



## ESG VIEWPOINT

### What makes supply chain due diligence effective?



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#### At a glance

- Regulatory pressure is increasing for companies to ensure traceability, due diligence, and sufficient transparency on practices and impacts.
- Effective due diligence requires a holistic approach in which risk assessment, monitoring, and remediation are integrated and each part informs the others.
- Supply chain monitoring should track outcomes and feed back into procurement practices and remediation strategy.
- Supply chain strategy should include capacity-building to improve resilience and ability to address breaches of labour standards.



## Supply chain risk is on the rise

Working conditions in supply chains remains a challenging issue that spans virtually all sectors and geographies. Some recent cases include:

- Operators of the UK government's Seasonal Worker Scheme were found to be lacking in effective due diligence. [Workers arriving at UK farms](#), having spent thousands of pounds in illicit recruitment fees.
- In October 2022, the US government announced that it considers lithium-ion batteries – critical for products from smartphones to electric vehicles – as [likely to be tainted](#) by forced labour due to conditions in cobalt and copper mining.

- Research by the [Business and Human Rights Resource Centre](#) shows a rapid deterioration of working conditions in the apparel industry in Myanmar.

As investors, we need to understand how investee companies are deploying effective due diligence to manage risk appropriately. Lack of clear disclosure can make this challenging, but with the right questions we can gain important insights into strategy and effectiveness through engagement dialogue.

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Current regulatory pressures



Risk assessment, monitoring, and remediation



Investing in effective supply chain due diligence



Final thoughts: strength in alignment



## Regulatory pressures

The United Nations Guiding Principles on Business and Human Rights were adopted in 2011 and established clear expectations on companies' duty to respect human rights.<sup>1</sup>

In 2015, laws came into effect in California<sup>2</sup> and the United Kingdom<sup>3</sup> to specifically address business-related modern slavery. These were focused on increasing corporate disclosure on risks in operations and supply chains, but leave the contents to companies, as long as the statements meet certain statutory requirements.

Regulatory frameworks are increasingly stringent. Expectations include the integration of due diligence into company policy, risk assessments and mitigation, and stakeholder engagement. Enacted and proposed legislation in France, the Netherlands, Germany, and the European Union include civil liability for harms that due diligence could have prevented and require annual reporting on the company's approach.

### Penalties can be severe

Under new German legislation, regulators can issue fines up to 2% of annual turnover.<sup>4</sup> In the US, the Customs and Border Protection has used Withhold Release Orders (WRO) to stop goods suspected of being tainted by forced labour from entering the country. As of January 2023 there are 53 active WRO's due, up from a total of 16 in 2020.<sup>5</sup> In 2020, palm oil shipments by Sime Darby Plantation<sup>6</sup> were halted until the company could provide evidence of due diligence in February 2023 to lift the ban.<sup>7</sup> Top Glove, a rubber glove manufacturer, was forced to pay back RM50 million in recruitment fees to foreign workers to be able to import its products into the US.<sup>8</sup>

For companies to effectively address working conditions and comply with increasingly stringent regulations, supply chain due diligence needs to be comprehensive, integrated, and well governed. However, in engagement we are often left pondering how key components such as risk assessments, monitoring, and remediation fit together and inform each other. In addition, governance including integration into policy and strategy, as well as how its effectiveness is assessed, could often be clearer. Finally, alignment with sourcing and procurement practices is key to delivering on company commitments and long-term improvements.

Companies should clearly demonstrate how these aspects connect and reinforce each other to drive improved risk management and actual improvements. Disclosure should include examples of how they identify near-misses, indicators of serious issues, violations of laws and norms, and take action.

Newer regulatory frameworks are increasingly stringent, with expectations including integration of due diligence into company policy

<sup>1</sup> Guiding Principles on Business and Human Rights, [https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr\\_en.pdf](https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr_en.pdf)

<sup>2</sup> The California Transparency in Supply Chains Act, <https://oag.ca.gov/SB657>

<sup>3</sup> Modern Slavery Act, <https://www.legislation.gov.uk/ukpga/2015/30/contents/enacted>

<sup>4</sup> European Coalition for Corporate Justice, <https://corporatejustice.org/publications/comparative-table-corporate-due-diligence-laws-and-legislative-proposals-in-europe-2/>

<sup>5</sup> U.S. Customs and Border Protection, [Withhold Release Orders and Findings List | U.S. Customs and Border Protection \(cbp.gov\)](https://www.cbp.gov/newsroom/national-media-release/cbp-modifies-finding-sime-darby-plantation-berhad-malaysia)

<sup>6</sup> <https://www.cbp.gov/newsroom/national-media-release/cbp-modifies-finding-sime-darby-plantation-berhad-malaysia>

<sup>7</sup> <https://www.freemalaysiatoday.com/category/nation/2023/02/03/us-finds-no-forced-labour-in-sime-darby-palm-oil-production/>

<sup>8</sup> <https://www.business-humanrights.org/en/latest-news/malaysia-top-glove-to-refund-recruitment-fees-to-migrant-workers/>



## Risk assessment

A robust and comprehensive risk assessment is critical to provide focus for monitoring and remediation efforts.

However, we often find that the link between risk assessment outcomes and monitoring priorities is not well explained. Applying monitoring only to direct suppliers might risk key risk areas upstream. Secondly, applying monitoring with consideration to local risks and circumstances might reduce their effectiveness. Monitoring practices informed by the risk assessment process are more likely to be effective at detecting risks, as particularities in production processes, workforce composition, local regulations and customs, and supplier capabilities all have an impact on risks to labour standards.

The risk assessment should include a broad range of inputs such as desk research, engagement with stakeholders like NGOs, labour rights experts, trade unions, and peers. Results from existing monitoring can be used to identify trends and developments – for example, reduced levels of transparency, increases in working hours, or changes in the workforce. This is also a good opportunity to involve sourcing and procurement teams as they are the key contact with suppliers and have a clear view on commercial developments that could influence risk in existing and potential sourcing markets. They naturally have a holistic view of the supply chain, which is helpful to highlight often-overlooked parts like logistics, warehouses, and service providers.

Vigilance is key, even in countries that might not have previously been in focus. As an example, child labour violations are on the rise in the US, with a 37% increase reported for 2022. In February 2023, a provider of cleaning services to some of the largest meat and poultry producers in the US was fined USD1.5m for employing more than 100 minors for hazardous work at their facilities<sup>9</sup>.

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Engaging suppliers in the risk assessment can help build understanding of risks associated with local business practices and prepare the ground for collaboration. For example, subcontracting to unapproved factories can provide flexibility, speed, and lower costs, but can also mean higher risks. A joint risk assessment with suppliers can help identify solutions where flexibility is retained but with transparent and good conditions.

In brief, an effective risk assessment should be:

- Comprehensive and forward-looking to identify current and potential risks, as well as where they might appear;
- Inclusive in considering the views of stakeholders including experts, NGOs, trade unions, and suppliers;
- Engage sourcing and procurement teams as commercial imperatives have an impact on risks in current and potential markets;
- Include an assessment of how company purchasing/ procurement practice may increase risk of poor labour standards.

<sup>9</sup> U.S. DOL, MORE THAN 100 CHILDREN ILLEGALLY EMPLOYED..., February 2023, <https://www.dol.gov/newsroom/releases/whd/whd20230217-1>



## Monitoring

For monitoring to be effective, it should be informed by the risk assessment outcomes and adapted to capture data on labour standards performance, honing in on indicators of local risks.

### Companies should:

- Take a flexible approach, adapting monitoring approaches to suit local conditions;
- Explicitly include worker input through hotlines and direct dialogues away from workplaces;
- Track key performance indicators to identify trends and developments.

The risk assessment outcome should help direct monitoring by pointing to the highest risk areas, thereby allowing companies to prioritise mitigation approaches. Companies can also be seen as having more responsibility for conditions at a strategic supplier than one that only receives occasional orders. Taking both risk levels and procurement footprint into account, the company can develop a heatmap to focus monitoring efforts and to adapt them based on local needs. Monitoring the production of raw materials far upstream requires a different approach than factories of direct suppliers.

Workers are the primary stakeholders, and it is key that monitoring captures their voices. Social audits typically include worker interviews, but often with methodological pitfalls reducing their effectiveness. Interviews conducted in the workplace should be taken with a grain of salt, as workers selected are highly visible to team leaders and can be expected to have reservations against sharing negative information about the workplace for fear of retaliation. Off-site interviews, though more difficult to arrange, help remedy such challenges. Online and phone grievance channels, using local platforms, can reveal details about working conditions that social audits might not capture.

### A key aspect to consider is how the monitoring of data will be used to track risks and performance, and to design the approach appropriately. Some questions to ask are:

- How does monitoring data inform an assessment of supplier performance to determine where increased scrutiny is needed and where monitoring can be relaxed?
- Is monitoring data integrated into procurement systems so that suppliers can be incentivised by linking order volumes to labour standards performance?
- Is monitoring data used to measure the effectiveness of remediation efforts?

It is also important to consider the impact of the monitoring approach on the supplier relationship. Fear of negative consequences on future orders can incentivise opacity, increasing risk for buyers. The past years have seen a continuing downward trend in transparency, exacerbated by COVID-19. According to a report by Elevate, factories presenting falsified documentation typically see 45% more critical violations, including child labour, than transparent ones.<sup>10</sup> Monitoring that is clearly framed within the business relationship and expectations on good working conditions, prioritising transparency in policy and practice, and linked to remediation for improvement can drive transparency and collaboration instead of obscurity and increased risk.

<sup>10</sup> Top Supply Chain Trends, Elevate Limited, <https://www.elevatelimited.com/blog/top-supply-chain-trends/>



## Remediation

Without improvements to working conditions and supplier management capability, risks levels will not be reduced and opportunities to reduce monitoring intensity are limited.

Addressing root causes and building capacity to provide remediation is key for sustainable improvements to supply chain working conditions. While the monitoring process typically includes corrective action plans for suppliers to follow, these often do not address root causes to reduce the risk of reoccurrence. Strengthening competence and systems in this way is likely to require time and resources from suppliers. This raises the question about incentives and the importance of such requests being part of overall procurement strategy, and those expected outcomes are clearly defined and tied to future business. As mentioned, a well-designed monitoring system should be able to track performance and feed into supplier evaluation.

Companies should also ensure preparedness to provide remedy to victims of abuse. A victim-centric process of gathering information, gaining consent of those involved, and establishing potential rehabilitation and compensation<sup>11</sup> should be in place before a case materialises as prompt action is critical. This

also requires a clear chain of command and potentially setting up collaborations with worker-focused organisations in high-risk locations.

In some cases, it might not be possible for the company to prevent or mitigate negative impacts. If it is unable to increase leverage to change this, it should consider exiting the business relationship in a responsible manner to minimise further harm.<sup>12</sup>

### Key points

- Remediation should not only be reactive, but function to address root causes to provide sustainable improvements.
- In case of labour rights violations, a victim-centred approach should be in place with sufficient clarity and preparation to act quickly.
- Procurement practices should be aligned to provide incentives for suppliers to strengthen systems and processes.

<sup>11</sup> Understanding remediation, Ergon Associates, [https://www.isealalliance.org/sites/default/files/resource/2019-02/Forced\\_Labour\\_Remediation\\_Working\\_Paper\\_0.pdf](https://www.isealalliance.org/sites/default/files/resource/2019-02/Forced_Labour_Remediation_Working_Paper_0.pdf)

<sup>12</sup> UN Guiding Principles, article 19 <https://globalnaps.org/ungp/guiding-principle-19/>



## Governance and integration

As in any process, due diligence will be effective only with proper governance in place. Investors want to see the board and committees exercise effective governance over social supply chain risk management.

This hinges on how the board and relevant committees and working groups are comprised by the appropriate competences and roles. For example, which board committees should take responsibility and how are materiality assessment and risk management processes addressing supply chain specifics? They will need to

oversee how executives assess the links between such risks and the operations, procurement, and any other aspects of the organisation's processes that have a material impact on risk, or risk being materially impacted by the challenges identified by the due diligence process.

### Five components of effective supply chain due diligence

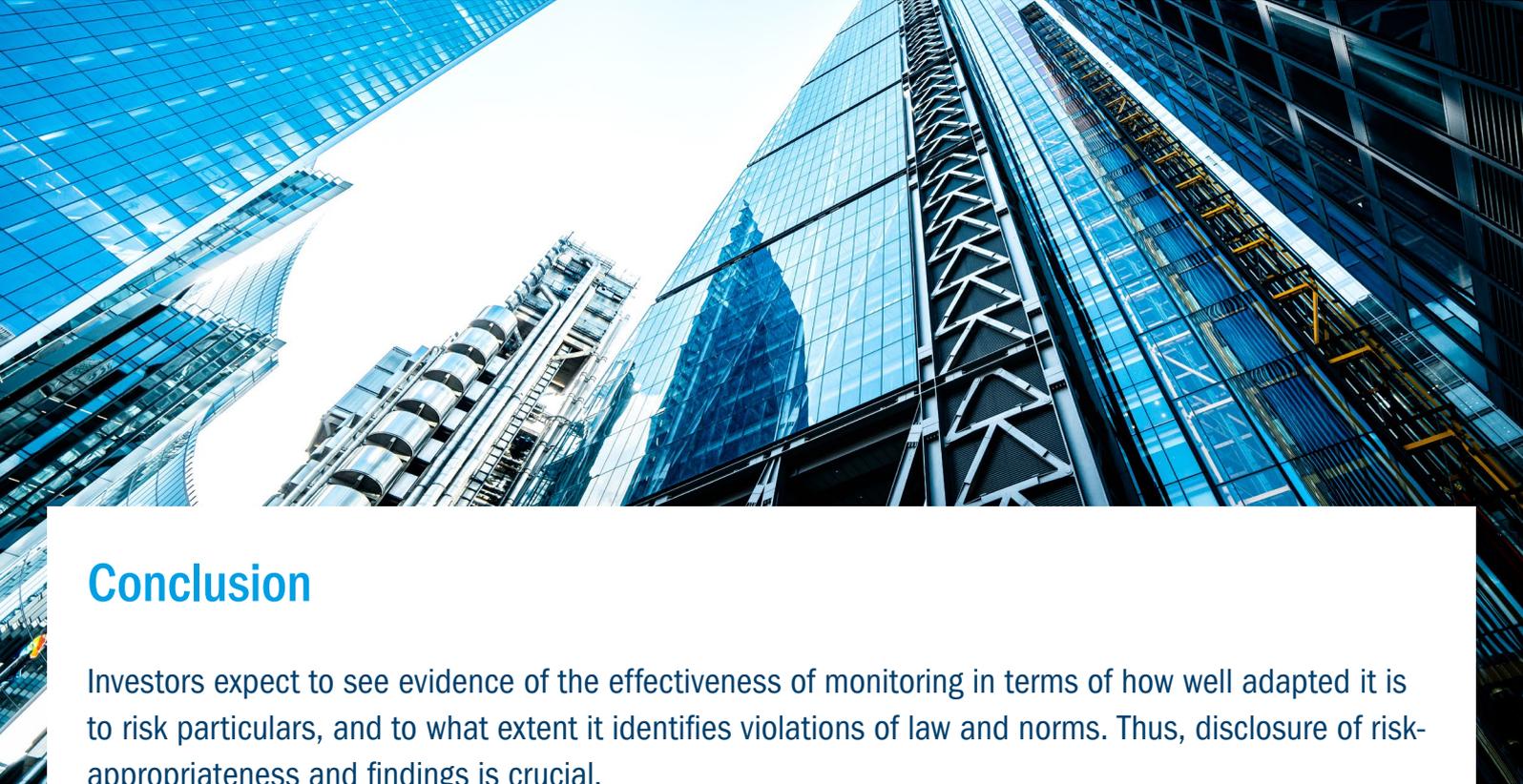
<b>Risk assessment</b>	Identifying types of risk and where they intersect with the company's supply chain
<b>Monitoring</b>	Verification of supplier performance, tracking developments, and taking in workforce perspective
<b>Remediation</b>	Building supplier capacity to identify and manage risks for long-term sustainable improvements, and provide a victim-centred approach to rights violations
<b>Governance</b>	Necessary competence and dedicated oversight of risks and opportunities relating to social supply chain management
<b>Integration</b>	Holistic approach to supply chain management aligning with sourcing and procurement strategy and identifying and addressing potential commercial drivers for poor labour standards

### Integration with procurement

Clarity and alignment between procurement and due diligence would help in embedding a responsible approach in supply chain design, selection of sourcing markets, and evaluation of potential new suppliers. It can also identify procurement practices that could

be drivers of poor labour standards and need to be scrutinised; late changes to orders, poor demand forecasting, and miscalculations of suppliers' production capacity can all have a negative impact on working conditions.<sup>13</sup>

<sup>13</sup> Locke, R. The promise and limits to private power, 2013.



## Conclusion

Investors expect to see evidence of the effectiveness of monitoring in terms of how well adapted it is to risk particulars, and to what extent it identifies violations of law and norms. Thus, disclosure of risk-appropriateness and findings is crucial.

As members of 'Find it, Fix it, Prevent it', a collaborative engagement on modern slavery responses co-ordinated by CCLA<sup>14</sup>, we subscribe to the assumption that cases of modern slavery are present in most, if not all, supply chains. An absence of detection or indicators should be viewed with concern, as it might indicate a lack of effectiveness of the program.

Clarity on the expected outcomes from risk assessment, monitoring, and remediation is key for robust due diligence. However, oversight that ensures its alignment with procurement strategy is also necessary to realise a company's

commitment to good working conditions. As such, the due diligence programme needs to provide outcome indicators to steer strategy and investments to react to long-standing issues and new developments. A shared view between sustainability and procurement teams on what constitutes good supply chain performance is important for strategic direction, but also for credible messaging to suppliers on the importance of good standards.

This way, the company can mitigate risks and realise opportunities to strengthen the resilience of its supply chain while delivering on commitments to the workers that contribute to its success.

### Governance

- Board expertise and training
- Links to sourcing strategy
- Operationalisation of commitments

### Integration

- Alignment of sourcing strategy
- Scrutiny of procurement practices
- Incentives for improvement

### Remediation

- Tailored to risks
- Driving improvement
- Increasing preparedness

### Risk assessment

- Risk locations
- Risk type
- Level of exposure

### Monitoring

- Risk-focused
- Locally adapted
- Worker-centric

<sup>14</sup> <https://www.ccla.co.uk/videos/find-it-fix-it-prevent-it>

## Get to know the author



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Marcus joined the team in 2020 and is focusing on labour standards and biodiversity. Before joining Columbia Threadneedle Investments, Marcus spent a decade and a half in supply chain sustainability across the world. When not working, he enjoys sailing and Filipino martial arts.

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