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Q&A: Germany set to shine spotlight on supply chains

The country is poised to increase scrutiny on human rights and eco standards within business. As investors, the investigation of environmental, social and governance (ESG) risks form an essential component of our bottom-up investment analysis

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Germany is considering laws to force big companies to disclose their supply chains, giving better protection for people and the global environment.[1] At the moment companies frequently violate fundamental human rights in value and supply chains. Examples are rife: Boohoo's suppliers exploited clothes factory workers;[2] Ikea used Ukrainian wood from protected forests for its furniture;[3] and Apple supplier Nanchang O-Film Tech's alleged use of forced labour.[4]

"The exploitation of people, nature, and child labour must not become the basis of the global economy and our prosperity," says Gerd Müller, Germany's minister of economic co-operation and development. "That would be a boomerang that would strike back at us. Our socio-economic model can be a model for a global economy."

The German government has to date relied on companies to voluntarily adhere to human rights and environmental standards in the supply chain. But of approximately 2,250 companies surveyed, only 455 could provide adequate answers[5] – the system is clearly not working. So, the proposed new law prompts direct government intervention to protect human rights in global supply chains – implementing the UN's 2011 Guiding Principles on Business and Human Rights.

How do you see the planned German legislation playing out?

Increased scrutiny of the supply chain is a step in the right direction to end the endemic exploitation of vulnerable workers and hidden environmental degradation. Companies with complex supply chains will find it a challenge to track their suppliers' behaviour; but this has to-date been exacerbated by the lack of a specific framework to assess the quality and reliability of the supply chain.

In disparate and decentralised supply chains it is easy for lax business practices to creep in, especially as companies focus on cutting costs. So we need a direct law to implement the UN Guiding Principles on Business and Human Rights to reinforce German protection for the people and the environment. Traceability is an important step but can be challenging in some industries. Publishing first-tier supplier lists will boost transparency.

How do you investigate ESG risks in the supply chain?

Such investigations form an essential component of our bottom-up investment analysis. This analysis is complex and cannot be bought off the shelf – it involves diligent engagement with each company and its suppliers.

Analysis of supply chain risks is facilitated by testing companies such as Bureau Veritas, Intertek and SGS. Until a few years ago, ESG certificates offered by ISO (International Organization for Standardization) and BSI (British Standards Institution) standard authorities focused mainly on the "E" of ESG – the easiest to measure and accredit; little scrutiny was placed on the "S". Now testing companies have started inspection and certification of supply chains and management processes, improving the ESG profile of their clients and increasing transparency. The investor, the market and the regulator all win – as, of course, do the environment and the victims of human rights abuses.

How can companies consider ESG criteria with regards to their suppliers, and how might we set such rules and ensure they are met?

At Columbia Threadneedle Investments, we measure supply chain risk as part of assessing our companies' ESG practices. This forms a key part of our proprietary materiality-based Responsible Investment ratings. We recognise that some retailers – especially smaller ones – will find this more challenging, and we aim to engage with companies where there is evidence of poor management or a particular risk.

Companies must understand that investors need high-quality disclosure to understand both the management of risks and effective implementation of ESG policies. We need to see how they monitor their suppliers' work with sub-contractors, and remedial action where there are problems.

There is a systemic industry risk and individual investors have limited resources, so engagement and collaboration are crucial: so in the UK, we are signing a collaborative engagement on this topic.

Just as investors need to collaborate, so do companies. We encourage them to work with each other and with other stakeholders to address challenges.

What are the experiences in countries that have already implemented similar legislation, for example France or the Netherlands? How have companies and their performances been affected?

Our experience has been positive. More transparency allows investors to make better informed decisions. Companies with a sustainable and fair supply chain have a lower risk of supply chain disruption, and that in turn has the potential to lead to better long-term performance.

The only other country with more stringent regulations than Germany is the UK. The Modern Slavery Act is a serious talking-point, but enforcement is key: while the Act benefits from universal adherence in a technical sense, only third-party mandatory inspections give it full effect. This happened in US toys in 2007. It happened after Dieselgate. So perhaps there is a good chance the EU and other regulatory authorities may take enforcement seriously, but only through the testing companies because there are not enough public sector inspectors.

Is it rational to be afraid that such legislation could impact competitiveness?

Absolutely not, in fact the opposite. Companies with strong and reliable supply chains have competitive advantage: they are *more* competitive in their respective markets. It is an ever-increasing differentiating factor for each and every industry.

What role do companies' ESG profiles – and those of their suppliers – play in your risk management? Are there concrete figures to illustrate this?

We fully scrutinise the ESG profile of every company before every investment decision. We devote huge resources to assessing internal ESG practices, environmental policies and those elements that are in control of the management. We focus on controversies because these are pressure points for management, and we need to see how management reacts – often more than we need to understand the controversy itself. We focus on what management does to mitigate such events, to make sure they won't happen again. This analysis gives us a window into the culture of the management and represents a valuable risk management tool.

How do smaller companies fare in this respect?

Smaller companies are more challenged than others to maintain a rigorous control on their supply chain. We engage with those companies and foster collaboration to make sure they have procedures to minimise supply chain risks.

As due diligence laws such as Germany's become more prevalent, companies will need to be proactive in assessing risks in their supply chains and improving traceability. The Covid-19 pandemic has underlined the need for further understanding of supply chains and related risk exposure.

[1] FT.com, German proposals for supply chain law spark fierce debate, 19 July 2020.
[2] Bloomberg, Boohoo Plunges After Suspending Business With Suppliers, 28 August 2020.
[3] Reuters, IKEA to review its Ukrainian wood supply after critical report, 23 June 2020.
[4] Associated Press, Gadgets for tech giants made with coerced Uighur labor, 7 March 2020.
[5] FT.com, German proposals for supply chain law spark fierce debate, 19 July 2020.

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