Trade Finance Insight

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Trade Finance Insight

Welcome to this edition of the Trade Finance Insight. In this edition we lead with an in-depth interview with Dr George Elombi, Executive Vice President and Member of the Board at African Export-Import Bank (Afreximbank), on the African Continental Free Trade Agreement (AfCFTA). The interview will discuss the challenges of implementing the AfCFTA, the successes it has experienced so far, the anticipated opportunities it will bring to the region in the mid to long term and the role Afreximbank is playing to contribute to its success.

Secondly, we examine the rapidly emerging concept of Transition Finance, which seeks to meet the financing needs of borrowers operating in high emitting sectors. A huge amount of capital is required to get economies on track for net-zero emissions by 2050 but the requirements of established green and sustainability-linked financing products can often not be met by those operating in high emitting sectors, hence the need for new and innovative financing solutions to be developed by the market.

Our concluding article outlines the key elements of a proposed UK piece of legislation, namely the Electronic Trade Documents Bill, at the centre of which are plans to bestow upon certain digital trade documents the same legal recognition as their paper equivalent. The passing of this Bill into legislation is anticipated to have a huge impact on the trade finance world globally given it is estimated that 80% of bills of lading alone operate worldwide under English law. This article continues our focus on the theme of digitalisation in trade finance globally - a topic that we have provided detailed coverage on in this publication over the last three years highlighting its importance to the development of the industry. Links to all previous articles on this topic are provided within this article.

Our regular Sanctions and Export Controls update page features some interesting reads on, amongst other things, an EU perspective on sanctions enforcement around the G7, a piece looking at the focus by the US, EU, UK and other on third countries and anti-circumvention of Russia sanctions and a webinar on key lessons from the Russia/Ukraine crisis that could help prepare for the next geopolitical event.

We have included some of our latest resources and tools on both the topics featured in the articles and relating to wider trade finance issues. And finally, we are delighted to share some new awards the team has won.

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Editor Highlights

- The AfCFTA Agreement promises to revolutionise trade, reshape markets across the region and boost output in the manufacturing and services sectors. It will accelerate the structural transformation of African economies to boost both extra- and intra-African trade.
- Development finance institutions, which straddle the public and private sectors, play a critical role in bringing the public and private sector together and directing investments to economic activities that drive development.
- Promoting intra-African trade and implementation of the AfCFTA Agreement remains the arrowhead of Afreximbank's strategy as it makes available a range of trade, investment and corporate finance products deployed through loans and guarantees to facilitate intra-African trade and investments, as well as championing a number of other initiatives such as the AfCFTA Adjustment Fund.

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What next for the implementation of the African Continental Free Trade Area Agreement:

An interview with Dr. George Elombi (Executive Vice President and Member of the Board of Afreximbank)

As a follow up to our article on Trade Finance and the efforts to boost intra-African trade in our June 2022 edition of our Trade Finance Insight, we are very pleased to have had the opportunity to interview Afreximbank in relation to the African Continental Free Trade Area (AfCFTA) and the challenges the implementation of the African Continental Free Trade Area agreement (the AfCFTA Agreement) has and is facing, as well as the great successes it has already achieved. Through its involvement in a wide range of implementation initiatives, Afreximbank has and continues to play a vital role in promoting intra-African trade and advancing the AfCFTA Agreement.

Michael Foundethakis (Global Head of our Trade & Export Finance Practice) posed the following questions to and received the following response from Dr George Elombi (Executive Vice President and Member of the Board of Afreximbank):

1. Please may you provide a brief background to the AfCFTA Agreement?

In a testament to the political will to ensure that Africa takes in economic destiny into its own hands, the AfCFTA Agreement, which was opened for signature in March 2018 in Kigali, Rwanda, entered into force in record time with the requisite 22 ratifications achieved by 20 May 2019. The operational phase of the AfCFTA Agreement was launched during the 12th Extraordinary session of the Assembly of the African Union on the AfCFTA Agreement in July 2019 in Niamey, Niger. To date 54 of the 55 African Union Member States have signed the AfCFTA Agreement and 46 of those countries have deposited their instruments of ratification to become State Parties to the AfCFTA Agreement.

2. Since the implementation of the AfCFTA Agreement, what have the biggest successes been and how does this compare to the main objectives it is striving to achieve?

The AfCFTA Agreement, which creates the world's largest free trade area since the creation of the World Trade Organisation, aims to bring together 55 African countries and create a market of around 1.4 billion people with a combined GDP of over USD 3 trillion - making it the 5th largest economy globally in terms of GDP. The AfCFTA Agreement promises to revolutionise trade, reshape markets across the region and boost output in the manufacturing and services sectors. It will accelerate the structural transformation of African economies to boost both extra- and intra-African trade. Preliminary estimates show that intra-African trade will increase by over 80% by 2035 and manufactured goods are expected to make the most gains.

Trading under the AfCFTA Agreement began on 1 January 2021. Negotiations continue in order to iron out some remaining issues but steps towards successful implementation of the main objectives have been plentiful. Negotiations in Phase I and II are running concurrently where significant progress has been made in the Trade in Goods and Trade in Services Protocols. 46 countries have submitted provisional schedules of tariff concessions either individually or as part of a Customs Union. Similarly, 47 countries have submitted initial services offered in the five priority sectors of business services, financial services, communication, transportation and tourism. Phase II negotiations have also delivered the Protocols on Intellectual Property Rights, Investment and Competition. A Phase III has also been added and will cover Digital Trade and Women and Youth in Trade.

While effective trading under the AfCFTA Agreement has been constrained, given complex and protracted negotiations on Rules of Origin, significant progress has been made. Over 88% of Rules of Origin have been agreed with only the automotive and textile sector currently outstanding. To ensure trade commences the AfCFTA launched the Guided Trade Initiative (GTI) in July 2022. The GTI will roll out a programme across the continent in 2023 that will allow selected African countries to commence commercially meaningful trade under preferential rules of the AfCFTA. Cameroon, Egypt, Ghana, Kenya, Mauritius, Rwanda, Tanzania and Tunisia have already agreed to start commercially meaningful trade under the AfCFTA for at least 96 products including, among others, ceramic tiles, batteries, tea, coffee, processed meat products, corn starch, sugar, pasta, glucose

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syrup, dried fruits, and sisal fiber. The key benefit behind launching GTI is to test the operational, institutional, legal, and trade policy environment under the AfCFTA. It is also sending an encouraging message to African economic operators and countries that are yet to submit their schedules of tariff concessions.

3. What in your view are the biggest challenges to the AfCFTA Agreement's implementation?

There a number of challenges that could undermine the implementation of the AfCFTA. This is due to decades of colonial rent-seeking behaviour that rendered African economies vulnerable to distorted and ineffective economic policies. Though rich in resources, African countries are heavily reliant on commodity trade with external partners and a limited industrial base that has kept Africa marginalised to the lowest rungs of global value chains. This distortion has also had an impact on Africa's infrastructure roadmap, which was designed to deliver bulk commodities for export to external partners with limited or no connectivity for trade among neighbours. Building the requisite industrial capacity, trade-enabling infrastructure, and ensuring technology transfers into manufacturing and industrial sectors will be critical to ensure the success of the AfCFTA. Key to achieving this will be taking the necessary action to address the significant financing gaps that remain in Africa. Although resource rich, Africa remains capital poor with huge infrastructure and trade finance gaps. Addressing this in the context of the current economic challenges and fiscally strained governments will most likely be the largest challenge to overcome in order to ensure the success of the AfCFTA.

4. What do you see the mid-term to long-term opportunities / trends being under AfCFTA?

By establishing an integrated market, the AfCFTA will create the environment and provide the incentive for African-owned companies to enter new markets competitively. This will in turn expand their customer base and facilitate the development of new products and services. With a market expected to reach 1.7 billion with combined business and consumer spending reaching USD 6.7 billion by 2030, Africa is likely to emerge as the preferred destination of foreign investment. It is expected that investors will seek to take advantage of the economies of scale Africa provides and should see a reorientation away from resource investments to the industrial and manufacturing sectors.

In particular, four key sectors that represent high-potential opportunities have been identified and are being prioritised, namely, the automotive industry, agriculture and agro-processing, pharmaceuticals, and transportation and logistics. These are sectors where significant local demand currently exists and is expected to grow. However, current demand for these goods and services is largely met through relatively high-cost imports from outside the continent. As the region's production capabilities grow and trade and investment barriers are dismantled, these sectors are expected to see rapid acceleration in production and trade volumes. Afreximbank is working closely with the AfCFTA Secretariat to advance the development of regional value chains across these sectors. For example, in recognition of the enormous potential of the automotive sector, Afreximbank launched a USD 1 billion Auto Financing Facility to support the sector. We are also supporting value addition in the agricultural sector through our AFRICOIN programme which supports end-to-end agro value chain development through financing, twinning and capacity development.

5. What role is Afreximbank playing to facilitate the implementation of the AfCFTA Agreement and how do you see the role of (i) development finance institutions and (ii) African sovereigns in that respect?

Afreximbank has taken the view that boosting African trade and mainstreaming the integration of the region into a global economy will depend on progress in a number of critical areas and drivers of structural transformation, including among others: boosting intra-African trade; accelerating the process of industrialisation and diversification of African exports in a world where manufacturing exports account for more than 80% of global trade; and leadership in trade finance in a region where on average trade financing gaps have been conservatively estimated at USD 120 billion annually. In this regard, Afreximbank made these critical areas pillars under its fifth strategic plan from 2017 to 2021 and has expanded them under its 6th Strategic plan from 2022 to 2026.

Development finance institutions, which straddle the public and private sectors, play a critical role in bringing the public and private sector together and directing investments to economic activities that drive development. As part of its strategic plan, Afreximbank has therefore embraced the transformative potential of the AfCFTA Agreement for African economic development. Utilising its unique position and convening power, Afreximbank is working closely with the African Union, the AfCFTA Secretariat member states, financial institutions and the private sector to support implementation of the AfCFTA Agreement through a number of financing and facilitation instruments.

Even before the AfCFTA Agreement was signed, Afreximbank created an Intra-African Trade Division, with the ultimate focus on promoting intra-African trade. Its mandate has been expanded to include implementation of the AfCFTA Agreement. We disbursed more than USD 20 billion on a revolving basis during the last five years in support of intra-African trade and plans to double this during the next five years. We are also working with the AfCFTA to put in place the AfCFTA Adjustment Facility as mandated by the African Union (AU) Heads of State. We are also partnering with the AfCFTA Secretariat and AU to ensure a successful implementation of the Pan-African Payments and Settlements System (PAPSS), with the view to facilitating the payment and settlements of trade transactions in local currencies in order to overcome the challenge of currency inconvertibility and foreign exchange shortages that hamper intra-African trade.

Afreximbank also launched the continent's first Customer Due Diligence Repository Platform, called the MANSA Platform. The MANSA Platform will essentially address the principal challenges of money laundering and other forms of illicit financial flows while at the same time promoting access to trade finance and attracting foreign direct investment into the continent. Afreximbank is also developing an African Collaborative Transit Guarantee Scheme that will provide a single transit guarantee to facilitate movement of goods throughout the continent. We are piloting the transit guarantee scheme in the Common Market for Eastern and Southern Africa (COMESA) and plan to extend it to other Regional Economic Communities.

Just as development finance institutions and the private sector have critical roles to play, African governments also have an important role to play. In addition to creating the framework for trade and investment through the AfCFTA,

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Governments have the responsibility to give effect to the AfCFTA Agreement in domestic markets and ensure its implementation. Effective implementation will provide the certainty that traders and investors require for trade and investments to grow. Governments need to reduce non-tariff barriers and create an enabling environment that will allow the private sector to take full advantage of the opportunities provided by the AfCFTA.

6. What are the features of some of the key products and initiatives that are being implemented and that are going to be instrumental to the progress of AfCFTA?

To optimise the benefits of the AfCFTA Agreement and support its implementation, Afreximbank is making available a range of trade, investment and corporate finance products deployed through loans and guarantees to facilitate intra-African trade and investments. This includes (i) Trade Finance facilities to bridge the enormous gap in export and other forms of trade financing to medium and large exporters; (ii) Investment Finance to support the mobility of capital across African countries and promote African Direct Investment; and (iii) Corporate Finance to promote the growth and competitiveness of African enterprises.

In addition, Afreximbank is championing several initiatives to advance the AfCFTA. Among others, this includes: the USD 10 billion AfCFTA Adjustment Fund, that will help countries adjust in an orderly manner to AfCFTA tariff removals, improve trade-enabling infrastructure, boost industrialisation and support the development of regional value chains and manufacturing capacity; and, the Intra-African Trade Fair (IATF), which is implemented in collaboration with the African Union Commission and the AfCFTA Secretariat. The IATF is the premier marketplace for the promotion of cross-border trade and investments. The first two fairs convened in Cairo, Egypt and Durban, South Africa generated business deals of over USD 75 billion with more than 1,100 exhibitors participating in each. The third edition, IATF2023, is scheduled to be held in Abidjan, Cote d'Ivoire from 21 to 27 November 2023.

Afreximbank is also leveraging digitalisation through the African Trade Gateway (ATG), which is a digital ecosystem created to facilitate intra-African trade. The ecosystem comprises an integrated and function-specific set of platforms that help surmount impediments to cross-border trade. The key platforms include The PAPSS, the MANSA Platform, the TRADAR Club-a member driven network of international businesses and executives and the African Trade Exchange (ATEX), which is a Business-to-Business / Business-to-Government platform that brings together African buyers and sellers of goods underpinned by the AfCFTA rules of origin.

To facilitate the movement of goods, Afreximbank developed the Afreximbank African Collaborative Transit Guarantee Scheme, a scheme that will ensure seamless transportation of goods across multiple borders, through the issuance of a single technology enabled transit bond. The scheme is backed by a USD 1 billion commitment provided by Afreximbank and currently being implemented in COMESA and will be expanded to the continental level under the AfCFTA. Afreximbank has also developed an Small and Medium Enterprise (SME) Programme, which is an integrated, cross-cutting solution for African SMEs. It provides financial and non-financial support to enterprises that are aligned to achieving Afreximbank's intra-African trade and export development objectives. The programme will provide the resources necessary for SMEs to expand and contribute to Africa's economic growth in a sustainable basis.

In addition, Afreximbank is acting as a catalyst for industrialisation and export development in Africa by directly addressing "hard" and "soft" infrastructure constraints inhibiting industrialisation and intra-African trade. Afreximbank has made a deliberate choice to facilitate the emergence and expansion of Industrial Parks (IPs) and Export Processing Zones (EPZs), focusing on light manufactures and agro-processing. Afreximbank is currently pursuing the development and expansion of IPs and EPZs in several countries, including Cote d'Ivoire, Nigeria, Kenya, Malawi, Senegal, Benin, Gabon and Togo.

7. Please may you explain more about the Pan-African Payment and Settlement System (PAPSS) and how it aims to facilitate free trade in Africa?

PAPSS is revolutionary not only in its value proposition, but also in the fact that it enables Africa to build, own and control its own payment rails specifically designed to solve challenges in the African payment landscape. In this sense, the success of PAPSS is key to economic prosperity and the AfCFTA. One of the major impediments to intra-African trade is the fragmented nature of payment and settlement systems on the continent. This has resulted in Africa being one of the least financially integrated regions in the world. Obstacles such as payment delays, operational inefficiency, limited transparency and high costs have to be addressed as Africa establishes a unified market under the AfCFTA .

The PAPSS is a Financial Market Infrastructure that aims to transform how cross-border payments are made in Africa by offering secured instant payments, in local currencies, and with a guaranteed settlement performed on a multilateral net basis. Developed by Afreximbank and endorsed by the Heads of State of the African Union PAPSS is one of the five key operational instruments of the African Continental Free Trade Area. The system achieved a successful pilot in the West African Monetary Zone and was officially launched in January 2022 in Accra, Ghana. The PAPSS current network of participants is constituted of 9 central banks, namely, Nigeria, Ghana, Liberia, Guinea, Sierra Leone, The Gambia, Djibouti, Zimbabwe, and Zambia. Almost 60 commercial banks and 7 switches have joined the system.

8. What is the purpose of the AfCFTA Adjustment Fund and what does Afreximbank's role as Fund Manager entail?

The AfCFTA Agreement will create significant and long-term benefits across the continent and catalyse structural transformation of the socio-economic environment by stimulating the industrialisation and localisation of production in the continent. However, as with any major trade liberalisation regime, the AfCFTA Agreement will introduce near-term disruptions as tariff revenues are reduced, industrial sectors are disordered, businesses and supply chains are reorganised, and employment in some cases are dislocated.

This informed the decision to establish the AfCFTA Adjustment Fund to facilitate and provide support through financing, technical assistance, grants and compensation funding to AfCFTA State Parties and private enterprises so as to adapt to and effectively participate in the AfCFTA. The AfCFTA Adjustment Fund will serve as a vehicle for mobilising resources, developing and operating a compensation facility aimed at mitigating the short-term fiscal impact of tariff revenue losses of State Parties, as well as to provide direct financing to governments, public and private enterprises to fund sectoral initiatives as necessary to enhance

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competitiveness of the established trading environment. Afreximbank and the AfCFTA Secretariat were mandated by the African Union Assembly to develop the AfCFTA Adjustment Fund and in May 2021, the Council of Ministers responsible for Trade appointed Afreximbank as the Fund Manager. The AfCFTA Adjustment Fund consists of three sub-Funds namely, the Base Fund, the General Fund and Credit Fund. The Base Fund will receive contributions from AfCFTA State Parties as well as grants and technical assistance to address tariff revenue losses that would result from the implementation of the AfCFTA Agreement, which prescribes the elimination of tariffs. The General Fund will receive concessional funding from partner institutions to support development of trade-enabling infrastructure while the Credit Fund will be used to mobilise commercial funding to support both the public and private sectors enabling them to adjust and take advantage of the opportunities created by the AfCFTA.

The Board of Afreximbank has approved and committed USD 1 billion to support the funding of the initiative and also a USD 10 million grant funding that will facilitate the establishment and operationalisation of the AfCFTA Adjustment Fund.

9. How does Afreximbank plan to continue to support and be a vital role player in intra-African trade and investments in the next 5 years?

Promoting intra-African trade and implementation of the AfCFTA Agreement remains the arrowhead of Afreximbank's sixth Strategic Plan dubbed 'Impact 2026: Extending the Frontiers'. In support of intra-African trade, Afreximbank intends to double its financing of intra-African trade to USD 40 billion on a revolving basis by 2026, up from USD 20 billion in 2021. In addition, we aim to expand the share of intra-African trade financing in Afreximbank's total loan and guarantees portfolio to at least 36% by the end of 2026. Over the next 5 years we intend to fully implement the African Trade Gateway and facilitate at least a 5% share of intra-Africa trade volumes through the ATEX. Afreximbank also plans to continue supporting several flagship intra-African trade initiatives, including the AfCFTA Adjustment Fund, the Intra-African Trade Fair, financing African creatives, supporting the African automotive sector, and harmonisation of industrial standards. Afreximbank will also enhance the provision of technical assistance and capacity development to member states in support of the implementation of the AfCFTA. Afreximbank will leverage digital technology extensively to facilitate greater access to African markets by African businesses, especially for small enterprises that constitute the bulk of firms in African countries. Digital technologies will also be leveraged to increase the economic access of disadvantaged groups, including those operating in the informal sector and in rural areas. Afreximbank plans to build and position the ATG as the digital single market for Africa in alignment with AU and AfCFTA initiatives. The ATG is expected to accelerate the AfCFTA target to have a digital single market in 2030 by almost a decade.

Our overall ambition is contribute towards an increase in Africa's share of global trade by financing 7.4% of cumulative intra-African trade in goods and services between 2022 and 2026 and help move the needle and increase the level intra-Africa trade in goods and services from current levels of 15% to 24% by 2026.

Any opinions and projections given in this interview are those of the interviewee and cannot be attributed to Baker McKenzie.

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Editor Highlights

- Transition Finance is an emerging concept as the requirements for the more established green and sustainability-linked financing products can often not be met by those borrowers operating in high emitting sectors.
- As yet there is not one single definition of Transition Finance but at the centre of the concept is the need for borrowers wishing to access transition finance to have a credible and achievable transition plan.
- The underlying nature of transition finance inevitably means greater legal, regulatory and reputational risk and lenders are understandably approaching the task of providing transition finance with caution. However, if the finance market is to move the economy closer to net-zero emission targets by 2050 the development of these products and structures is essential. We anticipate that, aided by the development of standard documentation provisions and industry guidance, transition finance will gradually become accepted in the market as its scope becomes clearer and an understanding of its potential improves.

02 **Transition Finance:** New Opportunities and Challenges for Financial Institutions

In Brief:

Energy transition is the most significant transformative change that the world is undergoing right now, leaving no sector untouched. A huge amount of capital is required to get economies on track for net-zero emissions by 2050. The amount of clean energy transition-related investment required before 2030 is estimated to be in the trillions of US dollars. The finance market is responding to this transformational change with new and innovative types of finance and funding structures.

Green and sustainability-linked bonds and loans have been the pioneer products in this space. Following their evolution in recent years, they are now well-established financing products commonly used to finance the energy transition. For example, "use of proceeds" green loans can be used to finance projects such as those relating to renewable energy and recycling; and sustainability-linked loans seek to encourage borrowers to strive for, amongst other ESG-related objectives, targets that are consistent with moving the economy ever closer to net-zero emissions by 2050.

However, a new concept of "transition finance" is emerging as the requirements for green and sustainability-linked financing products are often not met in the context of high emitting sectors looking to reduce emissions. According to OECD guidance, transition finance "is the dynamic process of becoming sustainable or reaching net-zero" by financing the higher emitting and harder-to-abate sectors of the economy as they transition. Nonetheless, the underlying nature of transition finance inevitably brings with it greater legal, regulatory and reputational risks. Top of the list is the taint of greenwashing, meaning that transition finance is still in its infancy as financial institutions work their way through the associated issues with caution and scrutiny. The essential foundation to transition finance is the development and agreement between the parties of a detailed, credible and testable long-view transition plan to engender confidence that the activities being financed are meaningfully contributing to the net-zero target.

In Detail: Setting the scene

The concept of transition finance finds its origins in Article 2.1c of the Paris Agreement, which calls for "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development." According to OECD estimates (and in line with the Sharm El-Sheikh Implementation Plan agreed at COP 27 in November 2022), the investment required to deliver on the Paris Agreement is approximately USD 5-7 trillion per year across the highest carbon-emitting sectors.
As recognized in that agreement and more recently at COP 27, financial institutions are critical players in the transition to a carbon-neutral economy because of their role in allocating capital. This transition will require a transformation in the structures and processes of the financial system and its actors.
In this regard, the financial sector has in recent years encountered, and continues to face, increasing commercial, stakeholder and competitive pressure to promote green and sustainability-linked finance, (i.e., lending that supports the greenest, cleanest and most ethical projects and businesses). Market and underwriter expectations and commitments around these considerations are changing the way global businesses operate and are at the very heart of decision making.

If net-zero goals are to be achieved, significant and rapid progress is required with respect to carbon intensive industries, for example, aviation, steel and cement among others. The position is more problematic still for the oil, gas and coal sectors.
The Imperial College Business School argues in a 2020 report that the market for green and sustainability-linked finance is simply creating a "market for virtue without driving systemic changes in business operations." Instead, financial institutions, as capital providers, must look to the gray areas associated with transition finance, which comprises trillions of dollars in mainstream financial markets.
At the same time, the financing of high-emission industries is coming under closer scrutiny with dis-investment policies by major institutional investors and campaigns by non-governmental organizations over fossil fuels.

Against this, the Glasgow Financial Alliance for Net Zero (GFANZ), in a November 2022 report on financial institution net-zero transition plans, argues that financing or enabling "accelerated managed phaseout" of high-emitting physical assets, is preferable to divesting, e.g., leaving behind stranded assets.

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The London Market Association's (LMA) glossary flags up that "Transitioning to a lower-carbon economy may entail extensive policy, legal, technology and market changes to address mitigation and adaptation requirements related to climate change. Depending on the nature, speed and focus of these changes, transition risks may pose varying levels of financial and reputational risk to organisations." Navigating the transition is, therefore, a complex proposition.

What is transition finance?

At a high-level, transition finance as a concept is clear. There is, however, no one common definition. Currently only a limited number of finance institutions have developed financing products let alone settled on a definition. As mentioned above, the OECD's guidance says it "is the dynamic process of becoming sustainable or reaching net-zero" by financing the higher emitting and harder-to-abate sectors of the economy as they transition. The Imperial College Business School considers it "is capital provided to economic agents to achieve a minimum rate of carbon emissions reduction," while according to the International Capital Market Association (ICMA), it "is the extent to which an issuer's financing program supports the implementation of its climate change strategy." GFANZ, in turn, in its November 2022 report suggests a wider concept that comprises several financing strategies:

- Enabling entities and activities to develop and scale climate solutions (e.g., the expansion of low-emission technologies and services)
- Supporting those entities that are already aligned to the net-zero target (e.g., businesses with a Science Based Targets initiative (SBTi) validated target substantiated by progress reports)
- Supporting entities committed to transitioning to net zero that have robust transition plans (e.g., a manufacturer implementing energy efficiency to reduce Scope 1 and 2 emissions or a retailer looking to reduce Scope 3 emissions in its supply chain)
- Enabling the accelerated managed phaseout, such as through early retirement, of high-emitting physical assets (e.g., the early decommissioning of a fossil fuel power plant)

Although the EU Taxonomy — an EU wide classification system that provides businesses and investors with a common language to identify to what degree economic activities can be considered environmentally sustainable does not specifically define transition finance, it refers to transitional activities as those for which there is no technologically and economically feasible low-carbon alternative and that "support the transition to a climate neutral economy consistent with a pathway to limit the temperature increase to 1.5°C above pre-industrial levels, including by phasing out greenhouse gas emissions, in particular emissions from solid fossil fuels." Moreover, the EU Taxonomy sets out three conditions for an activity to qualify as a transitional activity:

- It has greenhouse gas emission levels that correspond to the best performance in the sector or industry.
- It does not hamper the development and deployment of low-carbon alternatives.
- It does not lead to a lock-in of carbon intensive assets, considering the economic life of those assets.

There has been criticism of the EU Taxonomy, which is a key reference point for frameworks that determine whether a company's economic activity is sustainable. In summary, it is often said to be too binary. While this is to some extent true, its binary character is clearly mitigated by some of its transition-focused features. Most notably, capital expenditure invested into unsustainable activities can still be taxonomy-aligned as long as it is part of a "transition" plan to expand a company's taxonomy-aligned activities or to allow its unsustainable activities to become taxonomy-aligned – even if the underlying economic activity remains unsustainable for a number of years and/or is only considered to be eligible as a "transactional activity" – provided the plan meets certain conditions and this information is properly disclosed. Other taxonomies also potentially offer flexibility, such as Singapore's (which is currently being developed), which uses a "traffic light" system of classification, thereby facilitating the inclusion of transitioning activities.

In the absence of a single definition, a variety of approaches and frameworks have been put forward. Unsurprisingly, this means there is limited comparability between the pathways of different organizations, which creates uncertainty for lenders, borrowers and banking supervisors, potentially increasing costs.

According to the OECD, many of its respondents rely on ICMA's Principles and Handbook, the Climate Bond's Initiative's (CBI) Framework, the EU Taxonomy and their own internally developed frameworks. While ICMA and the CBI are more associated with capital markets at this nascent stage, this is borne out in our experience by their standards being referenced in loan documentation.

While only a limited number of businesses have developed and published credible transition plans that allow their alignment with the Paris Agreement to be assessed, there are nonetheless a growing number of initiatives to support those that choose to do so. These include disclosure frameworks and other types of services, for example, validation, assessment, data collection and analysis to support the development and disclosure of plans. Transition finance is particularly attractive to borrowers in carbon intensive sectors, especially those with high-emitting assets, as they seek finance to assist in meeting their net-zero commitments.

Our anecdotal assessment of current market transactions is that many bear the hallmark of transition finance, but there is a reluctance to use and indeed embrace this label. This extends even to those financial institutions that are more developed in their transition finance thinking. Often, such — transactions are still labelled sustainability linked (or not at all) possibly because it is a term more familiar to the market or that has less association with higher emissions.

What makes a credible transition plan?

To minimize the legal, regulatory and reputational risks from financing carbon intensive industries, the importance of borrowers having credible and testable transition plans cannot be understated. A weak plan at best opens a finance provider up to criticisms over its commitment to net zero and, at worst could see it face accusations of being engaged in greenwashing. Such concerns were highlighted and the subject of recommendations in a report published during COP 27 from the UN High-Level Expert Group on the Net Zero Emissions Commitments of Non-State Entities.

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Key questions for a finance provider to ask include the minimum rate of reduction in carbon or similar emissions (e.g., plastics or chemicals), whether the borrower has adequate capital to carry out the plan and critically, if there are meaningful consequences where insufficient progress is made. In this respect, there is much read-across with key performance indicators used in sustainability-linked loans.

In September 2022, GFANZ published a report on its expectations for real economy transition plans. It set out the components that financial institutions should look for from the companies they finance to inform their allocation of capital and services. According to GFANZ, a transition plan should "articulate a company's overall approach to the net-zero transition, including information regarding its climate objectives, targets, actions, progress, and accountability mechanisms." This enables financial institutions to assess the credibility of a borrower's climate objectives and compare them against sectoral and regional expectations, and against peers. Moreover, the transparency provided by the plan can act as a reporting mechanism to stakeholders. The UK government backed Transition Plan Taskforce is currently consulting on a disclosure framework that makes recommendations for both companies and financial institutions to develop "gold- standard" transition plans. The implementation guidance refers to finance providers using such plans to better understand their exposure risks at portfolio level, especially an entity's credit risks, where exposure is driven by climate-related, operational, market, legal and reputational risks. General guidance also comes from the OECD, which has identified 10 key elements for a credible corporate transition plan. These include the following:

- Measuring performance and progress through metrics and KPIs that should be independently verifiable· Clarifying the use of carbon credits and offsets, where caution and extra scrutiny should be exercised
- Enhancing the credibility of the plan not only through mitigation via the OECD's Do-No-Significant-Harm Principle, but also through conducting risk-based due diligence for Responsible Business Conduct
- Disclosing progress on targets regularly — alongside sound governance and accountability — with third-party verification of the plan and targets.
- Supporting a "just transition" by taking steps to mitigate any negative impact on workers, suppliers, local communities and consumers that arise from the adoption of the pathway

Borrowers seeking to access transition finance must ensure their transition plans are credible so as to access a larger number of prospective finance providers, as well as a wider selection of products and services that may be at a lower cost. Further, borrowers need to understand that if they fail to meet the undertakings made with respect to their transition plans, finance providers may impose more onerous requirements and increase the costs of finance. Therefore, the key question to unlock any proposed transaction is whether the borrower's transition plan is deliverable within the period of the financing.

What are the risks and challenges?

The main obstacles to assessing whether a borrower's transition plan is credible are incomplete information and a lack of comparable data. According to an OECD industry survey (see guidance at page 11), in order of significance, the key obstacles are the following:

- A lack of comparable data in corporate disclosures on climate-related data
- A lack of detailed information in the content of plans and their formats
- Uncertainty over what amounts to a Paris-aligned, country-level sectoral transition pathway
- A lack of definition of transition activities and use of inconsistent methodologies
- Uncertainty over how to assess the ambition of a corporate net-zero plan
- A shortage of commercially viable projects and companies

The fact that the shortage of commercially viable projects and companies is considered less significant than, say, comparable data is, in our view, a little surprising as the availability of credible proposals is surely a key precondition to the growth of transition finance.

In the absence of reported emissions, financial institutions typically rely on estimates, which vary in quality. While tools that allow financial institutions to set financed emissions targets are becoming available (e.g., the Paris Agreement Capital Transition Assessment (PACTA) and the SBTi guide for the finance sector), they do not yet cover all relevant business segments. The lack of emissions data from customers, however, is expected to improve, for example, in the EU with the implementation of a more exigent Corporate Sustainability Reporting Directive (CSRD). Under the CSRD, the disclosure of whether a business has a 1.5°C Paris-aligned climate transition plan will become mandatory for large EU banks and insurance companies and (EU and non-EU) listed* companies in 2025 (annual reports covering 2024) and for all large (even unlisted) EU companies in 2026 (for annual reports covering 2025). Unlisted non-EU entities with significant activities in the EU will also have to report on a group level in 2029 (annual reports covering 2028). While the obligation is limited to disclosure, not having a plan will not be an option for many companies from a PR perspective.

Finance providers must establish robust governance, effective procedures and processes, together with aligned reporting and disclosures to optimize their transition finance generally and to counter potential greenwashing allegations. Despite the challenges that it brings, the focus on increased transparency and accountability also brings the opportunity to be ahead of the curve, showcasing a financial institution's purpose, sustainability goals and progress toward them. Additionally, finance providers must focus on the quality of due diligence and other processes for selecting the businesses and projects it finances, monitoring that financing for the life of its outstanding loans, and explain how each financing aligns with their disclosed approach to providing ESG finance. In Europe, the EU's proposed Corporate Sustainability Due Diligence Directive will not only introduce formal requirements on customers, but equally on finance providers, as the disclosure of transition plans will also be mandatory under the CSRD for many financial institutions, with large EU banks (>500 employees) being captured in 2025 (for annual reports covering 2024). As bank transition plans build upon their customers' plans (as "financed emissions" are Scope 3 emissions for banks), this means that they will be under increasing pressure to ensure their customers develop credible plans to support their own.

* "Listed" means having securities on an EU regulated market.

What progress is the market making?

The Institutional Investors Group on Climate Change commissioned a review from the Transition Pathway Initiative to allow investors to assess banks, in particular, on the transition to net zero. The review looked at 27 bank members of the Net-Zero Banking Alliance. Banks' policies and engagement practices with high-risk sectors do not yet show that capital is being reallocated away from companies that are misaligned with a 1.5°C pathway. In fact, very few banks have, so far, disclosed comprehensive policies that would limit finance to highemission sectors and activities. Furthermore, engagement with such businesses is limited to sectors such as coal and does not involve imposing financial conditions on businesses that are "lagging" in their transition. Rather, only a small number of institutions have established a bank-wide engagement strategy requiring transition plans from high-risk companies. The highest "score" on banks' decarbonization strategies was 56%, but the average was only 20%. The review recommends by way of next steps that banks should disclose explicit financing conditions for those clients whose transition plans are not aligned with a netzero emissions pathway. The issue here, of course, is client confidentiality.

In our experience, while a number of financial institutions have invested significantly in transition finance as a concept from internal policies to external communication, the majority make little or no reference to it in present day transactions including contractual documentation.

This does not mean, necessarily, that the sector is not using transition finance; rather, there may be caution over the use of the term and a preference for better known and simpler, less controversial, concepts such as sustainability-linked. We believe that as the scope of transition finance becomes clearer, better understood and, consequently, more accepted in the market, this will change. The market would be aided by the development of standard documentation or clauses that, for example, the LMA may develop and publish, especially a user guide.

Conclusion

The key implication of transition finance for the financial sector is that those borrowers with credible transition plans should increasingly be able to access new products and services at a lower cost. In contrast, those that do not have credible transition plans will face higher costs and/or restricted access to financial products and services (i.e., higher costs of capital) depending on the underwriting process of their finance provider.

Well-executed, credible transition plans should allow those finance providers that embrace the concept to enjoy a competitive advantage. In consequence, they will be able to expand their portfolios to businesses that otherwise would not have aligned with the expectations of their supervisors and financial institutions' own transition plans. In short, their financed emissions will remain aligned to the net-zero target.

Similar to the development of green and sustainability-linked bonds and loans, we expect industry-wide frameworks to be developed for transition finance, and finance providers and borrowers should actively monitor this space.

> "The essential foundation to transition finance is the development and agreement between the parties of a detailed, credible and testable long-view transition plan to engender confidence that the activities being financed are meaningfully contributing to the net-zero target."
>
> **Nick Tostivin, Partner**

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Additional Insights

[Transition Finance: How we can help]

Browse our short, succinct guide to discover ways we can help you make a success of Transition Finance

[Sustainability Risk Radar]

An overview of trends and recent developments in the sustainability space

Editor Highlights

- The Bill seeks to implement recommendations made by the Law Commission and fulfil the commitment that the UK made as a G7 country to develop domestic law reforms that would bring it in line with the objectives set out in the Model Law of Electronic Transferable Records.
- A central element of the Bill is that it plans to bestow upon certain identified trade documents the same legal recognition as their paper equivalent.
- The Bill's enactment promises a number of potential benefits for the global trade finance market including, environmental benefits, cost savings, increased efficiency and increased transparency and security for participants.
- Immediate and wholesale adoption of the replacement of hard copy documents with electronic copies is unlikely, but we hope to see a steady and consistent uptick as early pioneers prove the legal and practical feasibility of the Bill's provisions.

03 **Overdue Bill!** Legislation towards digitalising trade finance a welcome response

Electronic Trade Documents Bill

What is it?

The Electronic Trade Documents Bill is proposed UK legislation that seeks to implement recommendations made by the Law Commission in March 2022, at the centre of which are plans to bestow upon certain digital trade documents the same legal recognition as their paper equivalent.

The Bill progressed through its first and second readings in the House of Lords during October and November 2022. It is currently due to progress through the Report stage in the House of Lords and have its third reading before going through the final stages of the House of Commons process to be enacted into law.

Why are digital trade documents not currently provided this status under English law?

Trade documents fall into a special category of documents, called "documents of title" that focuses on their ability to be "possessed". Under the current law of England and Wales only tangible things, which electronic documents are not considered to be, can be possessed – a key criteria to this being that they must be capable of being physically held.

By way of practical example, in an international trade arrangement that requires goods to be transported in several different ways and through different jurisdictions paper documentation will need to physically travel across the globe in order to be possessed by various different parties (e.g. shipping companies, warehouse operators, overland transporters etc).

What are the issues resulting from this lack of status?

This archaic practice, developed for use in a very different world to that which we live in today, comes with a number of burdens for all parties involved and certain inherent risks. There are the obvious additional costs and, a more recent focus, the environmental consequences of printing large quantities of paper trade documents and couriering them around the globe. Loss and delay in delivery of documentation can also result in inefficiencies in deliveries and consequential supply chains, leading to increased costs for all parties. As part of its impact assessment analysis the UK Government estimates that the implementation of the Bill could result in £1.14 Billion in net benefits to UK trade business.

Perhaps most significantly for all parties involved in trade finance and the wider economies in which they operate, as we highlighted in our article on Commodities Fraud and Trade Finance Digitalisation in our December 2020 edition of our Trade Finance Insight, are the increased opportunities for fraud to be committed when using paper documentation.

Real life cases have illustrated how easily bills of lading, warehouse receipts, invoices and sales contracts can be forged or duplicated.

What are the key elements of the Bill in more detail?

At just seven provisions, the Bill is certainly succinct! This is principally because it seeks to address a gap that has opened up in this area of law resulting from technological and commercial developments across trade finance, rather than because the wider law in relation to trade documents is considered to be in need of reform.

Provision 3 is the key provision that expressly creates the freedom for electronic trade documents to be possessed and considered to have the same effect as equivalent paper trade documents.

Provision 2 sets out the criteria that an electronic trade document must meet in order to be considered equivalent to its paper counterpart and requires that a 'reliable system' is used to:

(a) 'identify' and 'distinguish' the document from any copies of it

(b) protect against 'unauthorised alteration'

(c) ensure it is not possible for 'more than one person to exercise control of the document'

(d) allow that the one person who is able to exercise that control to demonstrate that to another, and

(e) secure that a transfer of the document has the effect to 'deprive any person who was able to exercise control of the document immediately before the transfer of the ability to do so.

However, the Bill is not prescriptive as to how that criteria should be met - similar to the approach taken by the URDTT, it is drafted in a 'technologically neutral' manner to permit its scope to evolve alongside that of technology and industry practice and permits current paper documents to be converted to electronic documents and vice-a-versa. This latter capability is to accommodate continuing operations in the industry across jurisdictions where technological developments will be occurring at different rates.

The Bill does not impose a requirement on organisations to use electronic trade documents, it simply provides businesses with the option. This of course allows greater flexibility to parties involved in the supply chain, but given that the use of digital trade documents is not mandatory may mean that we should expect a fairly gradual shift towards the use of electronic trade documents with businesses weighing up the time and cost of transition - at least until a "critical mass" and market standards are achieved.

What are the potential benefits of the implementation of this piece of legislation?

Its potential benefits include:

Environmental – reduction of paper use, which is currently estimated to be in the billions of pages every year across the international trade industry and a reduction in international air transportation.

Cost savings – although there will of course be an initial outlay for businesses in terms of the creation of new digital systems and training of staff the International Chamber of Commerce estimates that moving to electronic trade documents could "create £25 billion in new economic growth by 2024 and free up £224 billion in efficiency savings" across the trade industry.

Increased efficacy – fewer delays (and consequential financial savings and revenue increases) as a result of lost or delayed documents.

Increased transparency and security – the development of secure systems meeting the criteria set out in the Bill should help reduce the incidences of fraud in the industry by making it more difficult to forge replicate documentation.

Where does this legislation fit within wider international trade market developments in this area?

The UK is not the first to try to move trade financing away from its reliance on hard copy documents. In recent years, international organisations and individual jurisdictions have pursued similar initiatives to legally recognise electronic documents. In 2017 the UN Commission on International Trade Law (UNCITRAL) produced the Model Law of Electronic Transferable Records (MLETR), with the aim of allowing the legal use of electronic transferable records domestically and internationally. International adoption has not been prevalent - less than a dozen jurisdictions have enacted it as at today's date. In April 2021, G7 ministers committed to developing domestic law reforms that would bring their jurisdictions in line with the objectives of the MLETR. This is indeed the foundation of the UK Law Commission proposals and the Bill, creating an opportunity for the UK to be the first G7 country to fulfil its commitment.

In our June 2022 edition of the Trade Finance Insight, our colleagues in Singapore discussed 'Moving away from paper: Developments in the digitalisation of trade in Singapore', as Singapore implemented legal reforms to address their legal barriers to the digitalisation of trade by actually adopting the UNCITRAL Model Law via amendments to their existing Electronic Transactions Act. To complement those legal reforms several digital initiatives, including a comprehensive electronic banker's guarantee and the development of a digital utility comprising of globally accepted standards and frameworks that connects governments and businesses to a public blockchain, were launched with further initiatives being piloted or set for launch. Since then, the Monetary Authority of Singapore has launched a new industry pilot involving the issuance of tokens linked to trade finance assets. The project aims to digitise the trade distribution market, by transforming trade assets into transferable instruments that are more transparent and accessible to investors.

In our article asking 'Will the trade finance world finally swap its pen for a keyboard?' in the December 2021 edition of our Trade Finance Insight, together with our Turkish colleagues we considered the potential impact of and issues with the Uniform Rules for Digital Trade Transactions Version 1.0 (URDTT) published by the International Chamber of Commerce in October 2021. These rules were considered to offer a much welcome proposed industry standard on the enforceability of electronic records as between parties to a digital trade transaction. We anticipate these rules to be a point of focus when the Electronic Trade Documents Bill becomes law.

What next?

We anticipate the Bill to become law before Autumn 2023. Its passing will have a huge impact on the trade finance world globally – during a recent presentation by the ICC it was estimated that 80% of bills of lading alone operate worldwide under English law. Immediate and wholesale adoption of the replacement of hard copy documents with electronic copies is unlikely, but we hope to see a steady and consistent uptick as early pioneers prove the legal and practical feasibility of abandoning the concept of "possession" or "originals". As ever, we anticipate the principal impediments to be a combination of old dogs refusing to learn new tricks and the mantra of not fixing something that isn't broken - and of course these challenges will be stronger in certain markets and certain jurisdictions. We look forward to both these headwinds being blown away by demonstrably quicker, cheaper and securer trade finance transactions being concluded without a courier bag in sight.

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"The passing of this Bill will have a huge impact on the trade finance world globally given it is estimated that 80% of bills of lading alone operate worldwide under English law. Immediate and wholesale adoption is unlikely but we hope for a steady and consistent uptick in the use of electronic trade finance documents by early pioneers demonstrating quicker, cheaper and securer trade finance transactions can be concluded without a courier bag in sight."

James Clarke, Senior Associate

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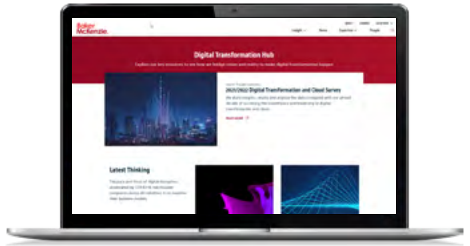
Additional Insights



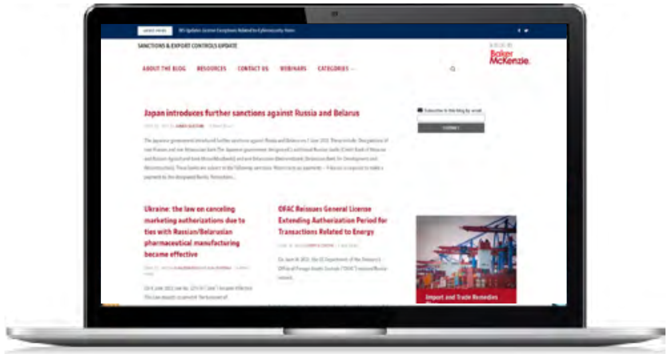
[Digital Transformation Hub]

Explore our key resources to see how we bridge vision and reality to make digital transformation happen

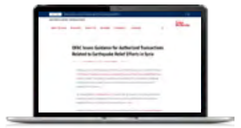
[Connect On Tech - Legal Insights on Data & Technology]

Explore our key resources for all things tech, including our recent Connect on Tech podcast series

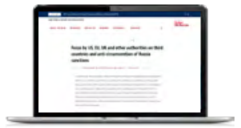
Sanctions & Export Controls Update



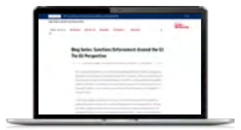
Baker McKenzie's Sanctions & Export Controls Update Blog aims to provide you with real time news and updates in respect of US and EU economic sanctions against key sanctioned countries, such as Russia and Iran. We will also keep you informed of developments in other countries, including Australia, Canada and Japan. Contributors to the blog are made up of comprise partners and associates from our market-leading International Trade Group. Here is a sample of our recent blog posts. Please click here for the full range.



OFAC Issues Guidance for Authorized Transactions Related to Earthquake Relief Efforts in Syria



Focus by US, EU, UK and other authorities on third countries and anti-circumvention of Russia sanctions



Blog Series: Sanctions Enforcement Around the G7, The EU Perspective

Ukraine introduces a new set of sanctions against Russian, Iranian, Syrian and UAE persons

UK: OFSI updates monetary penalties guidance to address issues of ownership and control

Webinar: Key Lessons from the Russia/Ukraine Crisis: Preparing for the Next Geopolitical Event

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2022: International Trade Developments in a Challenging New World

Join us for our 19th Annual Global Trade and Supply Chain Webinar Series which includes the latest international trade developments. This year, in a variety of sessions, our panels of experts will cover the key developments and latest trends on sanctions, export controls and Foreign Investment Review regimes. On the inbound side, there will be sessions on opportunities and compliance challenges arising out of FTAs, hot topics on Customs valuation, trends in customs audits and supply chain compliance challenges and logistics.

Please register for upcoming webinars here.

Import and Trade Remedies Blog

Baker McKenzie's Import and Trade Remedies blog (formerly the International Trade Compliance Update) provides an overview of the latest trends and developments across customs programs, policies and procedures, and trade remedies, including from the WTO and WCO. For other trade developments, please visit our other international trade blogs.

Global Supply Chain

We bring you supply chain compliance insights from practitioners around the globe to offer our analysis of emerging legal trends and hot topics in supply chain risk management. In addition to providing the latest updates on global and industry-specific supply chain risks, this blog has been created to flag pitfalls and navigate the complexities of supply chain legal regimes, as well as advise on opportunities, ethical considerations and best practices for organizations and in-house counsel.

Foreign Investment and National Security Blog

A growing number of jurisdictions have now introduced national laws enabling the screening and review of incoming foreign investments, often with a focus on specific sectors perceived to be particularly sensitive. This blog aims to provide you with the latest news and updates in respect of foreign investment review and national security trends and developments, keeping you up-to-date and informed about the legal and business risks impacting your next transaction.

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Awards

Export Finance Deal of the Year	Project Loan Deal of the Year	Power Deal of the Year	Banking and Finance Legal Adviser of the Year

Bonds and Loans Africa Awards 2023

Best Law Firm for Export Finance Global Trade Review for 2022	**Deal of the Year – Aspen Group Transaction** **Best Deal – Tanzania Standard Gauge Railway** Global Trade Review 2021	**Africa Deal of the Year – Tanzania Standard Gauge Railway** Asset Triple A Infrastructure Awards 2021	**Best Law Firm in Africa - EMEA Finance** African Banking Awards 2021
Banking & Finance Legal Advisor of the Year GFC's Bonds, Loans and Sukuk Awards 2021	**Sub-Saharan African ECA-backed Deal of the Year - Tanzania Standard Gauge Railway** TXF 2020	**Deal of the Year - Municipality of Istanbul waste-to-energy plant** **Deal of the Year - Oman Ministry of Finance hospitals** Global Trade Review Best Deals 2020	**Deal of the year: Project finance, IFC / City of Belgrade waste management PPP** IFLR Europe Awards 2020

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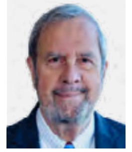

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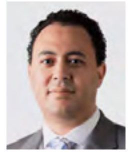

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