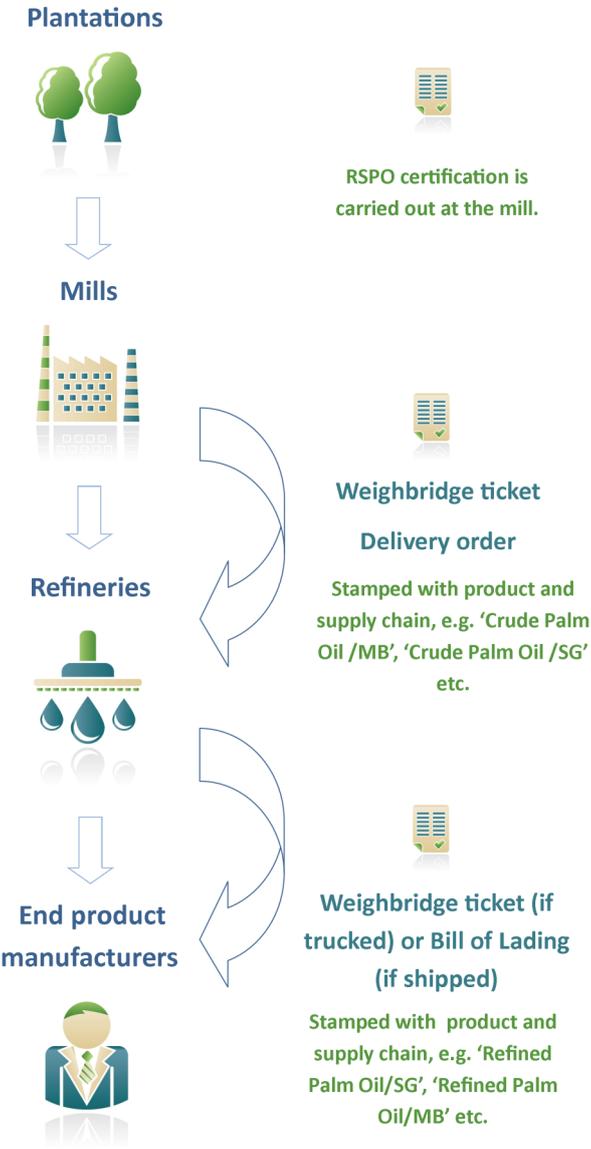


Figure 6: Supply chain documentation, with additions for certified palm oil in green.

How the RSPO system maintains its integrity: The audit process

The BEI Sustainable Shipment Working Group examined the process that the RSPO has in place to monitor and enforce the integrity of its supply chain systems. For banks considering the BEI's Sustainable Shipment LCs, understanding this process, and their role in it, is critical so as to avoid unnecessary complications to their role in facilitating trade flows.

Crucially, the key question became 'If the RSPO MB and SG supply chain systems depend on suppliers stamping relevant documentation, using their own rubber stamps, to verify that a particular shipment is CSPO, should banks servicing the LC for that shipment play a role in confirming the authenticity of such a stamp?'

This question is all the more important when we consider the possibility of incentivising buyers and suppliers to prioritise Sustainable Shipments.

Having studied the RSPO's supply chain audit process, the BEI's Sustainable Shipment Working Group concluded that provided the buyer and the supplier agree about the authenticity of the CSPO stamp, banks servicing relevant LCs have no role other than to ensure that the CSPO stamp that the buyer requested is present on the relevant documentation. For total clarity, banks will not have responsibility for verifying the authenticity of the CSPO stamp, as this is carried out separately by the RSPO.

The RSPO supply chain audit process works as follows. At the beginning of a trading year, producers have to forecast how much CSPO they will be producing. After each shipment of CSPO is made during the year, the supplier announces to RSPO's online tracing system the volume of CSPO that has been shipped. These announcements must indicate:

i. The seller and buyer details (name, address, contact person, telephone number)

ii. Transaction details (seller contract number, seller and buyer reference number)

ii. Product details (product name, quantity)

iv. Supporting documentation attached (e.g. Bill of Lading)

v. Transport details (vessel name, Bill of Lading number, Bill of Lading date)

Details are kept and tracked through the RSPO's online 'eTrace' system so that the annual volume that is announced as having been shipped through the supply chain by individual actors at the end of the year can be compared to both individual shipment volumes and the original forecast. Independent third parties carry out these annual retrospective audits.

If any discrepancy is found, the RSPO will issue a statement of non-compliance and the supplier may have their license to trade CSPO suspended. The RSPO is not currently aware of any errors within the system; any mistakes that arise tend to be admin-related rather than fraudulent.

In addition to this independent audit process, the BEI Sustainable Shipment Working Group took confidence from the fact that, under routine practices of servicing LCs, sellers will only be able to produce relevant documentation bearing the CSPO stamp if the buyer requests it. If the buyer has not requested it, and documentation does bear the CSPO stamp, the shipment may be refused.

Independent non-governmental organisation (NGO) view on RSPO supply chain integrity

On this subject, WWF provided the BEI’s Sustainable Shipment working group with the statement opposite. WWF has worked for many years with the RSPO and a variety of palm oil supply chain actors to raise the sustainability standards of palm oil production and trade.

“The Roundtable on Sustainable Palm Oil’s Mass Balance and Segregated supply chain systems are credible verification methods for ensuring the RSPO’s Principles & Criteria have been implemented on the ground. This includes assessment and protection of High Conservation Value Areas (HCVAs) such as native tropical forest. Though no system is perfect, the self-verification chain-of-custody systems in RSPO, backed by regular field audits, have proven sufficiently robust and effective over the past 7 years, providing confidence that the registered Certified Sustainable Palm Oil (CSPO) in the supply chain was indeed produced in accordance with RSPO principles and criteria.”



Palm oil producer, Thailand

7. How does the BEI's Sustainable Shipment LC work in practice?

An LC is a written undertaking from a bank on behalf of an importer to pay the exporter a given sum of money within a specified time, providing that the exporter presents documents which comply with the terms stipulated in the LC.

Operational detail from the banking perspective

When an LC is issued, the following documents are usually called for by the applicant (buyer) under field 46A (Documents Required) of SWIFT MT700 (the standard format used for issuing LCs):

First party documents (prepared by sellers):

- Commercial invoice
- Packing list
- Beneficiary certificate

Third party documents (prepared by third parties):

- Transport documents (Bills of Lading/Air Waybill)
- Insurance certificate
- Certificate of origin

For the BEI's Sustainable Shipment LC, the LC can call for special documents under field 46A of MT700. As explained in section 6 of this paper, the only special document that needs to be detailed is a Bill of Lading evidencing the CSPO stamp, under either the MB or SG supply chain system, as specified by the buyer. Figure 8 shows an example of a Bill of Lading bearing the CSPO stamp.

This means that the following clauses can be incorporated into the LC under field 46A (Documents Required) of SWIFT MT700 (while issuing LC):

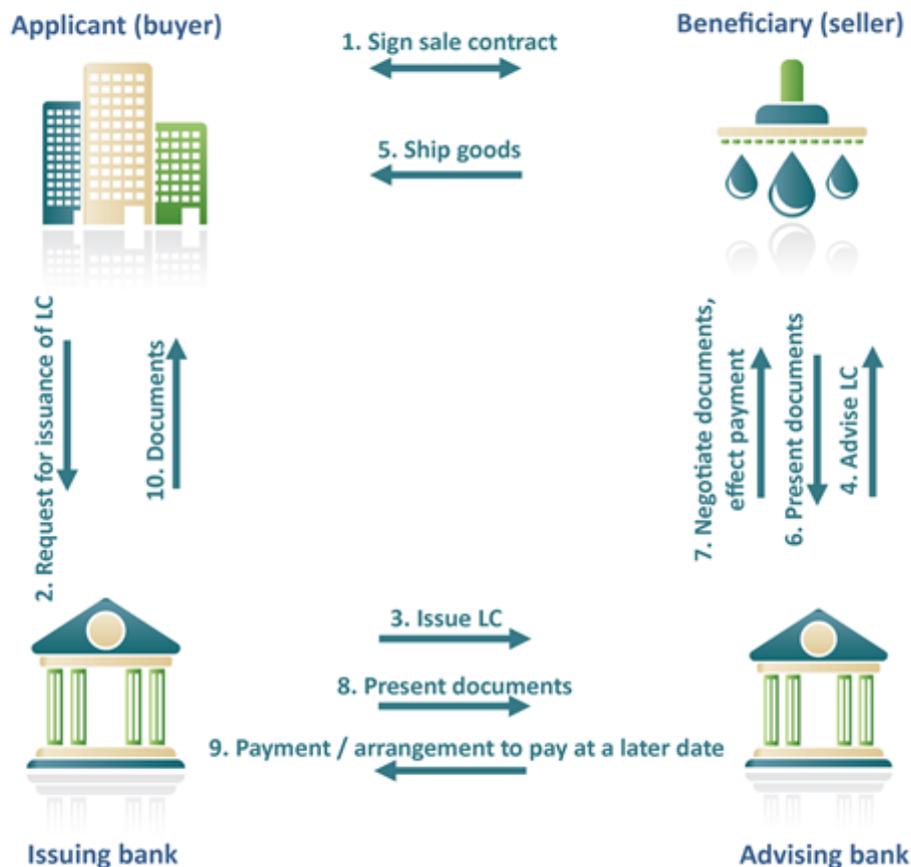
Bill of Lading consigned to XXXX notify <Buyers Name> showing 'Freight Collect/Freight Prepaid' and certifying CSPO (Certified Sustainable Palm Oil) Mass Balance/ Segregated.

Governance

As a reminder of the governance process to minimise the risk of documentary error or fraud, a Sustainable Shipment LC is only ever triggered at the specific request of the buyer. The seller then produces a shipment of sustainably-produced commodity in response and indicates its sustainability credentials by affixing a stamp to relevant documentation such as the Bill of Lading for the buyer's agreement. If the buyer has not requested a Sustainable Shipment LC and an LC is produced with this stamp, the trade will not be valid.

The bank's role is limited to checking for the presence or absence of the stamp in line with the buyer's instructions. Separate to this, a thorough retrospective audit process is carried out by the RSPO to ensure the integrity of its entire supply chain. This process has been supported by independent NGOs.

An education process will be needed to ensure banks understand how this governance process works and the limits of their role within it.



1. Buyer and seller negotiate a contract of sale.
2. The applicant (buyer) asks their bank to issue an LC in favour of the beneficiary (seller) with an instruction to advise it through the advising bank (also known as the confirming bank).
3. The issuing bank issues the LC through the advising bank.
4. The advising bank receives the LC and advises the seller.
5. The seller ships the goods in accordance with the contract of sale.
6. The seller prepares the documents called for under the LC and presents them to the bank nominated in the LC as the paying/negotiating/accepting bank, which checks the documents against the LC terms and conditions and follows up any documentary discrepancies with the seller.
7. If the documents are free from discrepancies and hold suitable reimbursement instructions, the nominated bank effects payment to the seller without recourse.
8. The nominated bank forwards the documents to the issuing bank and claims reimbursement at sight (sight LC) if the LC is available at sight, or at a determinable future date (maturity date) if the LC is available for acceptance, deferred payment or negotiation at a future date (usance LC). The nominated bank may also offer to discount (finance) the payment due at a future date.
9. The issuing bank checks the documents against the LC terms and conditions and, if these are free from discrepancies, reimburses the presenting bank at sight or, for a usance LC, agrees to pay on the maturity date.
10. Once payment or agreement to pay is received from the buyer, the issuing bank releases documents to the buyer for collection of goods.

Figure 7: The sequence of events underpinning trade supported by an LC

FIRST OIL PALM

TANKER BILL OF LADING B/L NO. SAN/JPN-01

Shipped on board in apparent good order and condition by (shipper) _____ (Shipper's name)
on board the tanker MT "GOLDEN FOUNTAIN" V.031 at the port of SANDAKAN, MALAYSIA
whereof IJU WEON is the Master, to be delivered to the port of YOKOHAMA, JAPAN
Consignee/Order of TO ORDER
Notify: _____ (Buyer's name)

A quantity in bulk said by the shipper to be:

Table with 2 columns: COMMODITY (Name of Product) and QUANTITY (lbs/tons/barrels/gallons). Row 1: CS RBD PALM OIL / MB IN BULK, 2646.459 MT. Includes handwritten annotations: 'Mass balance' with an arrow pointing to 'MB IN BULK', 'Product Name' with an arrow pointing to 'CS RBD PALM OIL', and 'CLEAN ON BOARD' and 'FREIGHT TO COLLECT'.

Stowed into tank/s No. 6P,6S & 7P

This shipment of _____ metric tons was loaded on board the vessel as part of one original lot of _____ metric tons stowed in _____

with no segregation as to parcels. For the whole shipment _____ sets of Bill of Lading have been issued, for which the vessel is relieved from all responsibilities to the extent it would be if one set only would have been issued. The vessel undertakes to deliver only that portion of the cargo actually loaded, which is represented by the percentage that the total amount specified in the Bill(s) of Lading bears to the total of the commingling shipment delivered at destination. Neither the vessel nor the owners assume any responsibility for the consequences of such commingling nor for the separation thereof at the time of delivery"

The quantity, measurement, weight, gauge, quality, nature and value and actual condition of the cargo unknown to the Vessel and the Master, to be delivered at the port of discharge or so near thereto as the Vessel can safely get, always afloat upon prior payment of freight as agreed.

This shipment is carried under and pursuant to the terms of the Contract of Affreightment / Charter Party dated AS PER CHARTER PARTY at AS PER CHARTER PARTY between AS PER CHARTER PARTY and AS PER CHARTER PARTY as Charterer, and all the terms whatsoever of the said Contract of Affreightment / Charter Party including the arbitration clause specified therein apply to and govern the rights of the parties concerned in this shipment.

If this Bill of Lading is a document of title to which the Carriage of Goods by sea Act of the United States, approved April 16, 1936, or similar legislation giving statutory effect to the International Convention for the Unification of Certain Rules relating to Bills of Lading at Brussels of August 25, 1924, applies by reason of the port of loading or discharge being in territory in which the said Act or other similar legislation is in force, this Bill of Lading shall have effect subject to the provisions of the said Act or other similar legislation, as the case may be, which shall be deemed incorporated herein, and nothing herein contained shall be deemed a surrender by the carrier of any of its rights or immunities or an increase of any of its responsibilities or liabilities under said Act or other similar legislation. If any term of this Bill of Lading is repugnant to the said Act or other similar legislation as so incorporated, such terms shall be void to that extent but no further.

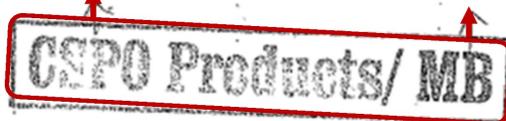
In Witness Whereof, the Master has signed THREE (3) ORIGINAL Bills of Lading of this tenor and date, one of which being accomplished, the others will be void.

Dated at SANDAKAN, MALAYSIA this 5TH day of MAY, 2013

"AS AGENT FOR AND ON BEHALF OF THE MASTER IJU WEON" LD CENTRAL SHIPPING & FORWARDING SDN BHD (220811 T)

Certified Sustainable Palm Oil

Mass balance



Handwritten signature and the text 'As Agent' and 'Master'.

Figure 8: An example of a Bill of Lading bearing the CSPO stamp

8. Incentive mechanisms enabled by the BEI's Sustainable Shipment LC

Throughout its work, the BEI's Sustainable Shipment working group has been mindful of the value that the banking industry can bring to supporting the supply chain transformations that the CGF is leading if it can find ways to incentivise buyers, suppliers and banks to prioritise Sustainable Shipment LCs. The operational mechanism of the BEI's Sustainable Shipment LC does not, in itself, create these financial incentives. Rather, it creates a platform on which individual banks can choose to offer financial incentives to support the shipment of sustainably produced commodities.

Two types of mechanism for incentivising sustainable production have been identified. The first is that the banks involved in servicing Sustainable Shipment LCs could decide to offer their clients preferential terms as part of their own business strategy. This could be justified on the basis of helping customers with one of the defining challenges of our time, enhancing the bank's own reputation and/or delivering its corporate citizenship commitments (such as the BEI's Soft Commodities Compact). Such a decision could create a competitive differentiator for individual banks. Incentivising sustainable production of major soft commodities, such as palm oil, arguably provides global banks with their biggest opportunity to reduce their total contribution to climate change, biodiversity loss and negative impacts on vulnerable communities.

Indeed, taking this approach to its logical conclusions, banks may choose to implement internal policies whereby they commit, gradually over time, to only handling Sustainable Shipment LCs. 2020, the same target date as given in the CGF-BEI Soft Commodities Compact, could be chosen.

The second incentive mechanism comes about through the role of development banks and has been brought to life by the active involvement of the International Finance Corporation (IFC), a member of the World Bank Group focused exclusively on the private sector in developing countries. It is possible that Export Credit Agencies (ECAs) and other government-backed bodies could play similar roles.

The development bank incentive mechanism: The case of the IFC

The IFC runs a \$5 billion Global Trade Finance Program (GTFP) that extends and complements the capacity of banks to deliver trade financing by providing risk mitigation in new or challenging markets where trade lines may be constrained. The GTFP was launched in 2005, and during the last fiscal year the IFC issued \$6.5 billion in guarantees globally to support the flow of goods and services into and from emerging markets.

The GTFP offers advising banks partial or full guarantees covering payment risk on issuing banks in emerging markets for trade-related transactions. These guarantees are transaction-specific and may be evidenced by a variety of underlying instruments, such as:

- Letters of Credit
- Trade-related promissory notes
- Accepted drafts
- Bills of Exchange
- Bid and performance bonds
- Advance payment guarantees

Guarantees are available for all private sector trade transactions that meet the IFC's eligibility criteria.

In order for the IFC to provide a guarantee to cover a specific transaction, the issuing and advising banks must be part of the IFC's GTFP network which now counts over 500 banks globally (of which 281 are issuing banks).

Figure 9 shows the geographic distribution of banks participating in the IFC's GTFP. Banks that want to enter the IFC's GTFP must be subject to a full banking due diligence process.



Figure 9: The geographic distribution of banks participating in the IFC's GTFP, courtesy of the IFC.

GTFP Climate Smart Trade

Under the GTFP, the IFC has launched an initiative called GTFP 'Climate Smart Trade'.

Through this initiative, the IFC works with its bank partners to support the trade of goods and services that enable their corporate clients to adopt energy efficient technologies, cut carbon emissions, and ensure the sustainability of their operations and supply chains.

Through the Climate Smart Trade initiative, the IFC may provide a price incentive or longer tenors for equipment and projects guaranteed under the GTFP that have clearly defined climate change benefits.

Banks may be asked to provide additional information, such as country of installation, equipment type/model, and expected energy savings, to ensure that the goods qualify under international protocols.

The IFC has now confirmed that the BEI's Sustainable Shipment LCs can benefit from a similar arrangement, whereby banks that are part of its GTFP could enjoy a price incentive or longer tenors for Sustainable Shipment LCs.

For participating banks, not only would these direct incentives be material, but increasing the volume of trade carried out as part of a development bank’s trade finance programme could improve its risk-weighted assets, and therefore its cost of capital.

Economic benefits could therefore multiply as the bank increases the proportion of Sustainable Shipment LC business it is doing. Participating banks could choose to share some or all of these economic benefits with their clients.

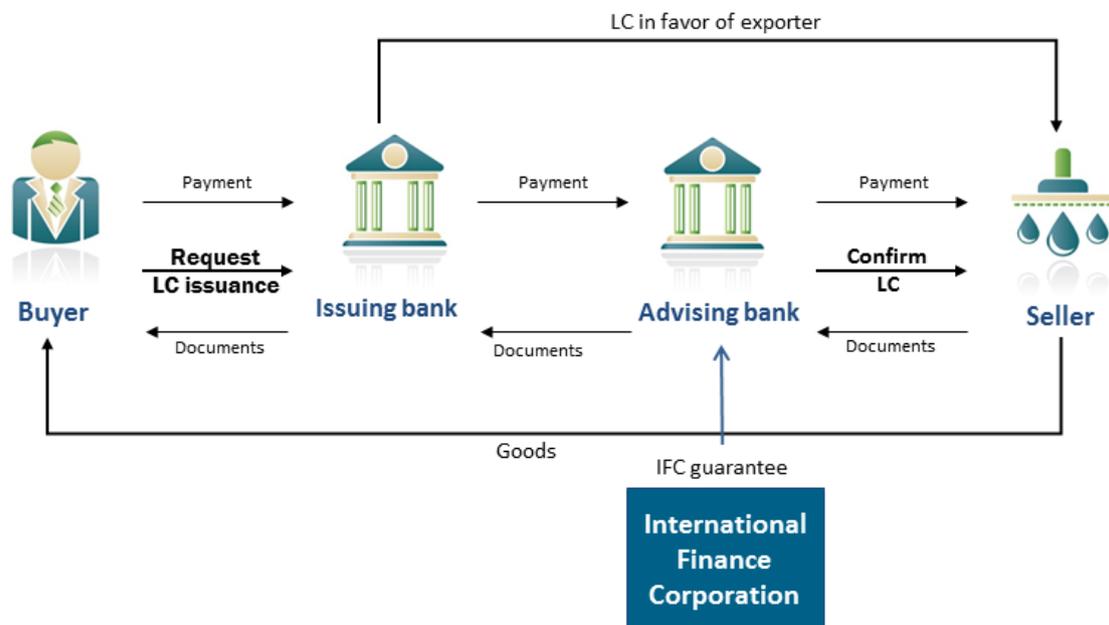


Figure 10: A schematic description of how the GTFP works, courtesy of the IFC.

9. What impact could the BEI's Sustainable Shipment LC have?

In order to be sure that the commodities they are procuring did not result in tropical deforestation when they were produced, buyers and traders want to improve the traceability of commodities to certified sustainable producers.

In the case of a complex commodity supply chain such as palm oil and its many derivatives, achieving full traceability quickly would imply developing segregated (SG) supply chains that preserve the identities of commodity producers, at considerable cost. This cost has been identified as one of the main barriers in achieving segregated supply chains, with no uniform position from buyers on the question of paying this premium.

In the palm oil supply chain, the MB supply chain system is seen by many as an important transition stage, being much cheaper than, for instance, the SG supply chain system (though still more expensive than non-certified palm oil) but nevertheless being a supply chain system that requires the physical trade of CSPO. Of the CSPO currently being purchased by end users, the RSPO reports that between 30 and 40% is traded physically, i.e. through the MB or SG supply chain systems.*

If the BEI's Sustainable Shipment LC can successfully serve as a platform for banks to offer financial incentives for MB or SG CSPO—and the possibilities for, and limitations on, this happening are covered in the previous section—these incentives can further catalyse the impact of buyers paying a reasonable premium for MB or SG CSPO and contribute to

transforming standards in supply chain practice. In the global palm oil supply chain, it is estimated that LCs account for approximately 15-20% of international trade shipments, which was worth around USD 7bn in 2013.** Within this global view, LCs are a particularly common form of trade finance in emerging markets trade.

Even for corporate end users that do not use LCs themselves, if the BEI's Sustainable Shipment LC can successfully serve as a platform for banks to offer financial incentives for shipments of MB or SG CSPO, those end users' upstream suppliers that do use LCs will benefit from these incentives, contributing to efforts to achieve overall market transformation. Further, the principles underpinning the BEI's Sustainable Shipment LC can equally apply to 'open account' trade finance. Progressing the expansion of this concept could form part of the future work of the BEI Sustainable Shipment Working Group.

*RSPO Growth Interpretation Narrative. Available (12/01/13) from: http://www.rspo.org/files/pdf/2011%20RSPO%20CSPO%20GIN_web.pdf

** Estimate from industry sources

10. Next steps

Having identified, as set out in this paper, an operationally practical and commercially desirable financing solution to incentivise sustainable commodity trade, the next step is to generate genuine traction in the market. In order to achieve this, the following co-ordinated next steps are envisaged.

Stakeholder education, engagement and endorsements

The concept behind the BEI's Sustainable Shipment LC, as set out in this paper, needs to be picked up and endorsed by a wider circle of key influencers. There will, no doubt, be an ongoing need for efforts to educate the market through industry forums, events and online channels.

The International Finance Corporation (IFC), BEI banks, BAFT-IFSA (the Bankers' Association for Finance and Trade and the International Financial Services Association), the International Chamber of Commerce (ICC) Banking Commission and CGF member commodity buyers and traders will all be influential parties in picking up and endorsing the Sustainable Shipment concept. Many of these have made a commitment to doing so in the near future. We would welcome expressions of interest from all other relevant parties.

Public dissemination

It will be important to use industry forums and events to publicise the Sustainable Shipment LC and ensure that it reaches as wide an audience as possible. BAFT-IFSA, the World Economic Forum (WEF), the IFC Global Trade Finance

Programme, The ICC Banking Commission and BEI itself have already made opportunities available for the BEI Sustainable Shipment Working Group to present at their key events. Similar opportunities at other relevant events would be welcomed.

The ICC Banking Commission and BAFT-IFSA are also looking at other ways they can support the education of their memberships, and the BEI is open to equivalent opportunities from other stakeholder groups.

Test trades and a new market norm

The most important and influential marker of success will be real shipments being carried out in accordance with the BEI's Sustainable Shipment LC process. Discussions between market participants can now take place in order to carry out test trades that demonstrate this concept in practice. The experience gained from these test trades will inform the route towards Sustainable Shipments becoming a new market norm.

Cambridge insight, policy influence, business impact

In 2013, the University of Cambridge Programme for Sustainability Leadership (CPSL) celebrated its 25th anniversary of working with leaders on the critical global challenges faced by business and society.

CPSL contributes to the University of Cambridge's mission and leadership position in the field of sustainability via a mix of executive programmes and business platforms, informed by world-class thinking and research from the University's School of Technology. HRH The Prince of Wales is the patron of CPSL and we are a member of The Prince's Charities, a group of not-for-profit organisations of which His Royal Highness is President.



In the UK

1 Trumpington Street
Cambridge, CB2 1QA, UK
T: +44 (0)1223 768850
F: +44 (0)1223 768831
E: info@cpsl.cam.ac.uk

In Brussels

The Periclès Building
Rue de la Science 23
B-1040 Brussels, Belgium
T: +32 (0)2 894 93 20
E: info.eu@cpsl.cam.ac.uk

In South Africa

PO Box 313
Cape Town 8000, South Africa
T: +27 (0)21 469 4765
F: +27 (0)86 545 5639
E: info.sa@cpsl.cam.ac.uk

www.cpsl.cam.ac.uk