Human Rights-Focused Lending Models Can Curb Trafficking

By **Sarah Byrne and Ed Ivey** (August 6, 2021)

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This summer marks the 10th anniversary of the United Nations Human Rights Council's adoption of the Guiding Principles on Business and Human Rights,[1] setting forth the internationally accepted framework for the role of businesses in promoting and protecting human rights.

These principles highlight the risks businesses face in their activities that may be linked to human rights violations.

According to the UNGPs:

> Business enterprises should respect human rights. This means that they should avoid infringing on the human rights of others and should address adverse human rights impacts with which they are involved.

For the financial services industry, a sector regularly focused on identifying and mitigating risk, human rights risks are unique.

The ways in which human rights-related risks are presented and mitigated are constantly developing as financial institutions and their advisers explore ways in which their services could not only promote human rights, but identify whether their services may cause, contribute to or be linked to human rights violations.

For example, financial institutions can affect human rights through activities related to customer due diligence, investment in certain development and commodities, privacy, supply chains, corruption, and pay and lending discrimination.

Institutions may also promote social goals as part of their environmental, social and governance, or ESG, frameworks, and identify risks in ways that go unnoticed, through their unique role in combating human trafficking and supporting survivors of this crime.

Below are examples of how banks are currently combating human trafficking. From these observations, we suggest a proposed next step on the road to measuring financial institutions' influence on human rights and aligning these activities with ESG goals.

Best Practices to Date

Over the last few years, there has been a continued focus on what steps financial institutions have taken to prevent human trafficking.[2]

From our work in the market, we have observed success in:

- Engaging in workforce training on human trafficking awareness;

- Enhancing methods to detect human trafficking in companies' anti-money laundering functions through trainings and typology refinement;

- Including human trafficking risk factors in consumer and commercial costumer due diligence and know-your-customer processes;

- Participating in the United Nations' Finance Against Slavery and Trafficking program's[3] Survivor Inclusion Initiative — and, consistent with its goals, beginning to onboard survivors as bank customers. As customers, survivors can access basic financial services and begin the journey to financial security;

- Promulgating and enforcing supplier codes of ethical conduct, and codifying human rights protection in public anti-modern slavery statements; and

- Engaging with local community-based efforts to support vulnerable populations at risk for being trafficked.

Regulatory Attention

These steps are a matter of compliance for financial institutions because there is criminal, civil and regulatory risk in not addressing human trafficking in financial flows.

The Federal Trafficking Victims Protection Act[4] and various state human trafficking laws provide for criminal and civil penalties for organizations that benefit from a trafficking scheme.

As a signal of increased regulatory attention, the Financial Crimes Enforcement Network released its 2020 supplemental advisory on identifying and reporting human trafficking and related activity,[5] which highlights four evolving tactics that can relate to labor trafficking, including front companies, exploitative employment practices, funnel accounts and alternative payment methods.

Additionally, the Anti-Money Laundering Act, or AMLA,[6] mandates studies and reports developed in consultation with financial institutions on "commonly used methods to launder and move the proceeds of trafficking [and] the types of suspicious financial activity that are associated with illicit trafficking networks," among other things.

Finally, on June 30, the Office of the Comptroller of the Currency, as well as other agencies, issued an interagency statement[7] explaining the new national anti-money laundering and countering the financing of terrorism priorities as published by FinCEN and other financial regulators in accordance with the AMLA.

The new national priorities include human trafficking and human smuggling. That human trafficking is on that short list is a forecast of increased regulation and enforcement.

As for ESG-related regulatory enforcement, the U.S. Securities and Exchange Commission earlier this year announced[8] the creation of a Climate and ESG Task Force in the Division of Enforcement to develop methods to identify ESG-related misconduct and monitor reporting.

The Next Step for Financial Institutions

The first decade of the financial services industry's commitment to human rights preservation and advancement as prescribed by the UNGPs must be followed by innovative initiatives.

A focus on human rights-linked lending frameworks, in addition to the other areas of impact listed above, could be that innovative next step.

What banks have done with sustainability-linked loans and derivatives could be the model. Banks, as evidenced by the growing market in sustainability-linked loans, are appreciating that nonpayment risks of a borrower can be mitigated in ways that are in addition to financial covenants and collateral requirements.

Here, lenders are better appreciating that reputational risks of a borrower are also tied to the borrower's repayment risks.

For borrowers whose line of business and/or supply chains risk association with human trafficking or other human rights violations, lenders can include, for example, covenants to address these risks. These covenants could be commitments to implementing corporate policies regarding labor practices, following fair trade requirements, conducting training intended to identify and prevent bribery and corruption, and committing to certain pay and diversity quotas.

In some instances, covenants alone may not be sufficient, and should be further supported by requirements for a borrower to provide certifications and related documentation evidencing compliance with any covenants.

In implementing any such terms, lenders will also need to weigh these terms and requirements against potential costs to the borrower to comply and difficulties in confirming compliance.

The element of additional costs, however, can be offset to some extent by including loan incentives, such as lower spreads and lower collateral requirements, when various requirements are satisfied.

This relationship between social sustainability goals and loan incentives is the driving concept of any sustainability-linked loan.

At the end of the day, human rights violations are not only societal concerns, but also a concern for lenders, given that a borrower linked to these violations poses a risk to the lender's credit, bottom line, reputation and social responsibility.

As a basic concept, banks require pledged collateral to hedge the risk of nonpayment. Banks might consider hedging risks to human rights by requiring borrowers to address any links to human rights violations and to create opportunities that minimize human rights violations.

Incentives could include lower spread, lower collateral requirements and modifications to affirmative covenants.

How to Measure Anti-Trafficking/Human Rights Outcomes

Measurable outcomes for financial institutions' effect on human rights as it relates to human trafficking generally can include the number of:

- Reported suspicious activities indicative of exploitation;
- Human trafficking survivors onboarded as customers;
- Anti-trafficking nonprofits supported through charitable giving and banking services;
- Human rights-linked loans;
- Lending covenants to advance human rights; and
- Commercial banking relationships with organizations that advance human rights.

Further development of lending incentives linked to borrowers' role in the protection of human rights could be a significantly influential next step.

Recommendations

As financial institutions look to promote social goals in their ESG programs, they should reflect on current and potential anti-trafficking activities. They should also consider human rights-linked lending frameworks and think about how to motivate their borrowers to appreciate both the social benefits of these goals and the reputational risks of human rights violations.

Although quantifiable metrics and concrete reporting on the social impact of the financial services sector's human rights activities are in the development stage compared to environmental and sustainability impacts, real progress is not far off.

Lenders are regularly thinking of new ways to not only promote desirable social outcomes but also to mitigate the credit risk of a borrower related to their reputational risks.

This approach carries the financial industry's commitment to anti-trafficking and human rights through to commercial and corporate customers and their supply chains — which is important in light of the emerging regulatory attention on social and human rights issues.

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[1] https://www.ohchr.org/documents/publications/guidingprinciplesbusinesshr_en.pdf.

[2] See, e.g., On-Ramps, Intersections, and Exit Routes: A Roadmap For Systems and Industries to Prevent and Disrupt Human Trafficking – Financial Services Industry (July 2018), available at https://polarisproject.org/human-trafficking-and-the-financial-services-industry/.

[3] https://www.fastinitiative.org/.

[4] https://www.govinfo.gov/content/pkg/PLAW-106publ386/html/PLAW-106publ386.htm.

[5] https://www.fincen.gov/news/news-releases/supplemental-advisory-identifying-and-reporting-human-trafficking-and-related.

[6] https://www.congress.gov/116/bills/hr6395/BILLS-116hr6395enr.pdf (SEC. 6505. GAO STUDIES ON TRAFFICKING).

[7] https://www.occ.gov/news-issuances/bulletins/2021/bulletin-2021-29.html.

[8] https://www.sec.gov/news/press-release/2021-42.